United States General Accounting Office

GAO

Report to Designated Congressional Committees

April 1991

TAX POLICY AND ADMINISTRATION

1990 Annual Report on GAO's Tax-Related Work

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-242620

April 16, 1991

The Honorable Dan Rostenkowski
Chairman, Committee on
Ways and Means
House of Representatives

The Honorable Lloyd Bentsen
Chairman, Committee on
Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Joint Committee on
Taxation
Congress of the United States

The Honorable John Conyers, Jr.
Chairman, Committee on
Government Operations
House of Representatives

The Honorable John Glenn
Chairman, Committee on
Governmental Affairs
United States Senate

This report is submitted in compliance with 31 U.S.C. 719(d) and summarizes our work on tax policy and administration during fiscal year 1990. It contains appendixes that include information on actions taken on our recommendations as of December 31, 1990, recommendations we made to Congress before fiscal year 1990 that remain open, and assignments for which we were authorized access to tax information under 26 U.S.C. 6103(i)(7)(A)(i).

Key Recommendations for Tax Policy and Administration

The recommendations in our reports articulated specific actions that Congress and the Administration could take to improve the accuracy of the Internal Revenue Service's (IRS) revenue estimates, improve compliance with the nation's tax laws, reduce growth in accounts receivable, simplify the tax system, and enhance the effectiveness of tax incentives.

Develop More Reliable Data for Estimating Revenues

Because of mounting concerns about the growing deficit, Congress has authorized IRS to increase enforcement personnel to bring in more revenue. However, to determine the impact of these enforcement initiatives on the deficit, Congress needs more reliable data on how much revenue each of IRS' enforcement programs will generate at various levels of staffing and how soon revenue can be expected to come into the Treasury. We identified several actions for IRS to consider to develop more reliable data for estimating revenues.

- Policy makers have generally thought the annual revenue impact of IRS' enforcement programs to be about $50 billion. However, IRS does not know how much revenue its enforcement programs generate and has had little success in establishing information systems to collect the requisite data. We recommended (GAO/GGD-90-85, June 20, 1990) that until IRS develops more reliable information on the revenues generated from its enforcement efforts, Congress should use the most conservative revenue assumptions in deciding whether to increase IRS' enforcement staff. (See p. 37.)
- IRS' estimates of revenues to be gained from hiring revenue agents have improved, but questions remain about some elements of IRS' projection model. In proposing a fiscal year 1991 staffing increase of 1,000 revenue agents, which Congress approved, IRS projected that $1.1 billion in additional revenue would ultimately be gained over several years. IRS arrived at that amount after revising its methodology because of concerns we raised about some of its critical assumptions that were overly optimistic (GAO/GGD-88-119, Aug. 8, 1988). Some assumptions in the revised methodology were also too optimistic. For example, IRS assumed that the influx of new staff would free experienced agents to work on higher revenue-yielding cases, thus further increasing the audit revenues generated by increased staffing. We questioned that assumption and recommended (GAO/GGD-90-119, Sept. 5, 1990) that IRS develop empirical data to support it. (See p. 39.)
- We estimated that by the time IRS finished training the new revenue agents hired by five of its districts between July 1, 1986, and September 30, 1988, it would have lost about $980 million in unrealized audit revenues because experienced revenue agents were training new hires rather than auditing returns. Such significant training costs delay the government's realization of additional revenues from an increased examination staff. In response to our report (GAO/GGD-90-77, Apr. 6, 1990), IRS planned to start contracting out some of its training in fiscal year 1991 and was considering other alternatives to its current training program. (See p. 36.)

We are continuing to monitor IRS' enforcement initiatives. Congress approved several new initiatives for fiscal year 1991. For example, it authorized $191 million for IRS to hire new enforcement staff with the expectation that $5.7 billion in new revenues would be generated over the next 5 years. IRS has agreed to track the incremental revenue effects of these initiatives, and we will monitor these results. A critical issue involves how IRS will define the baseline of revenues that would have been realized from its enforcement programs in the absence of the new staffing initiatives.

Improve Compliance Through Congressional and IRS Actions

Compliance with the nation's tax laws persists as a significant national problem that costs billions of dollars in lost federal revenues. Responding to a request from the Oversight Subcommittee of the House Ways and Means Committee, we examined ways to better identify and reduce the gross tax gap, defined as the difference between taxes owed and taxes voluntarily paid. IRS estimated that this gap would reach $113 billion by 1992. We suggested several strategies for enhancing enforcement that require legislative action.

- Business Information Returns. According to its statistics, IRS annually gains about $3 billion in revenues through the computer matching of information returns with individual tax returns. Information returns contain information on payments made to individuals. We believe that millions of dollars in additional revenues could be obtained if the law also required information returns for payments made to corporations. Estimates of the revenue that might be generated by a business information returns program vary considerably, ranging from $300 million to $8 billion. We are monitoring IRS' study of the costs and benefits of such a program for the Commerce, Consumer and Monetary Affairs Subcommittee of the House Government Operations Committee. (See p. 66.)
- Independent Contractors. In prior studies, we identified the misclassification of workers as independent contractors as a compliance issue that resulted in underreporting of significant amounts of taxable income. IRS is implementing a program we recommended (GAO/GGD-89-107, Sept. 25, 1990) that uses information returns to identify employers most likely to misclassify workers. But IRS is precluded, in many cases, from taking action against these employers due to section 530 of the 1978 Revenue Act, which exempts certain businesses from IRS action to correct the misclassification. We said that Congress should consider modifying these exemptions to permit IRS to require employers to reclassify workers on a prospective basis without imposing punitive back taxes. (See p. 121.)

- Civil penalties. These penalties may constitute an important inducement for taxpayer compliance, particularly in an era where the threat of an IRS audit continues to decline. In 1989 legislation that made many important improvements, Congress eliminated the only penalty applying to taxpayers who fail to report income disclosed through IRS' computer matching program. The "presumptive negligence" penalty not only generated $114 million in revenues for fiscal year 1988, but, more importantly, it provided some additional incentive for taxpayers to report income disclosed on information returns. Without such a penalty, taxpayers may take their chances in underreporting income and wait for IRS to catch them. We recommended (GAO/GGD-89-81, Sept. 6, 1989) that Congress enact an underreporting penalty for taxpayers failing to report income disclosed on information returns. (See p. 119.)

IRS' compliance programs also need enhancement to narrow the tax gap. Audit coverage has continued to decline to a level below 1 percent of all tax returns. Even for those returns it audits, IRS is losing significant revenue in the appeals processes. The nation's largest corporations are successfully obtaining reversals for nearly 60 percent of the amounts IRS auditors say the corporations owe, raising questions about the ability of IRS to effectively oversee tax compliance for these large businesses. We will be fully exploring these issues in work we are doing to assess IRS' methodology for selecting taxpayers for audit and in a review of the examination program covering large corporations for the Permanent Subcommittee on Investigations of the Senate Governmental Affairs Committee. We will soon be reporting to the Commerce, Consumer and Monetary Affairs Subcommittee of the House Government Operations Committee on work that shows the need for improvements in IRS' programs to identify nonfilers and underreporters.

Reduce the Growth in Accounts Receivable

After IRS identifies taxpayers with outstanding liabilities, it faces considerable problems collecting the amounts owed, giving rise to a growing accounts receivable inventory. We identified IRS' accounts receivable program as one of 14 federal programs particularly vulnerable to mismanagement, fraud, abuse, and major losses of funds due to poor internal control and financial management systems. The potential for reducing or stabilizing the growth rate offers major dollar savings and, therefore, warrants special review and oversight by Congress.

The trends are not good. In September 1990, the assessed value of accounts receivable, not counting accrued interest and penalties, totalled $72.2 billion, about a 250 percent increase since 1980. We believe that while much of this amount may be uncollectible, the growth is significant and represents a serious problem. Moreover, the inventory of uncollected accounts grew three times faster than actual collections of delinquent taxes. We identified several short- and long-term actions for IRS to consider as it increases its emphasis on reducing accounts receivable (GAO/T-GGD-90-60, Aug. 1, 1990). In the short term, improvements in staff management are needed to increase productivity and to ensure that cases with the highest potential yields receive priority attention. In the long term, improved financial and program information systems are needed to determine how much of the inventory can be collected. In addition, delinquency prevention programs, such as simplification of tax deposit rules, need to be emphasized to reduce the future growth of the inventory. (See p. 32.)

We are continuing to work with congressional committees to help IRS reduce the accounts receivable inventory. We are doing a number of projects for the Oversight Subcommittee of the House Ways and Means Committee focusing on such issues as IRS' approach to allocating cases among its staff, the potential applicability of innovative collection approaches pioneered by the states or other federal agencies, and trends in accounts that expire when they exceed the statute of limitations. We are also working with other interested congressional committees, including the Senate Governmental Affairs Committee and the Senate Budget Committee, in monitoring this issue.

Simplify the Tax System

If our nation's voluntary tax system is to remain strong, more ways must be found to simplify tax law and administration. We identified several areas of the law where simplification could improve tax compliance, increase federal revenues, and increase economic efficiency.

- IRS assesses one-third of the nation's employers at least one federal tax deposit penalty annually. This assessment occurs, in part, because the deposit requirements are complicated by variable deposit dates and exceptions to deposit rules. To make it easier for employers to comply with the deposit requirements and for IRS to administer them, we recommended that Treasury change the deposit requirements so that all employers would be required to make deposits within some specific time interval after each payday (GAO/GGD-90-102, July 31, 1990). Legislation now requires that all large employers deposit within 1 banking day. Requiring all other employers to deposit within 3 banking days of payday, for example, with a minor exception for smaller employers, would be much simpler than current deposit requirements. In addition, it would accelerate the receipt of taxes, saving about $100 million in borrowing costs annually. (See p. 98.)

- Alcohol excise taxes are structured in a way that results in beverages with the same alcohol content being taxed differently. The Omnibus Budget Reconciliation Act of 1990 increased alcohol and tobacco tax rates, however, it did not eliminate the problems associated with the differential tax rates on alcohol products. For example, distilled spirits are taxed at $.21 per ounce of alcohol compared to $.02 an ounce for table wine. This differential tax has prompted producers of distilled spirits to include lower taxed wines in their products at higher costs to consumers. We said that Congress should consider standardizing the tax rate per ounce of alcohol across products to promote more efficient economic decisions by industry and eliminate the need for a tax credit that cost the federal government about $90 million in revenue in fiscal year 1989 (GAO/GGD-90-123, Sept. 27, 1990). We also believe that a separate special occupational tax assessed on retailers of alcohol, tobacco, and firearms is cumbersome to administer because relatively small amounts must be collected from a large number of taxpayers. Congress could eliminate the occupational tax but increase existing excise taxes on alcohol, tobacco, and firearms by about 2 percent to collect the same amount of revenue. (See p. 50.)
- Section 809 of the tax code, which covers taxation of mutual life insurance companies, was designed to isolate the portion of dividends paid to policyholders that is a distribution of the company's earnings (taxable) from the portion that is simply a refund of excess premiums (not taxable). We found, however, that these taxes (1) were higher for the mutual companies as a whole in years when their earnings were low, and vice versa; (2) were regressive on the basis of company income because averages for all mutual companies dictated each company's taxes; and (3) depended disproportionately on the behavior and performance of the larger mutual companies. To eliminate the complex calculations that mutual companies must make each year and to reduce the inequitable results of section 809, we recommended that Congress repeal section 809 from the tax code and designate the portion of dividends that is a distribution of the company's earnings to be treated as distributed income (GAO/GGD-90-19, Oct. 19, 1989). To simplify computing and collecting these taxes, companies would pay the tax as a proxy for individual policyholders. (See p. 87.)

We are currently pursuing other issues where simplification could help both IRS and taxpayers. Prompted by congressional concerns that American subsidiaries of foreign corporations may be avoiding U.S. taxation by manipulating intracompany transfer prices, we are assessing problems experienced by IRS in applying transfer pricing rules and are looking at other simplified alternatives to transfer pricing that may promote a more administrable and predictable framework for international tax transactions. As part of a study for the Joint Committee on Taxation, we are analyzing the potential value of a specific set of schedules to govern the amortization of intangible assets acquired through mergers or other intercorporate acquisitions, including whether such an approach would provide a more certain environment in an area where policy is currently defined largely through case law.

Enhance Effectiveness of Tax Incentives

Tax preferences and incentives are often adopted by Congress to foster certain policy goals, such as improving access to housing or promoting employment. In 1990, over 120 tax preference items, accounting for over $300 billion in revenue forgone, remained in the tax code despite continuing concerns that they frequently are not well targeted at intended beneficiaries, and that the activities subject to the tax preference would have been undertaken in the absence of the tax subsidy. Our work contributed to congressional debate on the costs and benefits associated with various tax incentives. We suggested several opportunities for additional revenues by curtailing or better targeting incentives of marginal effectiveness.

- In 1986, Congress passed the Tax Reform Act, which eliminated many tax benefits provided to businesses. We found that, consistent with the act, U.S. and worldwide average effective corporate tax rates were higher in 1987 (28 and 36 percent, respectively) than in 1986 (19 and 28 percent) and the prior years studied by the Joint Committee on Taxation (GAO/GGD-90-69, May 10, 1990). We concluded, however, that a comprehensive evaluation of the Tax Reform Act should be done on the basis of more than 1 year of data because effective tax rates for particular companies can fluctuate widely from year to year. We are following up with another study of corporate effective tax rates for Congressmen Pease and Dorgan covering 1988 and 1989. (See p. 93.)
- Energy security considerations prompted Congress to pass new tax incentives for petroleum production in 1990, including a range of provisions—such as tax credits and faster and larger deductions of costs for tax purposes—that would increase the after-tax profitability of eligible investments. Because existing tax incentives already make the petroleum industry's effective tax rate one of the lowest, we questioned the merits of providing additional incentives (GAO/GGD-90-75, July 23, 1990). Given the expected federal revenue losses, we concluded that providing additional incentives would not be the most cost-effective

method of increasing U.S. energy security and urged Congress to consider such alternatives as increasing the Strategic Petroleum Reserve. (See p. 96.)

- The federal government forgoes $5 billion a year in potential tax revenues by not taxing the interest earned on life insurance and deferred annuities. Such interest is referred to as "inside buildup." We concluded that although this incentive may lower the cost of providing insurance and retirement income protection, Congress may wish to reconsider the preference because it is not clear that the increased insurance protection spurred by the incentive justifies the revenue loss (GAO/GGD-90-31, Jan. 29, 1990). Also, Congress should tax borrowing against the cash value of life insurance policies because, unlike inside buildup, such borrowing serves to reduce insurance protection. (See p. 89.)
- Congress could also better target below-market interest mortgage loans financed through tax-exempt bonds. Current policies provide the subsidy to people who can afford market-rate conventional loans. However, others who are experiencing rapid income increases continue to receive the interest subsidy long after they need it. Although Congress has moved to recapture the value of the subsidy from owners experiencing rapid income increases, these provisions have limitations, partly because they are payable only following the sale of the house. We recommended that Congress better target the subsidy by providing assistance only to those unable to qualify for conventional loans and by more effectively terminating assistance to those whose incomes grow sufficiently to qualify for conventional mortgages (GAO/RCED-90-117, Sept. 26, 1990). (See p. 64.)

We are currently pursuing work assessing other tax expenditure programs. At the request of Senator Bradley, we are studying work incentive and income targeting issues involved with the design of the Earned Income Tax Credit Program and IRS' administration of it. At the request of Congressman Donnelly, we are preparing a report on (1) elderly housing projects financed through tax-exempt bonds, (2) the fees charged by these projects, and (3) recent default experience in bond payments. Finally, we are doing a comprehensive overview of the tax subsidies provided for fringe benefits, with a focus on tax policy issues presented by the treatment of pensions, health and life insurance, and cafeteria plans.

We do our work on tax policy and administration matters pursuant to 31 U.S.C. 713, which authorizes the Comptroller General to audit IRS and the Bureau of Alcohol, Tobacco, and Firearms. GAO Order 0135.1, as amended, prescribes the procedures and requirements that must be followed in protecting the confidentiality of tax returns and return information made available to us when doing tax-related work. This order is available upon request.

Copies of this report are being sent to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Commissioner of Internal Revenue. Copies will also be sent to interested congressional committees and to others upon request.

Major contributors to this report are listed in appendix VIII. If you or your colleagues would like to discuss any of the matters in the report, please call me on (202) 275-6407 or Paul Posner, Associate Director, on (202) 272-7904.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Contents

Abbreviations

ADP	automated data processing
BATF	Bureau of Alcohol, Tobacco, and Firearms
ERISA	Employee Retirement Income Security Act
HUD	U.S. Department of Housing and Urban Development
IRS	Internal Revenue Service
OIG	Office of Inspector General
OMB	Office of Management and Budget
PBGC	Pension Benefit Guaranty Corporation
SSA	Social Security Administration
TEFRA	Tax Equity and Fiscal Responsibility Act
TRA	Tax Reform Act of 1986
VA	Department of Veterans Affairs

Summaries of Tax-Related Products Issued in Fiscal Year 1990 by Subject Matter

ADP and Information Technology

Budget Issues

Compliance

Excise and Consumption Taxes

General Management

Housing Subsidies/ Credits

Information Returns

Pension Issues

Social Security

Tax Policy

Taxpayer Service

Other

ADP and Information Technology

Treasury's Efforts to Improve Its Payroll and Personnel Systems

GAO/IMTEC-90-04, 12/15/89

In response to a request from the Chairman of the Subcommittee on Federal Services, Post Office and Civil Service, Senate Committee on Governmental Affairs, GAO provided information on (1) the Department of the Treasury's past and current efforts to improve its payroll and personnel systems, (2) characteristics of its existing systems, and (3) factors important to the success of current improvement efforts. At the time of GAO's report, Treasury used a single personnel system and two payroll systems—one for the Internal Revenue Service (IRS), the largest component of Treasury, and one for its other constituent bureaus and services.

GAO found that Treasury had (1) made several attempts to improve and consolidate its payroll and personnel processing systems, but still operated the same payroll and personnel systems it had in 1974; (2) determined in 1988 that both payroll systems lacked needed operating functions, used obsolete hardware, and contained hard-to-maintain programming designs and language, while the personnel system was not user-friendly; (3) worked with the Department of Agriculture's National Finance Center to convert its systems into a single, integrated system; (4) developed a schedule for converting 19 departmental units, including IRS' National Office and 7 regional offices, between November 1988 and June 1992; and (5) successfully converted 3 units and was on schedule with the conversion plan as of October 1989.

GAO also discussed three problem areas that threatened timely completion of the projects. These areas included (1) potential funding shortfalls in fiscal year 1990, (2) IRS' understaffing a portion of the conversion, and (3) the fact that a system for transmitting IRS time and attendance data to the National Finance Center had not been selected. GAO also noted that the Department of Agriculture had expressed concern about IRS' ability to complete its part of the conversion on schedule. The Finance Center's ability to accommodate any schedule slippages was restricted because it had also scheduled other federal agencies for conversion.

IRS Automation: Procurement Practices Need Strengthening

GAO/IMTEC-90-24, 01/12/90

In response to a request from the Chairman of the House Committee on Government Operations, GAO assessed whether (1) IRS procedures for noncompetitively awarding a contract to Vanguard Technologies Corporation for automated data processing (ADP) support services for the Electronic Filing System were appropriate, (2) IRS' agreement to pay $15,000 to Vanguard for withdrawing a bid protest was appropriate, (3) Vanguard's services under a prior ADP contract were within the contract's scope, and (4) requests for proposals for the Treasury Multiuser Acquisition Contract and Integrated Collection System limited competition.

GAO found that IRS did not comply with procurement regulations when it (1) allowed Vanguard to begin performing Electronic Filing System services without a written contract, before notifying other bidders, and without proper approval; and (2) improperly agreed to pay $15,000 to Vanguard for withdrawing a bid protest because IRS had no reasonable basis for concluding that it had unfairly excluded Vanguard from competition.

GAO also found that Vanguard's services under a prior ADP procurement were within the contract's scope and that IRS achieved full and open competition under the Multiuser Contract and Integrated Collection System procurements. GAO concluded that IRS' disregard for established ADP procurement policies and procedures indicated a lack of effective internal controls.

Recommendation(s)

GAO recommended that the Commissioner of Internal Revenue require IRS contracting officials to bring the procurement of ADP services for the Electronic Filing System in line with proper procurement practices by executing a limited, written contract with Vanguard for only that work already underway and essential to the 1990 filing season.

GAO also recommended that the Commissioner (1) determine fully the nature and extent of IRS' procurement weaknesses and assess whether corrective actions planned by IRS would correct them and (2) report the deficiencies we identified to the President and Congress as material internal control weaknesses under the Federal Managers' Financial Integrity Act.

Action(s) Taken and/or Pending

In February 1990, IRS (1) issued several instructions prohibiting the use of oral contracts, (2) initiated a study of its procurement and contracting practices, and (3) elevated the procurement function to the assistant commissioner's level. In June 1990, IRS settled its oral contract with Vanguard when it signed a written agreement with Cincinnati Bell Information Systems, which is the parent company of Vanguard, for $1.73 million.

In addition, IRS substantially increased the staffing of its procurement function from 109 people at the end of fiscal year 1989 to about 160 by the end of fiscal year 1990. IRS further plans to increase its procurement staff to about 240 by the end of fiscal year 1991. For the most part, the increased positions have occurred in the contract/specialist-cost/price analyst series.

Related GAO Product(s)

GAO/IMTEC-88-40, 07/13/88 and GAO/IMTEC-89-33, 05/05/89

Meeting the Government's Technology Challenge: Results of a GAO Symposium

GAO/IMTEC-90-23, 02/90

A GAO-sponsored symposium brought together leaders from industry and government, including IRS' then Acting Assistant Commissioner for Computer Services, to explore better ways of using information technology to meet the demands facing the government into the next century. This special report discussed the implications for the federal government's acquisition and management of information technology.

Participating industry and government leaders said that effective information technology development depended on

- senior managers' ability to envision and commit to long-term goals;
- agencies' access to knowledge and advice through the cultivation of external partnerships with other government entities, private industry, and Congress;
- agencies' encouragement of cooperative relationships between technical groups and program offices;
- consideration and fulfillment of the public's consumer needs;
- establishment of a clear, comprehensive plan for directing technology purchases;
- use of an incremental approach, to provide design flexibility and allow the public to benefit sooner from the system; and
- recruitment and retention of a highly qualified technical staff.

Related GAO Product(s)

GAO/T-IMTEC-90-3, 02/21/90; GAO/IMTEC-90-13, 02/08/90; and GAO/IMTEC-90-32, 04/24/90

Progress in Meeting the Challenge of Modernizing IRS' Tax Processing System

GAO/IMTEC-90-13, 02/08/90; GAO/T-IMTEC-90-05, 03/22/90; and GAO/IMTEC-90-26, 03/22/90

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, and in two reports to its Chairman, GAO discussed IRS' progress in achieving a fully automated and modernized tax processing system.

GAO said that (1) IRS had spent about $120 million on modernization since 1986 and had estimated a total cost of several billion dollars; (2) IRS had not fully defined the modernization and developed a master plan; (3) the lack of a master plan made it difficult for IRS to provide a clear and consistent relationship between ongoing projects and modernization goals; (4) IRS had not completed studies to examine the business functions, information requirements, and data structures for its business areas; and (5) IRS' ADP budget for 1990 sustained cuts of nearly $100 million due to sequestration and increased salary costs, with the largest cuts affecting projects aimed at increasing the number of computers and terminals for responding to taxpayer inquiries and researching problem tax returns.

GAO noted that most of IRS' modernization projects were intended primarily to provide near-term operational improvements. As a result, IRS risks basing projects on future benefits that may or may not materialize in the final modernization and creating a design to fit its newly purchased hardware, rather than allowing long-range goals to drive the design. To reduce its risks, IRS needs to complete its modernization planning and create a detailed long-range strategy that will transcend changes in leadership because lack of continuity at key leadership and project management levels has hampered past modernization efforts.

With respect to some specific projects, GAO said that (1) the lack of stated goals and purposes for IRS' Electronic Filing System made it difficult to assess the system's effectiveness; (2) IRS' On-Line Entity System, which is intended to help IRS validate taxpayer identities before sending tax return information to the master files, was in the early stages of a pilot test; and (3) the Automated Inventory Control System, which is intended to improve IRS' ability to provide more timely and accurate responses to taxpayer inquiries, had not yet been designed and thus was unlikely to have any significant impact on the handling of correspondence until 1992.

Related GAO Product(s)

GAO/GGD-88-101, 07/13/88; GAO/T-IMTEC-89-02, 03/16/89; and GAO/T-IMTEC-89-04, 04/04/89

Computer Security: Governmentwide Planning Process Had Limited Impact

GAO/IMTEC-90-48, 05/10/90

In a report to the Chairman of the House Committee on Science, Space and Technology, GAO reviewed the governmentwide computer security planning and review process required by the Computer Security Act of 1987. The act required federal agencies to identify systems that contained sensitive information and to develop plans to safeguard them. GAO reviewed the planning process in 10 civilian agencies involving plans covering 22 systems including IRS' Compliance Processing System and Tax Processing System.

GAO found that (1) the planning and review process implemented under the act did little to strengthen computer security governmentwide; and (2) while agency officials believed that the process heightened awareness of computer security, they typically described the plans as merely "reporting requirements" and of limited use in addressing agency-specific problems.

GAO pointed out that officials cited three problems related to the design and implementation of the planning process. The officials cited that (1) the plans lacked adequate information to serve as management tools, and some agencies already had planning processes in place; (2) managers had little time to prepare the plans; and (3) the planning guidance given by the Office of Management and Budget was sometimes unclear and misinterpreted by agency officials.

Related GAO Product(s)

GAO/IMTEC-88-61, 09/22/88; GAO/IMTEC-89-16BR, 02/22/89; GAO/IMTEC-89-55, 06/21/89; and GAO/IMTEC-89-70, 09/27/89

Management Mistakes Caused Delays in Automated Underreporter System

GAO/IMTEC-90-51, 07/10/90

IRS' Automated Underreporter System is intended to help IRS process cases in which taxpayers underreported their income. Among other things, it was to give IRS service centers the ability to readily locate individual case files. IRS considers this system its "point system" for modernization of the tax system, meaning that it will serve as an example of how to conduct system development during the modernization.

In response to a request from the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO said that IRS estimated in 1987 that (1) about $13.7 million would be spent to design the system, develop the software, and test the system in one IRS service center--an estimate that had increased to about $21 million by April 1990; (2) total life cycle costs would be $71 million, which subsequently increased to about $122 million primarily because operating costs were not included in the original estimate; and (3) IRS had not changed the system's planned function since its initial approval.

GAO said that (1) IRS officials' haste to complete the system had led them to use incomplete system designs and shortcut important systems development steps; (2) these problems, compounded by a lack of adequate technical expertise and experience, had delayed the scheduled start of the system pilot from 1988 to late 1990; and (3) as of April 1990, software coding had not begun, and plans to deploy the system to all centers were uncertain. To compensate for delays, IRS (1) was developing an interim system to track the locations of underreporter cases and (2) planned to deploy the system to all service centers by the end of 1990.

GAO also said that the problems IRS experienced in developing the Automated Underreporter System could be systemic and could adversely affect IRS' ability to successfully design, develop, test, and implement other modernization projects. In an attempt to mitigate these risks, IRS instituted a set of management processes to control its systems development efforts.

Recommendation(s)

The Commissioner of Internal Revenue should direct the Chief Information Officer to

- assess the option to save development costs by using the interim system as the starting point for completing the Automated Underreporter System;
- establish realistic milestones on which users and Congress can rely;
- verify that staffing needs were properly addressed; and
- assign experienced technical, procurement, and managerial staff to key positions for system development projects at the outset.

Action(s) Taken and/or Pending

IRS has initiated action to (1) ensure that user requirements and software for the interim system will be incorporated into the final system to the extent possible; (2) establish project milestones that it believes are achievable; and (3) increase project staffing to include technical expertise in several areas, such as telecommunications and quality assurance.

Related GAO Product(s)

GAO/IMTEC-89-33, 05/05/89; GAO/IMTEC-89-54, 06/22/89; and GAO/IMTEC-90-13, 02/08/90

Budget Issues

IRS' Budget Request for Fiscal Year 1991 and Status of the 1990 Tax Return Filing Season

GAO/T-GGD-90-26, 03/22/90

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' current fiscal condition, IRS' budget request for fiscal year 1991, and the status of the 1990 filing season. GAO noted that

- because of funding shortfalls in fiscal years 1989 and 1990, IRS implemented a hiring freeze; curtailed promotions; cut back training, travel, and other support services; and reduced various compliance programs. The administration estimated that those decisions would reduce revenues by $700 million over 2 years.
- prospects for a more stable fiscal environment in 1991 were encouraging. The administration's budget request for IRS was 12 percent higher than the authorized level for 1991, and IRS had improved its controls over spending. But such factors as having to fund the various pay proposals included in the President's budget could alter those prospects.
- IRS' budget included several initiatives that the administration estimated would raise about $3 billion in additional revenues. The initiatives that call for additional enforcement staff would, in effect, only serve to replace staff that IRS lost in the last year and a half due to a hiring freeze. While GAO generally agreed with the objectives of the other initiatives, which call for redirecting existing staff, GAO was not convinced that they were achievable quickly enough to produce the promised revenues in fiscal year 1991.
- IRS had improved the accuracy of its telephone service. IRS assistors responded accurately to 78 percent of test tax law questions GAO asked between February 5 and March 16, 1990, compared to 66 percent for the same questions last year. But taxpayers were having more difficulty in reaching an IRS assistor. In 1990, IRS answered one out of three calls; in 1989, it answered almost two out of three calls.
- taxpayers should have found it easier to obtain tax forms and publications in 1990 compared to 1989. IRS did a better job of stocking its walk-in sites and filling phone and mail orders. Taxpayers who wanted to order materials by phone, however, were probably having more difficulty reaching IRS than in 1989.
- except for a few problems that had delayed some refunds, returns processing had gone smoothly during the first 3 months of the 1990 filing season. Service center inventories were within what IRS considered

to be manageable limits, and the percentage of returns with taxpayer errors or IRS processing errors was lower than last year.

Summary of Related Action(s)

On December 20, 1990, the President signed into law IRS' fiscal year 1991 appropriation, which provided funding for $6.1 billion, the full amount included in the administration's budget request.

Related GAO Product(s)

GAO/GGD-90-36, 01/04/90; GAO/GGD-90-37, 01/04/90; GAO/GGD-90-101FS, 07/30/90; and GAO/GGD-90-120, 08/31/90

Effects of the Fiscal Year 1990 Sequestration on the Internal Revenue Service

GAO/GGD-90-101FS, 07/30/90

In a fact sheet to the Chairman of the House Committee on the Budget, GAO presented information on the effects of the fiscal year 1990 sequestration on IRS' operations. Sequestration is a process by which budgetary resources are reduced to bring the estimated federal deficit down to a pre-established target level.

GAO said that IRS was required to sequester $46 million of its original fiscal year 1990 appropriation of about $5.5 billion, affecting two of four sequestrable accounts IRS administers. One of those accounts—Processing Tax Returns--was reduced by about $25 million, and the other—Investigations, Collection, and Taxpayer Service—by about $21 million. The other two accounts subject to sequestration—Examination and Appeals and Salaries and Expenses—were not affected because their fiscal year 1990 appropriations were below the mandated post-sequester levels.

GAO noted that even after sequestration, IRS received about a 6 percent increase in obligational authority over fiscal year 1989, and despite the increase, IRS determined after the fiscal year began that it had about $463 million less than it needed to meet its operating requirements. According to IRS, sequestration accounted for about 10 percent of that $463 million shortfall with the rest attributed to (1) unfunded increases in compensation and benefit costs, (2) the need to absorb the 1990 general pay increase for federal employees, (3) additional program needs, and (4) IRS' share of the federal government's escalation of the war on drugs.

GAO also noted that (1) in response to its total shortfall, IRS curtailed hirings and promotions, cut back support services, and reduced some programs; (2) Treasury estimated that these cutbacks would result in a combined revenue loss of $700 million in fiscal years 1990 and 1991; and (3) IRS was unable to isolate the impact of sequestration from the impact of its overall shortfall.

Related GAO Product(s)

GAO/T-GGD-90-26, 03/22/90

The Budget Deficit: Outlook, Implications, and Choices

GAO/OCG-90-5, 09/12/90

In a report to Senators Charles E. Grassley, J. James Exon, Daniel P. Moynihan, and Bill Bradley, GAO provided its views on the dimensions of the budget problem facing the nation, the implications of the deficit for the U.S. economy, and some of the choices that must be made to attack the deficit. As noted by GAO, the deficit has doubled as a percent of gross national product every decade since the 1950s, reflecting a growing imbalance between revenues and outlays in the general fund portion of the budget.

GAO recommended that this trend be reversed by a $300 billion fiscal policy swing that would result in total budget surpluses of about 2 percent of the gross national product annually by 1997—and close to a balance in the general fund. GAO did not recommend specific program choices for reaching the fiscal policy goal but provided Congress and the executive branch with scenarios and packages covering defense and nondefense spending, as well as revenues, for achieving such a fiscal target.

As part of the revenue analysis GAO outlined the following three broad alternatives: (1) raising individual and corporate income tax rates within the existing income tax system; (2) broadening the current income tax base by including some items now excluded or eliminating certain deductions; and (3) raising existing consumption taxes, such as excise taxes on alcohol and tobacco, or introducing new consumption taxes, such as a value-added tax. GAO illustrated how each of those approaches, alone or in combination, could be used to raise three different levels of annual revenue—$60 billion, $120 billion, and $170 billion respectively—by 1997. GAO noted that (1) each of the various approaches has advantages and disadvantages, and (2) as the amount of revenue to be raised increases, reliance on a single approach becomes less and less reasonable.

The Question of Rolling Back the Payroll Tax: Unmasking the Deficit Illusion

GAO/T-HRD-90-10, 02/05/90

In testimony before the Senate Committee on Finance, the Comptroller General discussed GAO's views on a congressional proposal to return the Social Security payroll tax to a pay-as-you-go basis.

The Comptroller General noted that (1) the use of Social Security Trust Fund surpluses to decrease the federal budget deficit masks the fundamental budget deficit problem and encourages avoidance of difficult fiscal choices needed to reduce the general fund deficit; (2) the administration's proposal to create a Social Security integrity and debt reduction fund would further delay dealing with fundamental deficit problems and allow the national debt, and interest on the national debt, to increase; and (3) although Social Security Trust Fund revenues exceeded current needs, the burden of supporting the nation's aged will increase as the post-war generation begins to retire.

Related GAO Product(s)

GAO/HRD-89-44, 01/19/89 and GAO/AFMD-90-01, 10/89

Compliance

Information on IRS' Accounts Receivable Inventory

GAO/T-GGD-90-19, 02/20/90; GAO/GGD-90-111FS, 07/30/90; and GAO/T-GGD-90-60, 08/01/90

During fiscal year 1990, GAO issued three products dealing with IRS' growing accounts receivable—one of the 14 areas in government designated by the Comptroller General as having significant potential for loss of funds to the Treasury.

In February 1990 testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO said that (1) the accounts receivable inventory had grown from $24 billion in 1983 to over $60 billion in 1989; (2) although the amount that was actually collectible might be overstated by as much as half due to accounting errors or the taxpayer's inability to pay, the growth was significant and represented a serious problem; (3) the inventory grew three times faster than collections of delinquent taxes and twice as fast as total net tax receipts; and (4) the growth persisted even though IRS devoted more resources to collection activities and undertook numerous internal studies and projects aimed at slowing the growth.

GAO also said that IRS (1) lacked the internal controls and information systems to determine how much of the inventory could be collected with either existing or additional resources; (2) lacked basic information that would help in forging a more effective collection strategy; and (3) needed to collect unpaid taxes as quickly and equitably as possible in the short term and focus on IRS-wide efforts to improve prevention, detection, and collection of delinquent taxes in the long term.

In July 1990, GAO provided the Subcommittee on Oversight with more information on trends in the growth and age of IRS' accounts receivable. GAO reported that (1) accounts of individual taxpayers accounted for two-thirds of the dollar growth and three-fourths of the growth in the number of accounts from the end of fiscal year 1986 to the end of 1989; (2) over 60 percent of the dollar growth was in accounts for which IRS had suspended collection due to such factors as disputes over the liability, the taxpayer's bankruptcy, or IRS' inability to locate or obtain payment from taxpayers; and (3) the dollar value of accounts over 1 year old had grown 56 percent since 1986, exceeding the 32 percent overall growth in accounts receivable during this period.

In August 1990 testimony before the Senate Committee on Governmental Affairs, GAO discussed several possible short- and long-term solutions to the problem. As a short-term solution, GAO discussed the need for IRS to better focus its efforts to collect more from existing accounts. As part of this discussion, GAO said that (1) it was unconvinced that understaffing in the collection function was the key reason for IRS' poor performance but still felt that additional, steady increases in collection staffing were probably necessary and (2) increases in numbers of staff must be coupled with major human resource improvements. GAO identified three areas for potential improvement—staff productivity, staffing imbalances that may have been caused by a hiring freeze, and IRS' method for identifying the potentially most productive cases.

For the long term GAO said that several IRS-wide areas needed sustained management attention, including (1) improving financial management systems and developing useful management information, (2) ensuring that improved collection of delinquent taxes is seen as an IRS-wide goal, and (3) effectively modernizing systems to cut down on the considerable amount of time IRS spends correcting errors.

Related GAO Product(s)

GAO/T-AFMD-90-09, 11/29/89

IRS Can Use Tax Gap Data to Improve Its Programs for Reducing Noncompliance

GAO/GGD-90-53BR, 04/04/90 and GAO/T-GGD-90-32, 04/19/90

In a report and subsequent testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO provided information on IRS' gross tax gap estimates for 1987.

IRS defines the gross tax gap as the difference between the amount of income taxes that taxpayers owe and the amount they voluntarily pay. IRS estimated the gross tax gap to be $85 billion in 1987, its most recent estimate, and projected that it would reach $114 billion by 1992.

GAO analyzed four components of the tax gap that accounted for over half of IRS' 1987 estimate. Those components were (1) sole proprietors, or self-employed individuals, who report business income and deductions on schedule C of their tax returns; (2) informal suppliers, such as street vendors or "moonlighters," who operate on a cash basis; (3) small corporations with assets under $10 million; and (4) large corporations with assets of $10 million or more.

GAO noted that (1) sole proprietors underpaid 23 percent of their tax liability, which reflected both unreported income and overstated business deductions; (2) the income of informal suppliers was not documented in formal books and records and was unlikely to be subjected to third party reporting; (3) noncompliance by small corporations was about equally divided between unreported income and overstated deductions, such as for depreciation and repairs; and (4) noncompliance by large corporations generally involved the improper accounting of reported income and deductions, such as by misallocating income between foreign and domestic subsidiaries or misstating the period over which assets should be depreciated.

GAO said that research by IRS and others pointed to various reasons for noncompliance. These reasons, which vary somewhat by component, include (1) cash-basis operations that are not recorded and are not subjected to third-party controls, such as information reporting or withholding; (2) intentional noncompliance to survive in the competitive business environment; (3) the lack of wage withholding for sole proprietors and information reporting for payments made to corporations; and (4) tax law complexity or vagueness.

GAO noted that (1) IRS does not design its major enforcement programs to specifically pursue components of the tax gap; (2) with limited exceptions, IRS' programs address noncompliance in a general way by focusing on types of tax returns rather than types of noncompliance; and (3) IRS' enforcement programs have limitations in reducing the tax gap. In explaining the latter, GAO pointed out, among other things, that IRS (1) examines only about 1 percent of individual returns and about 2 percent of corporate returns, (2) cannot match all information returns to corresponding tax returns because some information returns contain erroneous data, and (3) does not have the resources to investigate all indications of unreported income that emerge from its matching program.

GAO cited several ideas for improving IRS' enforcement that have been suggested by various observers, including (1) using information returns to identify employers who misclassify employees as independent contractors; (2) developing a business document matching program to, among other things, identify corporations that have not reported income; (3) getting assistance from state and local authorities to verify that federal tax returns have been filed by street vendors and other informal suppliers who are seeking business licenses; and (4) expanding the use of information reporting and withholding.

Related GAO Product(s)

GAO/T-GGD-87-04, 03/17/87; GAO/GGD-88-66BR, 03/25/88; GAO/GGD-88-119, 08/08/88; and GAO/GGD-89-107, 09/25/89

Potential Audit Revenues Lost While Training New Revenue Agents

GAO/GGD-90-77, 04/06/90

From July 1, 1986, to September 30, 1988, IRS hired about 7,300 new revenue agents. At the request of the Senate Committee on the Budget, GAO assessed (1) the extent to which experienced revenue agents were involved in training 1,103 of those agents in five IRS districts and (2) the cost of that training in terms of the audit revenues that go unrealized while the experienced agents train new agents instead of auditing.

GAO reported that (1) IRS' training of new agents involved about 61 weeks of classroom instruction and on-the-job training over a 26-month period; (2) by the time IRS finished training the new hires in the five districts, it could end up losing about $980 million in audit revenues; (3) IRS concluded, in its own study, that the unrealized revenues associated with training 1,000 new agents would be about $527 million or about half as much as GAO's estimate—a difference that can be attributed to differences in methodology; and (4) because of the significant unrealized revenues involved, IRS planned to start contracting for some of its training in fiscal year 1991 and was considering other alternatives to its current training program.

Summary of Related Action(s)

IRS has revised its methodology for estimating the additional revenues that can be generated by an increase in examination staff. Unlike its earlier methodology, IRS now recognizes that an increase in staff produces reduced revenues in the short term because of the costs associated with training new staff.

IRS also (1) restructured its training program to give agents the training they need in a shorter period of time and thus increase the time they spend auditing and (2) will start using some contract trainers in early 1991 to free some of its experienced agents to do audit work.

Related GAO Product(s)

GAO/GGD-88-16, 12/02/87; GAO/GGD-88-119, 08/08/88; GAO/GGD-90-85, 06/20/90; and GAO/GGD-90-119, 09/05/90

IRS Needs More Reliable Information on Enforcement Revenues

GAO/GGD-90-85, 06/20/90

In a report to the Ranking Minority Member of the Senate Committee on the Budget, GAO assessed (1) IRS' budget and after-the-fact estimates of revenues generated by its overall enforcement program, (2) revenue estimates for the collection and document matching components of the enforcement program, (3) the use and usefulness of IRS' Enforcement Resource Allocation Model, and (4) IRS' efforts to develop more reliable data on enforcement results.

GAO found that (1) IRS does not know how much revenue its enforcement programs actually generate and, therefore, has had to estimate those amounts; (2) IRS' after-the-fact estimates of total annual enforcement revenues had been about $20 billion (40 percent) too high; (3) large differences between the revenues IRS estimated it would derive from the collection and document matching programs and the revenues IRS said it eventually realized could not be reconciled because IRS had not sufficiently documented how it arrived at its estimates; and (4) although IRS developed the Enforcement Resource Allocation Model to help allocate additional enforcement staff in a way that would maximize revenues, the model was not being used as intended because its principal users (IRS' Finance Division, the Department of the Treasury, and the Office of Management and Budget) lacked confidence in the reliability of input data.

Although IRS has long recognized the need for information on the revenues that actually result from its enforcement programs, it has had little success in developing the requisite information systems. At the time of GAO's report, IRS had several such efforts planned or underway, including development of an enforcement management information system.

Recommendation(s) to Congress

Both the Senate and House Committees on the Budget and Appropriations should monitor IRS' progress in improving its enforcement revenue data. In doing so, the Committees might require IRS to provide detailed plans and milestones and periodic status reports. Until more reliable data are available, the Committees should use the most conservative revenue assumptions in deliberating on future enforcement staffing increases for IRS.

Recommendation(s) to the Agency

IRS should provide Congress with information on actual revenues generated by its enforcement programs as soon as the information becomes available. In the interim, IRS and Treasury's Office of Tax Analysis should agree on the most reliable method of estimating after-the-fact enforcement revenues. IRS should explore ways to link the revenue data with proposed staffing increases to provide Congress with more reliable estimates of revenues expected from these increases.

GAO made several other recommendations directed at developing better data.

Action(s) Taken and/or Pending

IRS' fiscal year 1991 appropriation included funding for several initiatives intended to raise additional revenues through increased enforcement staffing. The Congressional Budget Office estimated that the initiatives would generate $300 million in 1991 and $4.3 billion over 5 years. IRS estimated that these initiatives would generate about $500 million in 1991 and about $5.7 billion over 5 years. The fiscal year 1991 budget reconciliation legislation used IRS' estimates.

IRS is implementing a comprehensive cross-functional information system through which it plans to track enforcement case results through completion. IRS does not intend, however, to track the staffing applied to individual collection cases, as GAO recommended. In addition, IRS is taking steps to (1) develop better documentation of its revenue estimates and (2) improve its monitoring of estimates and actual results.

Related GAO Product(s)

GAO/GGD-88-16, 12/02/87; GAO/GGD-88-119, 08/08/88; GAO/GGD-90-77, 04/06/90; and GAO/GGD-90-119, 09/05/90

IRS' Improved Estimates of Tax Examination Yield Need to Be Refined

GAO/GGD-90-119, 09/05/90

IRS' budget for fiscal year 1991 included several initiatives that were intended to generate additional tax revenues by increasing or modifying IRS' compliance efforts. One initiative called for hiring an additional 750 revenue agents (who audit the more complex tax returns) and 290 support staff. IRS said the audits resulting from such a staff increase would generate additional revenues of $1.1 billion by the end of fiscal year 1995.

In an August 1988 report, GAO discussed several problems with the methodology IRS was using to estimate the additional revenues associated with an increase in examination staff. As a result of that report, IRS revised the methodology for use in estimating the revenues associated with the staffing increase requested for fiscal year 1991. In this report to the Chairman of the Senate Committee on the Budget, GAO provided information on IRS' revised methodology and IRS' plans to track the results of the staffing increase, which was subsequently authorized by Congress.

GAO said that IRS' revised methodology produced a more realistic estimate of the results to be derived from an increase in examination staff than its previous methodology, but some of the assumptions IRS used in its revised methodology were still overly optimistic. IRS assumed that (1) all new staff would be on board by the beginning of the fiscal year (October 1, 1990)—an assumption that on the basis of experience was optimistic and proved to be overly optimistic in this case also, and (2) the influx of new staff would free experienced agents to work on higher-yield cases, thus increasing the audit revenues generated by additional staffing—an assumption that GAO also questioned in its assessment of IRS' past methodology.

GAO also said that (1) IRS planned to monitor the impact of the increase in examination staff if it was authorized; (2) the reliability of that monitoring information would depend, in large part, on the validity of the baseline (amount of revenue that would have been collected without the staffing increase) from which IRS would begin its tracking; and (3) IRS had not yet computed its baseline at the time of GAO's work.

Recommendation(s)

To further improve its methodology for estimating the revenue to be derived from an increase in examination staff, IRS should develop empirical data to show whether the influx of new staff allows more experienced staff to work higher-yield cases.

Action(s) Taken and/or Pending

IRS' appropriation for fiscal year 1991 was enacted on November 5, 1990. That appropriation included full funding for the various revenue initiatives that were part of IRS' budget request. IRS agreed with GAO's recommendation but had not decided, as of November 20, 1990, on the type(s) of data and analysis that would be most appropriate in assessing the effect of new staff on the work load of experienced staff.

Related GAO Product(s)

GAO/GGD-88-119, 08/08/88; GAO/GGD-90-77, 04/06/90; and GAO/GGD-90-85, 06/20/90

Erroneous Penalties for Failure to File Returns or Pay Taxes Can Be Reduced

GAO/GGD-90-80, 04/13/90

In a report to the Commissioner of Internal Revenue, GAO discussed IRS' assessment and abatement decisions relating to the civil tax penalties for failing to file a timely tax return and failing to pay taxes due. After analyzing a sample of 626 abatements from fiscal year 1987, GAO reported that (1) 91 percent were appropriate on the basis of IRS' criteria, and (2) 29 percent were needed to correct erroneous IRS assessments caused primarily by improper coding of income tax returns for processing and problems with processing taxpayer' extensions to file their income tax returns.

A lack of documentation regarding why a penalty was abated in the penalty case files prevents IRS managers from readily identifying and correcting processing problems. Existing internal controls—specifically, quality reviews—are also not designed to identify, summarize, and assess processing problems that lead to erroneous failure to file and pay penalties.

GAO noted that IRS' penalty abatement statistics included numerous computer-generated adjustments to taxpayers' accounts. Because those adjustments did not represent taxpayer-requested abatements, their inclusion in the abatement statistics overstated the number and dollar value of actual abatements.

Recommendation(s)

The Commissioner of Internal Revenue should require IRS tax examiners to more fully document their penalty abatement decisions—at least including the basis for the abatement and the cause of any erroneous assessments. The Commissioner should use this information to improve internal controls over the assessment of both penalties.

In order to have more accurate statistics on these abatements, IRS should isolate and delete changes that are merely computer adjustments. IRS should also clarify the requirements for coding tax returns.

Action(s) Taken and/or Pending

IRS is revising procedures for documenting penalty abatement decisions and is investigating whether the quality review process can be modified to assess how well examiners are documenting abatement decisions.

IRS said that isolating computer adjustments alone will not solve the problem of overstated abatements because many corrections are input manually. Therefore, IRS is looking at ways to isolate manual abatements. IRS is also revising its manual to clarify coding requirements and instructions.

Related GAO Product(s)

GAO/T-GGD-88-55, 09/28/88 and GAO/GGD-89-81, 09/09/89

IRS Can Improve Its Process for Recognizing Tax-Exempt Organizations

GAO/GGD-90-55, 06/08/90

In a report to the Commissioner of Internal Revenue, GAO examined several administrative steps IRS could take to better use its staff and improve its efficiency in recognizing organizations for tax-exempt status under section 501(c) of the Internal Revenue Code. This section contains 25 categories of tax-exempt organizations, including those organized for charitable, educational, religious, and social welfare purposes.

IRS determines tax-exempt status through a determination process IRS must use to judge whether an organization is organized and operated, or will be operated, for purposes compatible with those specified in section 501(c) under which it seeks tax-exempt status. Once an organization has received tax-exempt recognition, IRS uses its examination process to review reported activity and financial data to ensure compliance with legal requirements for tax-exempt status. This process is done during examinations of annual information returns filed by the organization.

GAO reported that (1) in October 1987, IRS authorized an expedited determination process to be used in certain cases as determined by the exempt organization examiner to facilitate more efficient and effective use of IRS staff; (2) the frequency of use of the expedited process during fiscal year 1989 varied among the seven district offices responsible for exempt organization matters, ranging from 17 percent of all determination requests in one district to 2 percent in another; and (3) an absence of clear guidance had led to both confusion among IRS' district offices as to when the process could be used and variation among the districts in the types of determinations for which the process was used.

GAO also found that (1) IRS could use its staff more effectively when doing advance ruling follow-ups to classify exempt organizations as public charities or private foundations by also reviewing expenditure data, and (2) IRS' procedures for closing cases due to lack of information created inefficiencies because these cases were often reopened when the applicant organization later provided the requested information.

Recommendation(s)

The Commissioner of Internal Revenue should direct the Assistant Commissioner, Employee Plans and Exempt Organizations, to (1) evaluate the current use of the expedited determination process as a basis for developing a national program that will include clear guidance on when the process is to be used, (2) assess the possibility of redirecting staff between the determinations process and the examinations process because increased use of the expedited determination process results in more efficient use of determination staff, and (3) obtain and analyze both expenditure and revenue data during the advance ruling follow-up process.

Action(s) Taken and/or Pending

IRS said that it plans to evaluate the use of the expedited determination process in fiscal year 1991 and develop program guidance and national procedures. IRS said that shifting staff between determinations and examinations will depend on the effective implementation of, and increased district use of, the expedited determination process. IRS also said that it will conduct a test in fiscal year 1991 in two or three districts to determine the benefits to be derived from obtaining and analyzing both expenditure and revenue data during the advance ruling follow-up process.

IRS Preparer Penalty Data Inaccurate and Misleading

GAO/GGD-90-92, 08/15/90

In a report to the Commissioner of Internal Revenue, GAO said that IRS' statistics on return preparer penalties did not accurately reflect preparer noncompliance with the tax laws.

The penalty data were inaccurate because IRS had (1) understated the number of penalties by recording multiple penalties as a single transaction, (2) understated both the number and amount of preparer penalties by including only penalties recorded in its computerized system, (3) prevented distinguishing between penalties assessed for different types of noncompliance by combining the penalties for preparer negligence and willful understatement, and (4) distorted the statistics by entering miscoded or erroneous assessment and abatement data in its files.

Recommendation(s)

To ensure that IRS' statistics more accurately reflect preparer penalty activity, the Commissioner of Internal Revenue should

- create an indicator to identify the number of penalties included in each transaction,
- identify and establish a means to include assessments made on the manual system,
- establish a means to differentiate between preparer negligence and willful understatement penalties, and
- evaluate the feasibility of developing methods to identify and correct miscoded or erroneously entered data and exclude these assessments and abatements from IRS' reported statistics.

Action(s) Taken and/or Pending

IRS generally agreed with GAO's recommendations and is planning to

- submit a request for data services that will provide for input of the number of penalties contained in a transaction as reflected on the adjustment document,
- expand the computerized database to allow input of an increased number of preparer penalty adjustments,
- submit a request for data services to assign different reference numbers for preparer negligence and willful misconduct penalties,

- issue a memorandum to its field offices recommending managerial review of adjustment documents after terminal input of preparer penalty assessment or abatement actions, and
- revise its manual to include a review of the adjustment document file to ensure that correct penalty data is entered.

Excise and Consumption Taxes

Perspectives on Potential Agricultural and Budgetary Impacts From an Increased Use of Ethanol Fuels

GAO/T-RCED-90-23, 02/01/90 and GAO/RCED-90-156, 07/16/90

In testimony before the House Committee on Ways and Means and in a report to the Chairman of the Subcommittee on Energy and Power, House Committee on Energy and Commerce, GAO discussed the potential effects of expanded ethanol production on the (1) domestic ethanol industry; (2) agricultural sector and consumer food prices; and (3) certain aspects of the federal budget, including the reduction of motor fuel tax revenues over an 8-year simulation period.

GAO noted that there were no technological impediments to increasing the domestic ethanol industry's production capacity to 2.2 billion or 3.3 billion gallons per year over the next 8 years under GAO's two growth scenarios. GAO also noted that American farmers could supply the corn necessary to produce those amounts of ethanol.

As to the federal budget impact, GAO's simulations showed that an expanded ethanol production would reduce federal farm program outlays by an annual average of about $930 million and $1.4 billion under GAO's low- and high-growth scenarios, respectively. On the other hand, increased use of ethanol fuels, if coupled with an extension of the 6-cent per gallon exemption for ethanol blended fuels (past the 1993 expiration date), could reduce annual motor fuel tax revenues by an average of about $442 million and $813 million, respectively, under GAO's two scenarios.

Considering only the impacts that expanded ethanol production would have on federal farm program outlays and motor fuel tax revenues, GAO's projections indicated that reductions in farm outlays would exceed the additional tax revenue losses, on average, by about $488 million and $608 million per year, respectively, under the two scenarios. However, GAO's simulations showed wide variations in yearly farm program outlays that resulted in net budget impacts varying widely from year to year. For example, GAO said that tax revenue losses exceeded farm program outlay reductions in one year by $924 million, while outlay reductions exceeded revenue losses by $2.7 billion in another year.

GAO's study did not examine all of the impacts that expanded ethanol production could have on the federal budget, such as changes in income tax revenues from farmers, ethanol producers, and the petroleum industry. However, GAO's study indicated that (1) the expanded use of ethanol would cause higher ethanol production costs, and (2) it may be necessary to increase the level of government subsidies or to pass the costs on to consumers through higher motor fuel costs.

Summary of Related Action(s)

The federal budget impact of future ethanol production will likely be affected by three developments since GAO's study. First, the Omnibus Budget Reconciliation Act of 1990 contains tax exemptions and tax credits extending to the year 2000 for ethanol. Second, the 1990 Clean Air Act amendments are expected to increase demand for ethanol. Finally, the level of future demand by the European community for U.S. corn gluten, which is a joint product of ethanol, may also have an impact on federal budget revenues and outlays for commodity programs.

State Tax Officials Have Concerns About a Federal Consumption Tax

GAO/GGD-90-50, 03/21/90

In a report to the Joint Committee on Taxation, GAO provided an overview of state tax officials' concerns about the enactment of a broad-based federal consumption tax as determined by a survey of state tax policymakers and administrators. One purpose of GAO's work was to assist Congress in its consideration of options for reducing the federal budget deficit.

When asked what potential revenue sources the federal government should use to reduce the deficit, 54 percent of state tax policymakers who responded to GAO's questionnaire selected the use of existing federal taxes exclusively, 8 percent selected a broad-based federal consumption tax exclusively, and 18 percent selected a combination of existing taxes and a new consumption tax. Only 20 percent of the respondents did not select a revenue option, indicating the federal government should not raise taxes to reduce the deficit.

GAO reported that 45 percent of state officials responding favored additional corporate income taxes to reduce the federal deficit, while 37 percent supported individual tax increases. Eighty percent of the state tax officials who were opposed to a federal sales tax, and 71 percent of those who were opposed to a federal value-added tax were concerned about intrusion into the states' traditional source of revenue.

GAO also reported that (1) less than 20 percent of state tax officials would reduce their opposition to a federally imposed consumption tax if they were offered a share of the resulting federal revenues, and (2) almost 60 percent of state tax officials were concerned about the regressivity of a federal consumption tax.

In responding to a question about a federal sales tax, 31 percent of state tax administrators who had a basis to judge expected the impact on their state sales tax administration to be great, 26 percent expected the impact to be moderate, and 43 percent predicted some or no impact. For a federal value-added tax, 59 percent expected no impact and 22 and 19 percent expected moderate or great impact, respectively.

Related GAO Product(s)

GAO/GGD-86-91, 08/20/86; GAO/GGD-89-87, 06/20/89; and GAO/GGD-89-125BR, 09/15/89

Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency

GAO/GGD-90-123, 09/27/90

As one of the constituent agencies of the Department of the Treasury, the Bureau of Alcohol, Tobacco, and Firearms (BATF) is responsible for collecting excise taxes imposed on alcohol, tobacco, and certain firearms—taxes that totalled over $10 billion in fiscal year 1989. BATF also administers special occupational taxes imposed on businesses that manufacture or sell alcohol, tobacco, or firearms. These taxes generated about $129 million in fiscal year 1989.

In a report to the Joint Committee on Taxation, GAO said that (1) economic inefficiencies and administrative problems had arisen due to the nation's fragmented alcohol excise tax structure; (2) alcohol excise tax rates were developed on an ad hoc basis without apparent consideration for their collective effect of altering the industry's product development and cost structure, or on BATF's administrative burden in implementing tax rates; and (3) differential tax rates on alcohol products resulted in similar products being taxed differently, such as table wine being taxed at a rate 95 percent lower than sparkling wine because the latter was at one time considered a "luxury" product.

As an example of the inefficiencies caused by differential tax rates, GAO discussed the tax credit codified in section 5010 of the Internal Revenue Code. GAO said that (1) the credit has provided producers with an incentive to use wine and flavors in distilled spirits even though these additional ingredients can increase a product's costs by 200 percent or more; (2) since enactment of the credit in December 1980, production has outpaced original projections, as have the federal revenue losses, which now total about $90 million annually; and (3) BATF is generally unable to verify compliance with the credit without extensive investigation.

GAO concluded that standardizing tax rates on the basis of alcohol contained in the product would encourage more efficient economic decisions by producers and eliminate the need for the section 5010 credit.

GAO also reported that the special occupational taxes BATF administers (1) had become controversial since BATF began identifying and contacting retailers who had been unaware of their obligation to pay the tax, (2) are cumbersome because occupational taxes require collection of small amounts from a large number of taxpayers, and (3) resulted in BATF spending a relatively higher amount of resources to collect occupational taxes in fiscal year 1989 (8 cents spent for every dollar collected) than to collect alcohol and tobacco excise taxes (one-half cent spent for every dollar collected).

GAO offered two options for simplifying special occupational taxes aimed at lowering both the compliance burdens on thousands of small retailers and the administrative burdens on BATF.

Matter(s) for Congressional Consideration

Congress should consider (1) simplifying the structure of alcohol excise taxes by standardizing the rates across products on the basis of the percentage of alcohol contained in a beverage regardless of the mix of ingredients, thereby permitting the elimination of the section 5010 tax credit and (2) changing the special occupational tax by either eliminating it with a corresponding slight increase in excise tax rates (of about 2 percent) or collecting the tax from only producers and importers and varying it on the basis of the size of the facility.

Action(s) Taken and/or Pending

The Omnibus Budget Reconciliation Act of 1990 increased alcohol and tobacco tax rates. However, it did not eliminate the problems associated with the differential tax rates on alcohol products. The rates were not standardized on the basis of the percentage of alcohol contained in a beverage.

In October 1990 three members of the House Ways and Means Committee, in a letter to the Committee Chairman, urged repeal of the special occupational tax on alcohol. They pointed out the compliance problems and administrative burdens of the tax and suggested that higher alcohol excise taxes could absorb any revenue loss from repeal of the special occupational taxes.

Related GAO Product(s)

GAO/GGD-86-49, 06/05/86 and GAO/GGD-89-52, 05/09/89

General Management

Need for More Management Attention to IRS' College Recruitment Program

GAO/GGD-90-32, 12/22/89

At the request of the Chairman of the Subcommittee on Federal Services, Post Office and Civil Service, Senate Committee on Governmental Affairs, GAO reviewed IRS' efforts to recruit college graduates for its enforcement staff. GAO focused on (1) the quality of IRS' enforcement recruits, (2) IRS' management of its college recruitment program, and (3) IRS' relationships with colleges and universities.

GAO found that (1) noncompetitive starting salaries were the main obstacle to IRS' recruitment of quality enforcement staff; (2) although IRS increased its starting salaries in some high-cost geographic areas, they were still below competitors' salaries; (3) IRS had no quantitative data to support its managers' generally positive views on the quality of enforcement recruits; and (4) many managers cited the same evaluation factors in commenting on recruit quality, but used different standards to interpret them.

GAO also found that (1) inadequate funding, insufficient staffing, and field office resistance impeded IRS' progress in implementing recruitment improvement projects; (2) IRS relied on duplicative, uncoordinated efforts at the local level, rather than addressing IRS-wide problems on a national scale; (3) IRS' Human Resources Division provided little recruitment guidance to the field offices, did not require reporting of field activities, and did not review recruitment activities; and (4) although IRS established a Campus Executive Program that targeted certain schools for special attention, many schools were not aware of the program or their status under it.

Recommendation(s)

The Commissioner of Internal Revenue should direct the Human Resources Division to (1) assess the Campus Executive Program to determine what each district office is doing to establish effective working relationships with target schools and to identify any needed changes to the program and (2) take a more active role in directing and overseeing the college recruitment program.

In addition, the Human Resources Division should (1) develop a set of performance measures, such as academic performance, that can be used to assess the quality of new enforcement staff; (2) establish standards, such as being in the top 10 percent of the graduating class, for each of those measures; (3) develop a measurement system that will allow comparisons of data on new enforcement staff to the standards; and (4) use this information to periodically evaluate the effectiveness of the college recruitment program at the district, regional, and national levels.

Action(s) Taken and/or Pending

IRS established a Campus Executive Task Force to assess that program and established a program agenda for the future. Also, IRS' annual business review process, which began in fiscal year 1990, provides a vehicle for the National Office to assess field offices' recruitment programs.

As part of its Strategic Management Process, IRS plans to reassess its recruiting efforts over the next several years. Its most recent Strategic Business Plan (covering the period from fiscal year 1991 through fiscal year 1996) calls for, among other things, redefining the required occupations and skills necessary to accomplish the most critical IRS work and expanding recruitment efforts and inducements by 1996.

Related GAO Product(s)

GAO/GGD-87-37, 02/10/87; GAO/GGD-88-16, 12/02/87; GAO/GGD-88-79, 05/03/88; GAO/T-GGD-88-48, 07/12/88; GAO/PEMD-88-27, 08/04/88; GAO/GGD-89-01, 10/14/88; GAO/OCG-89-2TR, 11/88; GAO/T-GGD-89-32, 06/19/89; GAO/T-GGD-89-27, 06/26/89; and GAO/GGD-90-117, 09/11/90

Recruitment and Retention: Inadequate Federal Pay Cited as Primary Problem by Agency Officials

GAO/GGD-90-117, 09/11/90

In a report to the Chairmen of the Senate Committee on Governmental Affairs and the House Committee on Post Office and Civil Service, GAO examined a number of issues relating to federal recruitment and retention problems. The report provided information on what officials believed to be the causes and effects of these problems. GAO surveyed officials in 8 federal agencies, including IRS, within 16 metropolitan statistical areas on recruitment and retention in 11 federal occupations with high quit rates. Three of those occupations—clerk typist, tax examiner, and data transcriber—applied to IRS.

Among other things, GAO found that (1) low federal pay was the factor survey respondents most frequently cited as a reason for employees to leave the federal government and for applicants to decline a federal job offer in these occupations; (2) respondents in geographic areas with the highest costs of living and private sector pay were much more likely to view federal pay as a cause of recruitment and retention problems than respondents in areas where living costs and private sector pay were lower; and (3) pay-related recruitment and retention difficulties were having serious adverse effects on agency operations. GAO concluded that pay reform, particularly locality-based pay adjustments, would improve federal recruitment and retention efforts.

Summary of Related Action(s)

On November 5, 1990, the President signed the Federal Employees Pay Comparability Act of 1990. The act was intended to restore, over a period of time, federal pay rates to competitive levels and address the recruitment and retention difficulties documented in the GAO report. The act (1) instituted a more systematic process for determining annual salary adjustments and (2) provided for additional adjustments to close the pay gaps in all localities where federal rates are 5 percent or more behind nonfederal rates. The locality-based adjustments are to be phased in over a 9-year period beginning in 1994.

Related GAO Product(s)

GAO/GGD-87-37, 02/10/87; GAO/OCG-89-2TR, 11/29/88; GAO/GGD-89-19, 01/19/89; GAO/IMTEC-89-12BR, 02/07/89; GAO/T-GGD-89-27, 06/26/89; GAO/GGD-90-32, 12/22/89; GAO/T-GGD-90-22, 03/14/90; GAO/T-GGD-90-21, 03/21/90; GAO/GGD-90-81FS, 05/15/90; and GAO/GGD-90-105, 08/22/90

IRS Senior Executives' Views on the Impact of the 1987 Reorganization

GAO/GGD-90-45, 03/08/90

In 1989 GAO and IRS surveyed IRS executives to obtain their views on the impact of IRS' 1987 reorganization. That reorganization was intended to improve managerial accountability, communications, and decision-making and featured the establishment of a senior deputy commissioner, a deputy commissioner for operations, and a deputy commissioner for planning and resources.

GAO reported that IRS senior executives viewed the reorganization's effect as positive overall but had mixed views on how well it achieved its stated goals. Specifically, they believed that it helped organizational communication and decisionmaking but had little impact on strengthening managerial accountability throughout IRS. For example, 76 percent of the responding executives said that the new senior deputy commissioner position positively influenced the flow of information from the national office to the field. Since 91 percent of IRS' employees are located in the field, the quality of such communication is extremely important.

IRS executives said that the impact of the reorganization on IRS' managerial accountability had been less effective. Of the respondents, (1) 50 percent said that the reorganization had strengthened managerial accountability to a small extent, (2) fewer than 25 percent believed that the reorganization improved IRS' ability to hold managers accountable for performance goals, and (3) over 50 percent said that greater accountability was still needed in the critical area of information resources management.

Summary of Related Action(s)

Since the survey, IRS has taken additional steps to enhance accountability in the information resources and financial management areas through designation of a chief information officer, a chief financial officer, and an assistant commissioner (finance)/controller.

Related GAO Product(s)

GAO/GGD-89-01, 10/14/88

Treasury's Office of Inspector General Properly Established

GAO/AFMD-90-70, 06/14/90

In response to a congressional directive in the conference report on the Department of the Treasury's appropriations act for fiscal year 1990, GAO reported on Treasury's actions to establish a statutory Office of Inspector General (OIG) and specifically addressed certain congressional concerns that were voiced during deliberations over Treasury's fiscal year 1990 appropriation. Establishment of a statutory OIG at Treasury was required by the Inspector General Act Amendments of 1988. Before then, Treasury had established an administrative OIG and the Secretary of the Treasury was responsible for appointing the Inspector General.

GAO found that (1) Treasury had consolidated audit resources from the Bureau of Alcohol, Tobacco, and Firearms, the U.S. Customs Service, the Secret Service, and the administratively established OIG to form the statutory OIG; (2) IRS, Treasury's fourth law enforcement bureau, had retained its own internal audit function; (3) there were no indications that OIG had assumed any improper operational responsibilities, such as budget approval, for the four Treasury law enforcement bureaus; and (4) there was no evidence that the OIG had been prohibited from performing any audit or investigation.

Related GAO Product(s)

GAO/AFMD-86-03, 08/21/86

IRS Needs to Assess Options to Make Faster Deposits of Large Tax Payments

GAO/GGD-90-120, 08/31/90

In a report to the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed the timeliness of IRS' deposits of tax payments at two service centers—Cincinnati and Philadelphia. These centers averaged about 7 days to deposit about $6 billion in individual income tax payments received between April 15 and May 7, 1990. According to IRS officials, the additional time was needed to make deposits during this period because IRS processes returns on a first-in, first-out basis, and it does not have the staff or equipment to handle more quickly the large volume of returns received in mid-April of each year. At other times of the year, when the volume of receipts is smaller, IRS requires service centers to deposit payments within 24 hours of receipt, and they generally meet that requirement.

GAO said that one way IRS could reduce deposit times and increase interest earnings would be to isolate and expedite the deposit of large tax payments. For example, GAO's work at the two service centers showed that tax payments of $5,000 or more accounted for about 70 percent of the potential interest earnings during this period, but less than 8 percent of the volume. GAO estimated that the government could have earned additional interest of about $6.2 million if the two centers had deposited payments of $5,000 or more within 24 hours—the time IRS officials believed was achievable if they focused on large payments. IRS officials believed that similar results could be expected at IRS' other eight centers.

Recommendation(s)

The Commissioner of Internal Revenue should assess various options to reduce the time it takes to deposit large tax payments, including the ones discussed in GAO's report, and adopt one that strikes an appropriate balance between administrative costs, taxpayer impact, and potential benefits.

Action(s) Taken and/or Pending

IRS generally agreed with GAO's recommendation and said that it was being explored in conjunction with IRS' cash management initiatives under Tax System Modernization. Specifically, IRS said that a procedure for accelerating deposits would be part of its Check Handling Enhancement and Expert System. That system would introduce high-speed check processing image equipment in IRS service centers, thereby eliminating most manual check processing activities. Because IRS expects to implement the new check handling system in 1993, it does not believe development of another procedure for 1992 (as suggested in GAO's recommendation) would be cost-beneficial.

Housing Subsidies/ Credits

Rental Housing: Inefficiencies From Combining Moderate Rehabilitation and Tax Credit Subsidies

GAO/T-RCED-90-34, 02/27/90 and GAO/RCED-90-168, 06/19/90

In response to a request from the Chairman of the Subcommittee on HUD/Moderate Rehabilitation Investigation, Senate Committee on Banking, Housing and Urban Affairs, GAO provided information on the financial implications of combining subsidies under the Department of Housing and Urban Development's (HUD) Section 8 Moderate Rehabilitation Program and the Department of the Treasury's Low-Income Housing Tax Credit Program. In June, GAO reported on eight specific housing projects. In February, it testified on one of those projects.

GAO reported that (1) developers for the eight projects realized cash proceeds that exceeded their costs for acquiring and rehabilitating the properties by 11 to 34 percent, and (2) developers generated the proceeds by selling their ownership interests in the projects, along with the related tax credits, and combining them with mortgage loans secured by moderate rehabilitation rental subsidies.

GAO said that (1) by combining rehabilitation subsidies and tax credits, developers received more assistance than needed to ensure the projects' financial viability or to compensate them for their limited financial risk; (2) the use of both programs was questionable because the projects were located in areas with ample vacant units and with rents generally well below the established rents for the eight projects; and (3) it would have been more economical to rely on existing rental housing subsidized by certificates and/or vouchers under HUD's Certificate and Voucher Programs rather than developing the eight projects GAO reviewed.

GAO noted that Congress and HUD had taken steps to better control subsidies under the Moderate Rehabilitation and Tax Credit Programs. Those changes (1) limited the amount of subsidies allowable and the way they could be used, (2) placed greater responsibility on state credit-allocation agencies, (3) and prohibited the use of tax credits in conjunction with the Section 8 program.

Recommendation(s)

Congress may wish to consider restricting the use of tax credits generally to areas where vacancy rates are low for suitable units renting at or below the area's fair market rents. Congress could further require that any deviation from this policy by a state credit allocation agency be documented and subject to review by an authorized representative of the federal or state government.

Action(s) Taken and/or Pending

The Omnibus Budget Reconciliation Act of 1990 requires the Secretary of the Treasury and HUD's Inspector General to jointly conduct a study on the combined use of the low-income credit and the Section 8 Moderate Rehabilitation funds and to submit the results to Congress no later than January 1, 1993.

Summary of Related Action(s)

HUD revised its program policies and guidelines to require that when projects are to receive tax credits in conjunction with HUD subsidies, HUD must consider the value of the tax credit and adjust accordingly the amount of other subsidies awarded to the project. In addition, HUD revised its program policies to target rental subsidies to geographic areas with high unit vacancies.

Related GAO Product(s)

GAO/T-RCED-89-58, 08/02/89; GAO/T-RCED-89-72, 09/29/89; GAO/RCED-90-73, 04/27/90; and GAO/T-RCED-90-203, 09/14/90

Low-Income Housing Tax Credit Utilization and Syndication

GAO/T-RCED-90-73, 04/27/90

In testimony before the Subcommittee on HUD/Moderate Rehabilitation Investigation, Senate Committee on Banking, Housing and Urban Affairs, GAO discussed use of the Low-Income Housing Tax Credit Program.

GAO reported that (1) tax credits were intended to induce investors to supply equity for low-income housing; (2) since the Low-Income Housing Tax Credit Program began in 1987, award and use of the credit has steadily increased from 20 percent of the total amount states were authorized to allocate in 1987 to 98 percent in 1989; (3) by the end of 1989, about $565 million worth of initial-year credits had been awarded in connection with the development of about 236,000 low-income housing units; and (4) the credit program has grown to be the nation's primary effort to encourage low-income housing production.

Syndication is the process of structuring financial arrangements to secure cash from outside investors. GAO said that most tax credit syndications have been conducted as public offerings, sold to individual investors, with limited partnership interests in projects that are eligible for tax credits. Many other syndications involve direct placements, usually to corporate investors.

GAO noted also that (1) when the federal government issues tax credits, it incurs a tax expenditure equal to the tax revenues foregone; (2) for low-income housing development, some of the tax expenditures are used to attract equity capital so investors can realize a competitive rate of return; and (3) not all of the equity capital is available to directly invest in low-income properties because some of the capital is needed to pay syndication fees and expenses.

Related GAO Product(s)

GAO/GGD-89-100FS, 07/10/89; GAO/T-RCED-89-58, 08/02/89; GAO/T-RCED-89-72, 09/29/89; GAO/RCED-90-168, 06/19/90; and GAO/GGD-RCED-90-203, 08/14/90

Observations on the Low-Income Housing Tax Credit Program

GAO/RCED-90-203, 08/14/90

The Low-Income Housing Tax Credit Program was authorized in the Tax Reform Act of 1986 as a 3-year program to provide an incentive for investors to construct or rehabilitate low-income housing.

In a report to the Chairman of the Subcommittee on HUD/Moderate Rehabilitation Investigation, Senate Committee on Banking, Housing and Urban Affairs, GAO provided information on (1) the estimated cost to the Treasury of low-income housing tax credits awarded during 1987 to 1989, (2) whether the awarded tax credits have resulted in reduced rents paid by tenants in credit-assisted units, (3) whether such tenants have been selected from waiting lists maintained by public housing authorities, (4) the adequacy of existing compliance monitoring requirements, (5) the adequacy of current statutory provisions designed to prevent noncompliance, and (6) alternative tax credit allocation formulas.

GAO estimated that tax credits awarded during 1987 to 1989 cost the Treasury about $5.7 billion in foregone revenues without taking into account such things as interest costs the government would have to pay on funds it borrowed to replace the foregone revenues. GAO said that in the time available it was unable to determine the extent to which tax credits alone, without any other form of subsidy, had been used to reduce total unit rents to no more than the legally required 30 percent of the tenant's adjusted incomes; but, based on GAO's limited information, it did not appear that the credits had typically been used to achieve this purpose.

GAO said also that (1) except in certain situations, there was no legal requirement to select tenants for credit-assisted housing from waiting lists; (2) the program's existing compliance monitoring requirements were inadequate by themselves to ensure that credit-assisted units were suitable and actually being used to house low-income families; and (3) on the basis of its limited work, it did not appear that the current statutory program provision related to noncompliance—recapture of a portion of the awarded credit—would effectively discourage noncompliance with program requirements by credit recipients.

GAO said that due to time constraints and other work limitations, it lacked the necessary data to endorse any alternatives to the existing per capita formula used to authorize tax credit amounts for each state. GAO also said, however, that there were numerous other potential options for allocating states' respective shares of the credits. As an example, GAO cited a formula that could be established on the basis of need so that those states, or areas within states with the greatest need (such as a state lacking vacant suitable rental housing), would receive a larger allocation.

Summary of Related Action(s)

In the Omnibus Budget Reconciliation Act of 1990, Congress amended low-income housing credit program legislation to include a requirement that states' allocation plans include procedures for monitoring and reporting noncompliance with program requirements to IRS for enforcement action. The act also extended the credit program through December 31, 1991.

Related GAO Product(s)

GAO/GGD-89-100FS, 07/03/89; GAO/T-RCED-90-34, 02/27/90; GAO/T-RCED-90-73, 04/27/90; and GAO/RCED-90-168, 06/19/90

Home Ownership: Limiting Mortgage Assistance Provided to Owners With High-Income Growth

GAO/RCED-90-117, 09/26/90

A popular form of assistance for first-time homebuyers is a below market interest rate mortgage loan financed through tax-exempt qualified mortgage bonds. A related form of assistance is the mortgage credit certification, which allows first-time buyers to take a credit on their federal income tax return for a portion of mortgage interest paid. Congress has restricted the eligibility of recipients of these forms of assistance to prevent their use by upper-income households. Toward that end, the Technical and Miscellaneous Revenue Act of 1988 included provisions intended to recapture some or all of the assistance from owners who experience rapid income increases after purchasing their subsidy-assisted home, thereby eliminating the need for such assistance.

As required in that legislation, GAO reported to the Chairmen of the Senate Committee on Finance and the House Committee on Ways and Means on (1) how the recapture mechanism would likely affect assisted homeowners and (2) whether it could be expected to limit the home ownership subsidy provided to households with rapid income growth.

Assisted homeowners must pay the recapture amount as part of their federal income tax for the year in which the house is sold. The recapture amount is based on an assumed interest rate reduction of 1.25 percentage points per year during the first 5 years of ownership. The recapture amount is phased out during years 6 to 10, after which no recapture amount is due.

GAO found that while the recapture provisions would recover some or all of the subsidy from certain assisted homeowners, it did not treat all owners with income increases equitably. The 1.25 percentage point recapture rate could be larger than the interest rate reduction that some owners received, and other owners could continue to receive the assistance even after their income had risen to a level where they would be able to make unassisted housing payments. Assisted loans were still available to those who could afford market-rate conventional loans with comparable terms and, therefore, they did not need such assistance. The recapture mechanism is also relatively ineffective because it is triggered solely by an owner's decision to move.

Matter(s) for Congressional Consideration

GAO suggested that (1) if Congress wanted to retain the existing recapture framework with some modification, it could tailor the recapture amount more closely to the interest rate reduction received and eliminate the phase-out after year 5, so that owners who continue to benefit would continue to pay a recapture portion; and (2) if Congress wanted to replace the recapture approach, it could enact an alternative that ends assistance when owners can afford unassisted housing payments.

In any case, Congress should limit qualified mortgage bond loans or mortgage certified credit assistance to prospective buyers who are not able to afford a conventional market rate loan of comparable terms.

Action(s) Taken and/or Pending

Congress did not address this issue in the tax provisions of the 1990 budget reconciliation legislation.

Related GAO Product(s)

GAO/RCED-88-111, 03/28/88; GAO/T-RCED-88-31, 03/28/88; and GAO/RCED-88-190BR, 06/27/88

Information Returns

Status of IRS' Test of a Business Information Returns Program

GAO/GGD-90-38, 05/29/90

In this second status report to the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, GAO provided information on the IRS' progress in evaluating a business document-matching program.

In September 1987, IRS sent the Subcommittee an action plan to test the feasibility of developing a business document-matching program similar to IRS' document-matching program for individual taxpayers. The plan contained three initiatives that were scheduled to be completed by December 31, 1990. IRS planned to (1) develop a cross-reference file to help associate sole proprietors' information returns with their tax returns, (2) evaluate the merits of using information returns to identify partnership and corporate nonfilers, and (3) determine the costs and benefits of establishing a document-matching program if information returns were required for payments to corporations.

GAO said that IRS (1) met all of the scheduled completion dates for the first initiative concerning sole proprietors; (2) completed the second initiative on partnership and corporate nonfilers 6 months late; and (3) under the third initiative, was 7 months late in completing work on an interim milestone that called for determining the computer costs associated with a corporate document-matching program.

GAO reported that IRS concluded from its study of 1,610 potential nonfilers that field contact with potential business nonfilers identified through the use of information returns was not cost effective because it obtained only 16 delinquent tax returns per 100 cases. GAO's analysis showed that IRS' study results should have excluded cases, such as those where investigations were still ongoing. By excluding these cases, IRS' "success rate" rose to 22 returns per 100 investigations. As a result, IRS agreed to explore how to use information returns to supplement its current program to identify business nonfilers.

GAO also reported that IRS (1) successfully tested a cross-reference file intended to allow IRS to match sole proprietors' information returns filed under their employer identification number with income tax returns filed under their Social Security numbers and (2) estimated that the computer costs for personnel, space, equipment, and operations would be $166 million over 7 years, which was in line with the costs of its individual document-matching program.

Related GAO Product(s)

GAO/PEMD-87-02, 11/10/86; GAO/T-GGD-87-04, 03/17/87; GAO/GGD-88-77, 05/24/88; and GAO/GGD-88-102, 07/22/88

Correcting Taxpayer Identification Is Possible Without Disclosing Tax Data

GAO/GGD-90-90, 06/05/90

Pursuant to section 7714 of the Omnibus Budget Reconciliation Act of 1989, GAO determined what could be done to help financial institutions provide correct names and taxpayer identification numbers to IRS, without disclosing tax data.

Each year, as part of IRS' Information Returns Program, banks and other financial institutions ("payors") file with IRS information returns reporting interest and dividend income paid to individuals ("payees"). IRS matches the income shown on the information returns provided by payors with that reported by payees on their tax returns. This procedure allows IRS to identify taxpayers who have potentially failed to report all their interest and dividend income. For IRS' matching program to be successful, information about payees on the information returns must be accurate.

Of the 407 million interest and dividend information returns processed for calendar year 1988 (totalling $511 billion), IRS was unable to match about 20 million, or 5 percent of the returns. In these cases, the payee's name and/or identification number, which is usually a Social Security number, did not match information in either Social Security or IRS files.

GAO found that (1) payors could obtain more information about payee name changes that are not reported to the Social Security Administration (SSA) (such as those due to marriage) when payees open an account and include both maiden and married names on information returns sent to IRS; (2) IRS could reduce the number of mismatches by expanding its plans to correct names on income tax returns; and (3) IRS should tell payors when there is no current record of a particular taxpayer identification number in IRS or SSA files, which would help payors find out why some identification numbers are incorrect.

Recommendation(s)

The Commissioner of Internal Revenue should

- encourage payors to obtain information from payees about name changes not reported to Social Security when payees open new accounts and to include the names on information returns,
- expand IRS' plans to correct names of primary filers on income tax returns to include secondary filers, and

- tell payors when taxpayer identification numbers are not in SSA or IRS files when providing lists of incorrect taxpayer identification numbers to payors.

Action(s) Taken and/or Pending

IRS generally agreed that GAO's recommendations would enhance its Information Returns Program and has taken or plans to take actions to implement them. Here are some examples.

- IRS intends to prepare a news release asking payors to emphasize the instructions to payees that they provide their current names, and the names on their Social Security cards, if different, when opening new accounts.
- IRS scheduled the changes necessary to correct the names of primary filers on income tax returns and expects to implement the changes in July 1991. If these changes are successful, IRS said that it plans to enhance the system to correct names of secondary filers.
- IRS will notify payors when taxpayer identification numbers are not included in SSA or IRS files when it issues the tax year 1989 list of incorrect taxpayer identification numbers in April 1991.

Related GAO Product(s)

GAO/GGD-88-110, 09/06/88

Data Needed on Whether to Regulate Filers of Information Returns for Others

GAO/GGD-90-95, 07/03/90

Pursuant to section 7715 of the Omnibus Budget Reconciliation Act of 1989, GAO studied whether service bureaus that transmit information returns or other documents to IRS on behalf of other persons, known as payors, should be subject to registration or other regulation. GAO focused on those service bureaus that submit information returns on magnetic tape. GAO reported its results to the Chairmen of the Senate Committee on Finance and House Committee on Ways and Means.

GAO said that (1) IRS did not appear to have more of a problem with service bureaus that filed returns on magnetic media than it did with payors who filed magnetic media information returns for themselves; and (2) about 96 percent of the tax year 1988 information returns submitted on magnetic media by all filers, including service bureaus, were processed the first or second time they were submitted.

GAO also said that IRS needs better information on (1) who service bureaus are, (2) what kinds of magnetic media processing errors they cause, and (3) how much regulating or controlling service bureaus would cost IRS and the industry. Once IRS has this type of information, it will be better able to consider whether various options for regulating service bureaus are warranted.

Recommendation(s)

The Commissioner of Internal Revenue should collect information on problems caused by service bureaus that submit information returns in order to decide what type of regulation or control, if any, is warranted. Specifically, IRS should (1) modify its records to identify which filers are service bureaus and more accurately identify magnetic media processing errors and (2) modify its method of calculating the magnetic media rejection rate. IRS should also obtain data on the (1) costs and benefits to IRS and service bureaus of instituting standards and controls and (2) impact any regulation or control may have on the entry of new small businesses into the service bureau industry.

Action(s) Taken and/or Pending

IRS generally agreed with GAO's recommendations and is taking or plans to take action to implement them. For example, IRS has (1) said that for fiscal year 1991, it will collect data on whether the filer of an information return is a service bureau; (2) expanded, for fiscal year 1991, its database to better identify why information returns were not readily processed; (3) taken several steps to improve the quality of all information return data; and (4) said that it would further investigate the costs and benefits of regulating service bureaus if the improved data indicate that service bureaus are submitting more erroneous information returns than other filers do.

Administration of Selected Filing Penalty Cases at Austin Service Center

GAO/GGD-90-99, 09/28/90

In a report to IRS' Assistant Commissioner for Examination, GAO presented the results of its review of the Austin Service Center's administration of the information return filing penalty. This penalty is generally assessed when an information return is filed late, not filed on magnetic media when required, or filed in an improper format.

GAO analyzed 295 cases involving the assessment and/or abatement of an information return filing penalty by the Austin Service Center. GAO said that (1) the vast majority of computer-generated penalty assessments were appropriate on the basis of IRS' assessment and abatement criteria and (2) problems frequently occurred when IRS staff manually assessed the penalty or abated the penalty.

GAO found that examiners (1) erroneously assessed penalties in about half of 68 manually assessed cases GAO reviewed, with 26 unwarranted penalties and 10 miscalculated penalties and (2) erroneously granted abatements in 118 of 221 cases, including 67 cases where no abatement was warranted and 51 cases where an abatement was warranted but not for the reasons cited by the examiner. In another 58 cases, taxpayers either had an abatement request erroneously denied or failed to request an abatement to which they were entitled.

As part of the Omnibus Budget Reconciliation Act of 1989, changes were made to make the penalty provisions more consistent across all types of information returns. GAO concluded that those changes would not rectify the assessment and abatement problems it identified because the problems were caused by factors not affected by the law—such as the failure of examiners to follow IRS' assessment and abatement criteria and guidance and the failure of supervisors to catch those errors.

Related GAO Product(s)

GAO/GGD-88-55, 09/28/88 and GAO/GGD-89-81, 09/06/89

Pension Issues

Private Pensions: Impact of Vesting and Minimum Benefit and Contribution Rules in Top-Heavy Plans

GAO/HRD-90-4BR, 10/23/89

In a report to the Subcommittee on Labor-Management Relations, House Committee on Education and Labor, GAO showed how certain rules for top-heavy pension plans affected participants' pension benefits. A pension plan is top-heavy when more than 60 percent of the benefits or contributions go to company owners or other key employees.

The Employee Retirement Income Security Act of 1974 (ERISA) set vesting rules for pension plans governing the length of time before participants earn the right to receive pension benefits. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the maximum time top-heavy plans could require for vesting, increasing the likelihood of shorter-tenured workers receiving pension benefits. These special top-heavy rules, enacted to curb perceived inequities in small pension plans where key employees were the primary beneficiaries, also stipulated minimum benefits or contributions that participants who are not owners, officers, or other key employees must receive. The Tax Reform Act of 1986 (TRA) significantly lessened the vesting period for plans that were not top-heavy, calling into question the need for special rules for top-heavy plans.

To assess the effect of TEFRA's top-heavy vesting rules, GAO analyzed 55,000 top-heavy plans for about 346,000 participants. That analysis showed that many more participants would have had smaller or no vested benefits if TEFRA's top-heavy vesting rules had been repealed and replaced with TRA's vesting rules. The effect of this change on participants' retirement income, however, would likely have been small and would only have occurred if these participants left their jobs before being fully vested. This result would occur because the participants would have been vested in a relatively small pension benefit at that point in their careers.

To assess the effect of TEFRA's top-heavy minimum benefit and contribution rules, GAO analyzed 26,000 top-heavy plans with about 142,000 participants. That analysis showed that (1) over one-half of the 26,000 plans and over two-thirds of the 142,000 participants had accrued benefits or received contributions exceeding the minimum and thus were not affected by the rules, and (2) short-service participants (those with fewer than 3 years' service) appeared to be more likely than those with longer service to be affected by the defined benefit minimum after just 2 years under top-heavy rules.

Related GAO Product(s)

GAO/HRD-86-11BR, 07/21/86; GAO/HRD-86-118BR, 07/21/86; GAO/HRD-88-31, 10/30/87; GAO/PEMD/88/15BR, 03/29/88; GAO/PEMD-88-20FS, 04/29/89; GAO/HRD-89-15BR, 02/03/89; GAO/HRD-89-105BR, 09/26/89; and GAO/HRD-90-4BR, 10/23/89

Pension Plan Terminations: Recapturing Tax Benefits Contained in Asset Reversions

GAO/HRD-90-51BR, 11/22/89 and GAO/HRD-90-126, 07/13/90

In two reports to the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO reviewed the adequacy of the 15-percent excise tax levied on employers who recover excess pension assets by terminating overfunded pension plans—called asset reversions. Specifically, GAO estimated the excise tax rates that would be needed to offset the tax benefits associated with 55 asset reversions. The November 1989 report provided preliminary estimates for 18 cases, and the July 1990 report analyzed all 55 cases.

In each of the 55 cases the 15-percent excise tax was not enough to offset the tax benefits. The excise tax rate required to recapture tax benefits depends heavily on an employer's marginal income tax rate. Therefore, GAO used three different tax rate scenarios with three different results. GAO determined that using (1) the maximum federal statutory rates that prevailed from 1975 to 1986, the excise tax rate required to recapture tax benefits ranged from 17 to 59 percent and exceeded 15 percent in all 55 cases; (2) average effective tax rates for each year GAO analyzed, the excise tax rate tax required to recapture tax benefits equaled or exceeded 20 percent in 73 percent of the cases; and (3) the then current maximum corporate tax rate of 34 percent, the excise tax rate required to recapture tax benefits equaled or exceeded 20 percent in 90 percent of the cases.

GAO noted that pension plans that primarily obtained their investment income from sources that would normally be subject to the maximum statutory tax rate, such as interest from corporate bonds, would require higher excise taxes to offset the tax benefits received. On the other hand, pension plans that mainly derived their income from sources normally subject to the capital gains tax rate (lower than the maximum statutory tax rate), such as stock price appreciation, would require lower excise taxes to offset the tax benefits received.

Summary of Related Action(s)

The Omnibus Budget Reconciliation Act of 1990 raised the excise tax rate to 20 percent.

Private Pensions: Spousal Consent Forms Hard to Read and Lack Important Information

GAO/HRD-90-20, 12/27/89

In compliance with the Retirement Equity Act of 1984, GAO examined the content and readability of certain government-required pension documents. GAO's work focused on whether the consent forms that spouses must sign (1) explain survivor benefits and the consequences of not selecting them and (2) present the information in a way that most people can understand. GAO's analyses and conclusions were based on a survey of administrators of 550 large pension plans and a review of 106 of their spousal consent forms.

GAO found that (1) 68 percent of the spousal consent forms served as retirement applications that listed the various payment options, including the joint and survivor annuity, and required the worker's signature while only one-fourth of the forms required the spouse's signature regardless of the option selected; and (2) companies did not offer formal counseling to workers in 40 percent of the plans and offered only some workers counseling in about 10 percent of the plans.

In addition, GAO found that (1) neither laws nor regulations stated the type of information employers were required to include in spousal consent forms; (2) only 40 percent of the consent forms reviewed included information about reductions in monthly benefits, the portion of benefits continuing to the surviving spouse, and the dollar amounts; (3) more than 40 percent of the forms did not explain the consequences of rejecting the joint and survivor annuity or explained them only partially; and (4) many of the forms had serious language problems, lacked organization and informative headings, lacked letter formatting instructions, and had design characteristics such as very long lines of type, that affected document readability and use.

Recommendation(s)

The Commissioner of Internal Revenue should issue guidance on the content of spousal consent forms. Specifically, IRS should require employers to provide consent forms that explain in nontechnical language the terms of the joint and survivor annuity, as well as other payment options, and the consequences of not selecting the annuity. This guidance should (1) state the spouse's monthly survivor benefit as a percentage of the retiree's monthly amount, (2) explain that the retired worker's monthly annuity will be less if the joint and survivor annuity is selected instead of the single-life annuity, (3) clearly communicate the consequences of rejecting this annuity, and (4) communicate the relative financial effect on a worker's pension benefit if this annuity is selected.

To help employers present this information in nontechnical language, IRS should develop model language for presenting information in the spousal consent form. IRS guidelines for these forms should consider issues of content, readability, and design.

Action(s) Taken and/or Pending

IRS has initiated a comprehensive review of existing spousal consent form requirements to improve the readability of the forms and develop model language as recommended by GAO. The review is expected to be completed in 1991.

Related GAO Product(s)

GAO/HRD-87-94BR, 08/12/87; GAO/HRD-88-31, 10/30/87; GAO/HRD-88-77, 07-11-88; GAO/HRD-89-105BR, 09/26/89; and GAO/HRD-90-4BR, 10/23/89

Taxation of Pension Income for Retired New Jersey Police and Firefighters

GAO/GGD-90-73BR, 04/13/90

In a report to Senators Bill Bradley and Frank R. Lautenberg, GAO reviewed (1) the fairness of actuarial tables IRS used to compute taxable pension income and (2) the feasibility of using an alternative approach that takes into account occupations and other factors. To do this GAO (1) compared the actuarial tables IRS used with tables for the general U.S. population and (2) estimated life expectancies for retired New Jersey police and firefighters.

GAO found that (1) the estimated life expectancies for New Jersey police and firefighters were the same as those of the general population but shorter than those in the IRS tables; (2) using estimates of New Jersey police and firefighters' life expectancies instead of IRS tables reduced taxable pension income during the initial years of retirement, followed by 1 or more years of increased taxable income; and (3) taxes paid over the period during which the retirees' contributions are recovered were the same despite the use of different tables—only the timing was affected.

GAO concluded that the small tax savings resulting from timing differences did not warrant a separate table of life expectancies for police and firefighters because (1) the life expectancies for New Jersey police and firefighters are essentially the same as those of the general population and (2) using separate tables could complicate tax administration, confuse taxpayers, and set precedents—other occupational and demographic groups may want their own tables. GAO said that IRS Publication 575, Pension and Annuity Income, failed to clarify when a simpler approach to calculating the taxable portion of pension income (called the simplified general rule) was to a retiree's advantage.

Recommendation(s)

The Commissioner of Internal Revenue should revise IRS Publication 575 to clarify that (1) it is always to the advantage of retirees whose employers cannot segregate the contributions they made before and after July 1986 to use the simplified general rule, and (2) use of the simplified general rule may or may not be to a retiree's advantage if contributions can be segregated.

Action(s) Taken and/or Pending

No action had been taken to revise Publication 575 as of December 31, 1990.

Federal Government's Oversight of Pension and Welfare Funds

GAO/T-HRD-90-37, 06/13/90

IRS and the Department of Labor are responsible for ensuring that government pension plans, with about $2 trillion in assets, and welfare benefit plans comply with ERISA. In testimony before the Subcommittee on Oversight of the House Committee on Ways and Means, GAO discussed (1) the effectiveness of federal oversight of employee benefit plans' compliance with ERISA and (2) the government's potential exposure to underfunded pension plans insured by the Pension Benefit Guaranty Corporation (PBGC).

GAO testified that IRS (1) had devoted significant resources to examining plans that posed no risk to the federal government's insurance program and had placed little emphasis on examining plans that were or might be underfunded; (2) was finding violations in far fewer examinations than it had expected because it was using outdated criteria to identify plans with characteristics that indicated a high potential for violations; and (3) had recently initiated a quality assurance program that, if properly implemented, could help ensure that examinations are thorough enough to identify ERISA violations.

GAO also testified that (1) the Department of Labor and IRS had made substantial progress in improving the quality and timeliness of plan annual report data essential to effectively identifying violations, and (2) the results of Labor's new enforcement strategy for investigating financial institutions and welfare plan service providers that it characterized as having high potential for fiduciary abuse were disappointing.

GAO said that (1) Labor's proposal to strengthen ERISA's independent audit requirements would improve ERISA oversight and enhance the security of participants' benefits, and (2) auditors should be required to review and report on plan management's assertions regarding the effectiveness of the plans' internal control structure and compliance with laws and regulations, in addition to reporting on the plans' financial statements.

Related GAO Product(s)

GAO/HRD-86-12, 10/21/85 and GAO/T-AFMD-90-25, 07/24/90

Audits of Employee Benefit Plans Need to Be Strengthened

GAO/T-AFMD-90-25, 07/24/90

In testimony before the Subcommittee on Labor, Senate Committee on Labor and Human Resources, GAO discussed the role that independent public accountants play in auditing employment plans covered by ERISA. Under ERISA, the Department of Labor requires that administrators of employee benefit plans with 100 or more participants hire an independent public accountant to audit the plans' financial statements. The administrators of these plans are required to submit reports on these audits to IRS.

GAO said that preliminary observations from several of its ongoing reviews in the ERISA area showed that the enforcement efforts of the Department of Labor and IRS, who are both responsible for enforcing ERISA, are not as effective as they could be. GAO said that IRS had increased its examinations of employee plan operations but placed little emphasis on plans that are or may be underfunded, thereby posing a risk to participants and PBGC, which is responsible for insuring certain plans. GAO also said that IRS found violations in far fewer examinations than expected because it used outdated criteria to identify plans with characteristics that indicated a high potential for ERISA violations.

Because of the limited coverage by Labor and IRS, GAO felt that additional measures were needed to adequately protect plan participants and PBGC against ERISA violations. GAO felt that such protection could be provided through strengthened audits by independent public accountants. GAO suggested several steps that could be taken toward that end.

Related GAO Product(s)

GAO/T-HRD-90-37, 06/13/90

Private Pensions: Impact of New Vesting Rules Similar for Women and Men

GAO/HRD-90-101, 08/21/90

Federal rules limit how long a participant must wait to be entitled to "vest" in pension benefits. The TRA reduced the maximum allowable vesting period from 10 to 5 years for most workers in qualified private pension plans. The change was made to better meet the needs of the many employees who change jobs frequently. Women, who tend to be more mobile employees, were identified as one group particularly disadvantaged by the old rules.

Pursuant to a requirement in the Retirement Equity Act of 1984, GAO estimated the impact of the new vesting rules on men and women participants. (GAO did not analyze top-heavy plans in which over 60 percent of the benefits or contributions go to company owners or other key employees.) GAO said that (1) the new rules would improve the vesting status of shorter-tenured workers with a similar effect on women and men, and (2) about three-fourths of all pension participants in 1986 would have been vested under the new rules; however, only half were vested under the old rules.

GAO estimated that (1) the new vesting rules would increase the value of vested benefits for 40 percent of the participants in defined benefit plans; (2) if the defined benefit plan participants with increased vested benefits under the new rules suddenly left their plans, they would be entitled to additional vested benefits equal to an average of 5 percent of their compensation; (3) the median annual gain in the dollar value of vested benefits for those affected by the new rules would be $1,240 in 1990 dollars; and (4) the additional vested benefits would amount to $1,987 for men and $980 for women. GAO said that the difference between men and women was generally due to the fact that the women in the analysis were younger than the men, and women usually start receiving their benefits later than men.

Related GAO Product(s)

GAO/HRD-86-118BR, 07/21/86; GAO/HRD-88-31, 10/30/87; GAO/PEMD-88-15BR, 03/29/88; GAO/PEMD-88-20FS, 04/29/88; GAO/HRD-89-105BR, 09/26/89; and GAO-HRD-90-4BR, 10/23/89

Pension Benefits: Processing of Applications by the Pension Benefit Guaranty Corporation

GAO/HRD-90-127, 09/25/90

In a report to Representative Claudine Schneider, GAO provided information on four benefit applications processed by PBGC. The applications were submitted by participants in pension plans for which PBGC assumed responsibility after the plans terminated with insufficient assets.

In two of the four cases reviewed, GAO found that PBGC had reversed its previous denials of benefits and was providing or planned to provide benefits to the affected participants. In the third case, GAO said that PBGC was correct in denying survivor benefits because at the time the plan terminated, ERISA did not require that survivor benefits be paid if the participant died before reaching the earliest retirement age.

In the fourth case, PBGC delayed providing benefits to participants in two plans because IRS took over a year to provide tax information PBGC needed. While PBGC said that such delays are common, it made no attempt to resolve the problems with IRS' National Office. After GAO brought the problems to the attention of IRS officials, IRS started actions to ensure that PBGC would receive the requested information within 90 days. These actions should help ensure that eligible participants receive the benefits due them as quickly as possible.

Social Security

Alternative Wage-Reporting Processes

GAO/HRD-90-35, 11/08/89

This report to the Chairman of the Subcommittee on Social Security, House Committee on Ways and Means, discussed alternatives to the current wage-reporting system—a system whose shortcomings GAO discussed in a September 1987 report. GAO found that (1) in millions of cases, wages reported to IRS differed from those reported to the Social Security Administration (SSA); and (2) these differences were not being reconciled, possibly resulting in lower Social Security benefits or underpaid Social Security taxes.

Under the current system, employers annually report wage data to SSA. SSA receives, processes, and uses the data to record earnings in workers' accounts and sends computer tapes of selected data to IRS. IRS compares the wage information provided by SSA with (1) aggregated quarterly tax information and (2) wages reported by individuals on their tax returns.

GAO examined three alternatives to the current wage-reporting system. The first alternative would make IRS, rather than SSA, responsible for receiving and processing earnings reports. The second alternative would make use of the Department of Labor's unemployment compensation earnings file to check the wage data submitted to IRS and SSA. The third alternative involved setting up a new wage-reporting entity that would receive and process wage data for IRS, SSA, and the states. GAO concluded that each alternative had advantages but none warranted changing the existing process in the near future. IRS and SSA were making changes that would likely improve the current system, the results of which would not be known before 1990 because of time lags associated with reporting, processing, and reconciling wage information. In addition, GAO said that a significant change in the way SSA provides workers with information about their earnings histories and future benefits would give workers a better opportunity to correct any discrepancies found in SSA's earnings reports.

Related GAO Product(s)

GAO/HRD-87-52, 09/18/87; GAO/T-HRD-88-02, 10/15/87; GAO/HRD-89-21, 10/14/88; GAO/T-HRD-88-29, 08/09/89; and GAO/HRD-90-11, 10/17/89

IRS Data Can Help SSA Credit More Wages

GAO/HRD-90-112, 08/31/90

SSA processes wage reports from employers and credits wages to workers' Social Security accounts. Proper credits are important because they determine a worker's eligibility for and amount of future Social Security benefits. If SSA cannot match identifying information on the wage report to an established account, SSA considers the report invalid and records the earnings in a suspense file, where they remain until crediting to a valid account is possible.

In a report to the Chairman of the House Committee on Ways and Means, GAO (1) provided statistics on the growth of SSA's suspense file over recent years and (2) discussed whether SSA could reduce the size of its suspense file by using information developed by IRS for tax compliance purposes.

GAO reported that (1) as of June 1989, about 178 million wage reports worth $138.4 billion of uncredited earnings were in SSA's suspense file; and (2) the file had grown by 24.2 million reports, or 16 percent, and $58.2 billion, or 73 percent, over the past 5 years.

GAO said that SSA could reduce the size of the suspense file and credit more workers' wages by using independently developed IRS data. IRS receives wage report information from SSA and uses that information to verify income reported on individual tax returns and to identify those who failed to file a tax return. IRS uses its own computerized techniques in an effort to resolve those wage reports that SSA identified as invalid.

GAO also said that (1) as of June 1989, IRS had resolved about 346,000 tax year 1987 wage reports, representing $2.1 billion in wages that SSA continued to carry in its suspense file; (2) it believed that SSA could immediately use IRS' resolutions to record the earnings on about 120,000 uncredited wage reports worth about $762 million in uncredited tax year 1987 earnings; and (3) SSA should, at a minimum, be able to use IRS' information as leads in resolving some of the 226,000 other uncredited wage reports.

Recommendation(s)

The Commissioners of Social Security and Internal Revenue should amend their existing agreement governing the exchange and use of tax information to provide for the routine sharing of IRS' wage report resolution data.

Action(s) Taken and/or Pending

In October 1990, SSA and IRS staffs completed their review of the current memorandum of understanding on Combined Annual Wage Reporting. The resulting proposed amended agreement, which incorporates the GAO recommendation, is expected to be signed by the Commissioners of Social Security and Internal Revenue in early 1991.

Taxing Nonqualified Deferred Compensation

GAO/HRD-90-82, 03/15/90 and GAO/T-HRD-90-21, 04/05/90

In a report to the Chairman of the Subcommittee on Social Security, House Committee on Ways and Means, and in testimony before that Subcommittee, GAO looked at whether self-employed taxpayers use deferred income arrangements that achieve similar income tax treatment as plans called "nonqualified deferred compensation plans" used by employers and employees. These nonqualified plans are basically employer promises to pay employees future benefits in return for current services. GAO also looked at how the imposition of the Social Security tax on employees using these kinds of plans differs from its imposition on self-employed taxpayers for similar types of income.

The Subcommittee's interest in this matter stemmed from section 3121(v)(2) of the Internal Revenue Code as enacted by the Social Security Amendments of 1983, which changed the Social Security tax treatment of nonqualified deferred income for employees, but did not make a similar change for comparably situated self-employed taxpayers.

GAO found that employees currently participating in nonqualified plans to defer income are subject to Social Security tax on the deferred amount in the year income is earned, whereas self-employed taxpayers who defer income through contractual arrangements with their customers or clients pay Social Security tax on the deferred amount in the year it is received.

GAO also noted that (1) self-employed taxpayers used contractual arrangements to defer income but probably not extensively; (2) the risks associated with collecting deferred income and tax prerequisites appeared to discourage use of such arrangements; (3) limited reporting on nonqualified plans precluded measurement of the effects of section 3121(v)(2) on Social Security revenues, but IRS and SSA believed the effect was minimal; (4) IRS officials believed that the section had complicated tax administration and that regulations on use of the provision were necessary; and (5) IRS had been unable to issue such regulations because of higher priority projects and problems in drafting the regulations.

Tax Policy

Allocation of Taxes Within the Life Insurance Industry

GAO/GGD-90-19, 10/19/89 and GAO/T-GGD-90-03, 10/19/89

In a report to the Chairmen of the Subcommittees on Health and Select Revenue Measures, House Committee on Ways and Means, and in testimony before the Select Revenue Measures Subcommittee, GAO discussed (1) the effect of section 809 of the Internal Revenue Code on the income tax split between stock and mutual life insurance companies and within the mutual segment itself and (2) alternative methods of taxing mutual life insurance companies. Congress enacted section 809 to make the taxation of mutual companies more parallel to that of stock companies.

GAO found that section 809 imposed taxes that (1) were higher for the mutual companies as a whole in years when their earnings were low, and vice versa; (2) were regressive on the basis of company income because averages for all Mutual companies dictated each firm's taxes; and (3) depended disproportionately on the behavior and performance of the larger mutual companies. GAO also found that for 1984 through 1987 the mutual stock split in taxes produced by the section 809 approach was consistent with the mutual stock split in income.

After examining various alternatives, GAO concluded that the most equitable approach would be to repeal section 809, allow mutual life insurance companies to deduct all policyholder dividends in determining corporate taxable income, and tax policyholders on the earnings part of certain dividends.

Recommendation(s)

Congress should repeal section 809 from the tax code and designate what portion of policyholder dividends paid by life insurance companies consists of distributed earnings. For administrative reasons, companies would pay the tax as a proxy for individual policyholders.

Action(s) Taken and/or Pending

GAO's proposal and a number of others have been part of the ongoing discussion about the tax treatment of mutual life insurance companies. At the end of the 101st Congress, no legislative action had been taken.

Related GAO Product(s)

GAO/GGD-88-88FS, 09/26/88 and GAO/T-GGD-88-54, 09/27/88

Tax-Exempt Bond Issuance Costs

GAO/GGD-90-9BR, 12/18/89

At the request of Congressman Brian Donnelly, GAO reviewed state and local governments' tax-exempt bond issuance costs and evaluated whether limiting those costs would affect the ability of state and local governments to issue bonds.

GAO found that issuance costs depend on the size of the bond issue. In 1985, for example, such costs ranged from 2.2 percent of bond proceeds for bond issues greater than $75 million to 4.1 percent for smaller bond issues between $10 and $25 million. GAO also found that bond underwriter spreads—the difference between the price the underwriter pays the issuer for the bonds and the price at which the underwriter sells the bonds to investors—comprised 48 to 88 percent of issuance costs, depending on issuance costs, and the spreads decreased by about 40 percent from 1982 to 1988.

GAO concluded that additional issuance cost limits did not seem justified because underwriting services were relatively competitive. Of the private activity bonds—those generally used by private rather than public sector entities—44 percent in 1985 and 37 percent in 1986 would have exceeded the proposed cost limits. The proposed issuance cost limits could reduce state and local governments' bond issuance capabilities unless bond issuers found ways to redistribute or reclassify bond issuance costs.

Tax Treatment of Life Insurance and Annuity Accrued Interest

GAO/GGD-90-31, 01/29/90

In a report to the Chairmen of the Senate Committee on Finance and the House Committee on Ways and Means, GAO responded to section 5014 of the Technical and Miscellaneous Revenue Act of 1988. Section 5014 called for GAO to report on (1) the effectiveness of the revised tax treatment of life insurance products in preventing the sale of life insurance primarily for investment purposes; and (2) policy justification for, and the practical implications of, the current tax treatment of earnings accruing on the cash surrender value of life insurance and annuity contracts in light of the Tax Reform Act of 1986 (TRA).

Under current law, the interest that is earned on life insurance and deferred annuity contracts, commonly referred to as "inside buildup", is not taxed as long as it accumulates within the contract. By choosing not to tax the interest as it is earned, the federal government forgoes an estimated $5 billion in tax revenue each year. Also, as a result of this preferential tax treatment, there are incentives to design life insurance and annuity products more targeted toward generating investment income than toward providing insurance protection.

GAO found that recent changes in the definition of life insurance had reduced the sales of single-premium policies but it is more difficult to evaluate the effect on other investment-oriented life insurance products.

GAO noted that the most convincing policy justification for the current tax treatment of accrued interest is that it lowers the cost of providing insurance and retirement income protection. Even if more is spent on life insurance and annuity protection as a result of this tax preference, it is not clear that the revenue loss is justified. In addition, although borrowing against the cash value of life insurance is not taxed, it reduces the protection afforded beneficiaries. As a result, the current tax treatment, which allows the borrowing of life insurance accrued interest without tax, appears inconsistent with (1) the goal of fostering increased protection and (2) the tax treatment of similar products, such as Individual Retirement Accounts and 401(k) plans.

Recommendation(s) to Congress

Because the pattern of policy usage as well as the type of products offered can change, Congress may wish to periodically reconsider its policy decision to grant preferential tax treatment to inside buildup, weighing the social benefits against the revenue forgone. If Congress decides not to tax inside buildup, it should eliminate tax-free borrowing of life insurance proceeds. Any borrowing of those proceeds should be considered a distribution of interest income. To offset the advantages of accruing interest income without tax, a penalty provision needs to be added to the regular tax. Since repayment of the amount borrowed restores the death benefits, any amount that is taxed when it is borrowed should be tax deductible if subsequently repaid.

Action(s) Taken and/or Pending

At the end of the 101st Congress, no legislative action had been taken.

Related GAO Product(s)

GAO/GGD-88-9BR, 10/16/87 and GAO/GGD-88-95, 06/14/88

Information on Timber Harvesting, Planting, Federal Assistance Programs, and Tax Provisions

GAO/T-RCED-90-45, 03/08/90 and GAO/RCED-90-107BR, 04/13/90

In testimony before the House Committee on Ways and Means and in a briefing report to Congressman Sander M. Levin, GAO discussed timber harvesting and planting, federal timber assistance programs, and federal tax laws specifically affecting the timber industry.

GAO noted that (1) various tax code provisions affect the industry's calculation of taxable income and (2) according to the Joint Committee on Taxation estimates, two such provisions affecting the industry's calculation of taxable income reduced federal revenues by $460 million annually. The two provisions involved amortizing reforestation expenses and the related investment tax credit and allowing the deduction of timber growing expenses after establishing a stand of trees rather than capitalizing the expenses.

GAO also noted that (1) timber harvesting nationally increased 4 percent from 1986 to 1988 while tree planting and seeding increased 23 percent over the same period; (2) most of the increase in national tree planting and seeding resulted from three major Department of Agriculture financial assistance programs for plantings by small landowners; and (3) the Forest Service projected that although timber harvesting will increase by over 55 percent over the next 50 years, industry employment will drop by about 27 percent chiefly because of labor productivity gains.

Summary of Related Action(s)

Although the House-passed version of the Omnibus Budget Reconciliation Act of 1990 contained a preferential capital gains tax rate for timber income, the enacted version did not.

Related GAO Product(s)

GAO/GGD-87-77FS, 06/03/87

Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income

GAO/GGD-90-35, 03/26/90

TRA repealed the tax deferral of foreign-earned shipping income. Until that repeal, shipping income earned outside the United States and reinvested in shipping assets could be excluded from income subject to taxation in the year earned. In response to a request from the Chairman of the Subcommittee on Seapower and Strategic and Critical Materials, House Committee on Armed Services, GAO reviewed the effects of that repeal on the availability of merchant ships planned for use in national emergencies.

GAO reported that (1) since the passage of TRA, a higher percentage of foreign-based shipping income has been subject to immediate taxation; (2) from the available tax data, GAO could not determine the amount of tax revenue generated from foreign-earned shipping; and (3) tax revenues may have fallen in 1987 compared with 1984 due to lower corporate tax rates and a decline in reported foreign-earned shipping profits. Department of Defense, Maritime Administration, and industry representatives said that tax changes could accelerate the decline in the number of U.S.-owned foreign flag ships and adversely affect the military's plan to use some of these ships in wartime. GAO said that other factors, such as the small average tax burden relative to other ship operating costs and companies' ability to find other ways to offset taxable income, suggested that tax changes would not necessarily lead to significantly fewer ships.

GAO reported that (1) it found no evidence that the deferral's repeal had affected the number of U.S.-owned foreign flag ships to date and (2) although the military planned to use 124 of the 328 U.S.-owned foreign flag ships for wartime sealift, there were unresolved issues regarding those ships' wartime availability. Specifically, the United States' legal right to demand civilian vessels for military use may not extend to ships owned by U.S. corporations' foreign subsidiaries, and the foreign country may have the right to control those ships.

Summary of Related Action(s)

On the basis of GAO's concern that the United States may not have clear legal authority to use U.S.-owned foreign flag merchant ships in wartime, the Director of the Navy's Strategic Sealift Division arranged for written approval from Liberian maritime authorities for the U.S. right to demand all 159 U.S.-owned merchant vessels flagged in Liberia for military use.

1987 Company Effective Tax Rates Higher Than in Prior Years

GAO/GGD-90-69, 05/10/90

In a report to Congressmen Don J. Pease and Byron L. Dorgan, GAO reviewed the overall domestic and worldwide tax burdens of large U.S. companies for 1986 and 1987.

GAO reported that (1) the U.S. companies included in its study had higher U.S. and worldwide effective tax rates in 1987 than in 1986 or in the years examined in earlier studies by staff of the Joint Committee on Taxation; (2) the U.S. rate was 28 percent in 1987 versus 19 percent in 1986 while the worldwide rate was 36 percent in 1987 versus 28 percent in 1986; and (3) these increases in effective tax rates appear consistent with the intent of the changes introduced in the TRA, which reduced or eliminated many tax benefits, such as the lower rate for long-term capital gains and the elimination of the investment tax credit. GAO noted, however, that a comprehensive evaluation of the Tax Reform Act should be done on the basis of more than 1 year of data because effective tax rates for particular companies can fluctuate from year to year.

GAO found that nearly 19 percent of the companies and 7 percent of the industry groups had U.S. effective tax rates below 10 percent in 1987 while 20 percent of the companies and 17 percent of the industry groups had rates above 40 percent. In an attempt to explain these very low and very high effective rates, GAO examined the importance of timing and permanent differences. Timing differences result from transactions, such as accelerated depreciation and pension deferrals, that are recognized for financial statement purposes in one reporting period and for tax purposes in another period. Permanent differences result because some financial income items are not taxable and some deductions on financial statements are not allowable for tax purposes.

GAO (1) determined that the high and low U.S. effective tax rates for 38 of the 63 companies in 1986 and 34 of the 71 companies in 1987 resulted from timing differences, (2) could not determine the impact of permanent differences on U.S. rates because the information on financial statements did not lend itself to such a determination, and (3) determined that the combination of timing and permanent differences explained the high and low worldwide effective rates in 47 of 64 companies in 1986 and 57 of 80 companies in 1987.

Related GAO Product(s)

GAO/GGD-90-75, 07/23/90

Nonprofit Hospitals: Better Standards Needed for Tax Exemption

GAO/HRD-90-84, 05/30/90 and GAO/T-HRD-90-45, 06/28/90

In a report to and testimony before the House Select Committee on Aging, GAO discussed the role of nonprofit hospitals in providing (1) acute medical care to indigents and (2) other community services, such as health education and screening. Private nonprofit hospitals, which account for about one-half of the nation's hospitals, are exempt from federal taxation if they meet certain tests established by IRS. Until 1969 the test for tax-exempt status included specific reference to providing services to those unable to pay. Since then, IRS has not required such care as long as the hospital provides benefits to the community in other ways.

GAO analyzed the distribution of uncompensated care among hospitals in five states to assess the role of nonprofit hospitals in supplying such care. GAO found that (1) nonprofit hospitals provided a smaller share of their states' uncompensated care than they provided of general hospital services; (2) uncompensated care expenses were not distributed equally among the nonprofit hospitals but were disproportionately concentrated in large urban teaching hospitals; (3) among the rest of the nonprofit hospitals, the tendency was for those hospitals with the greatest ability to finance charity care to have the lowest rates of uncompensated care; and (4) about 57 percent of the nonprofit hospitals in the five states incurred charity care costs that amounted to less than GAO's estimate of the value of the hospitals' tax exemptions.

GAO noted that (1) some hospitals' goals did not focus on the health needs of the poor or underserved in their community, (2) physician staffing and charity admissions policies discouraged indigent admissions except in emergency cases, and (3) nonprofit hospitals were more likely than investor-owned hospitals to offer community services but were equally likely to charge patients for them and more likely to recover their costs.

Recommendation(s)

Currently, there are no requirements relating hospitals' charitable activities for the poor to tax-exempt status. If Congress wishes to encourage nonprofit hospitals to provide charity care to the poor and underserved and other community services, it should consider revising the criteria for tax exemption. Criteria for exemption could be directly linked to a certain level of (1) care provided to Medicaid patients, (2) free care provided to the poor, or (3) efforts to improve the health status of underserved portions of the community.

Action(s) Taken and/or Pending

The Chairman of the House Select Committee on Aging introduced H.R. 5686, "The Charity Care and Hospital Tax-Exempt Status Reform Act of 1990," which makes charity care the basis of federal tax exemption and sets charity care criteria for individual hospitals. The bill would require tax-exempt hospitals to serve Medicare and Medicaid patients and a "reasonable" number of charity patients in proportion to each hospital's size. A deficient hospital would lose its tax exemption or pay an excise tax that would be earmarked to assist states in financing charity care. At the end of the 101st Congress, no further action had been taken on the bill.

IRS is developing procedures for coordinated examinations of hospitals and is revising its examination guidelines.

Additional Petroleum Production Tax Incentives Are of Questionable Merit

GAO/GGD-90-75, 07/23/90

In a report to the Chairman of the Subcommittee on Energy and Power, House Committee on Energy and Commerce, GAO provided information on (1) the effects of additional tax incentives on petroleum production and federal revenues, (2) the federal tax burden on new domestic petroleum production investments under current law, and (3) the comparative tax treatment of petroleum production investments in the United States and other nations.

GAO noted that (1) additional federal tax incentives for petroleum investments would probably increase U.S. petroleum production to a limited extent, citing two incentives proposed in the administration's 1991 budget that would increase U.S. petroleum production by a total of 0.2 to 0.3 percent; (2) the increased production would come at the expense of substantial per barrel revenue losses, which GAO estimated could be $3 to $14 for each barrel of additional production resulting from these two proposals; and (3) other policies, such as filling the Strategic Petroleum Reserve (U.S. oil reserves available for use in an energy emergency) might be more effective for increasing U.S. energy security.

GAO's analysis and other recent studies of effective tax rates for new investments showed that (1) additional incentives would further contribute to a federal tax system that already favors petroleum production investments over those in most other industries, (2) some proposed incentives would also further favor certain types of petroleum production investments and categories of producers over others, and (3) the favorable tax treatments received by the industry as a whole and by certain activities within the industry both provide incentives for relatively inefficient investments within the industry.

GAO reported that (1) U.S. producers were making petroleum production investments abroad, rather than in their own country, largely due to factors other than taxes, such as the decline in oil prices and generally more favorable foreign geological characteristics, including lower finding and development costs; and (2) some foreign governments had eased their tax and royalty treatment of petroleum production in response to lower petroleum prices, thereby creating even more potential incentive for investing abroad.

Matter(s) for Congressional Consideration

Before approving additional tax incentives for petroleum investments, Congress should weigh carefully their costs and benefits. GAO believes that providing additional tax incentives is not the most effective method of providing significant increases in U.S. energy security. In addition, GAO said that where the incentives benefit certain types of activities and classes of producers that already receive relatively favorable tax treatment, they tend to encourage relatively inefficient investments.

Action(s) Taken and/or Pending

In its deliberations of the Omnibus Budget Reconciliation Act of 1990, Congress considered a number of petroleum tax incentives discussed in the GAO report. Despite GAO's reservations, the act (1) included a 15 percent tax credit for enhanced oil recovery, (2) eased the rules on taking percentage depletion, and (3) reduced the degree to which intangible drilling costs and percentage depletion allowances are subject to the alternative minimum tax.

Related GAO Product(s)

GAO/RCED-87-204FS, 09/29/87; GAO/RCED-88-170, 08/31/88; GAO/AFMD-89-52, 08/24/89; GAO/T-RCED-90-12, 11/08/89; and GAO/GGD-90-69, 05/10/90

Federal Tax Deposit Requirements Should Be Simplified

GAO/GGD-90-102, 07/31/90

In a report to the Secretary of the Treasury, GAO discussed (1) the results of its evaluation of federal tax deposit requirements for withheld income and Social Security taxes and (2) IRS' administration of the penalty assessed against taxpayers who do not make sufficient and timely deposits. Employers who withhold income and Social Security taxes are required to deposit these employment taxes under the Federal Tax Deposit System using the Federal Deposit Coupon. In fiscal year 1988 about 5 million employers made over 73 million deposits totalling $627 billion in employment taxes. About 32 percent of these employers were penalized over $2.6 billion for not making timely deposits.

GAO found that (1) frequency of deposits and when they are due is determined by the amount of employment taxes withheld by employers each payday and how often paydays occur, and (2) deposit requirements are complex and difficult to understand because employers can be subject to more than one deposit requirement during a tax period and because the exceptions to the requirements can be confusing.

GAO said that (1) deposit requirements were established with different deposit frequencies to give small employers more time to pay their employment taxes while ensuring a constant flow of funds for government operations by having larger employers remit their taxes more frequently, and (2) the complexities inherent in the requirements have made it more difficult for small employers to comply.

GAO noted that the complexities of the system also made it difficult for IRS to administer the penalty. For example, in 44 percent of the cases GAO examined, IRS tax examiners miscalculated the flat rate penalty because in most cases they did not properly apply the deposit requirements. In addition, 1988 IRS data showed that IRS assessed over 300,000 computer-generated deposit penalties totalling $324 million even though IRS did not have information on the deposit period to which a specific deposit applied. As a result, many of these penalty calculations were wrong.

Recommendation(s)

To make it easier for employers to understand and comply with the deposit requirements and for IRS to administer them, the Secretary of the Treasury should change the deposit requirements so that all employers are required to make employment tax deposits within some specific time interval each payday. Requiring all deposits to be made within 3 banking days of a payday would be fairly consistent with current deposit requirements and familiar to most employers. This change should include the repeal of various exceptions to the requirements but not affect the statutory deposit requirements contained in the Omnibus Budget Reconciliation Act of 1989. That act required employers with employment tax liabilities of $100,000 or more each payday to make deposits within 1 banking day beginning August 1, 1990.

If an exception is granted to this standard deposit requirement to reduce the number of deposits made by small employers, a single exception should be provided to minimize confusion and administrative burdens. One option that could be considered is establishing a threshold of $30,000 in tax deposits per quarter because it covers 89 percent of the employers but only 12 percent of the employment tax revenues.

The requirements should include a look-back procedure, which would allow employers to know what their deposit requirement will be even before the start of the quarter. This procedure, which should be adopted even if the deposit requirements are not changed, should also apply to employers required by the 1989 act to deposit employment taxes within 1 banking day of each payday.

To improve employers' compliance with current deposit requirements and IRS' administration of the deposit penalty the Commissioner of Internal Revenue should (1) modify the coupon used to make federal tax deposits by having employers indicate the specific deposit period to which the deposit applies, (2) clarify IRS' guidance to employers on the deposit requirements and instructions for completing the Quarterly Federal Tax Return (Form 941), and (3) require all service centers to use computer programs to calculate the deposit penalty.

Action(s) Taken and/or Pending

Treasury, at first, did not agree that deposit requirements should be simplified. In later discussions with GAO, however, Treasury changed its mind and approved a notice IRS issued requesting public comments on replacing the current system with a less complex deposit system, such as the one discussed in the GAO report.

IRS said that while it would take action on the GAO recommendation, it would consider an alternative to modifying the Federal Tax Deposit Coupon by requiring that deposits be applied in deposit date order against the oldest periodic liability first, rather than having employers indicate the specific deposit period, as GAO suggested. GAO disagrees with the alternative because it could lead to penalties that exceed the amount intended by Congress. As of December 31, 1990, the issue had not been resolved.

Related GAO Product(s)

GAO/GGD-87-86, 07/02/87

Taxpayer Service

Monitoring the Accuracy and Administration of IRS' 1989 Test Call Survey

GAO/GGD-90-36, 01/04/90 and GAO/GGD-90-37, 01/04/90

In response to requests from the Chairmen of the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, and the Subcommittee on Oversight, House Committee on Ways and Means, GAO evaluated IRS' administration of the Integrated Test Call Survey System during the 1989 tax return filing season. The system measures the quality of service provided taxpayers through the toll-free telephone assistance program.

GAO reported that (1) its independent scoring of 577 random test calls during the 1989 filing season indicated a 67-percent accuracy rate; (2) IRS calculated an overall accuracy rate of 63 percent in its national sample of 14,876 test calls; and (3) with few exceptions, IRS' test callers asked test questions in a fair manner and scored telephone assistors' responses objectively and accurately. GAO noted that (1) the criteria it had used in scoring an assistor's response as correct were those on which GAO and IRS had mutually agreed; (2) during the 1989 filing season, however, IRS had reported accuracy rates that were based on more liberal scoring criteria with which GAO did not agree; and (3) for the 1990 tax filing season, IRS planned to report system accuracy rates that were based on scoring criteria mutually agreed upon by GAO and IRS.

GAO concluded that the Integrated Test Call Survey System, with periodic oversight, could be used as the principal monitor of the performance of IRS' telephone assistors.

Related GAO Product(s)

GAO/GGD-89-30, 02/02/89; GAO/T-GGD-89-13, 03/15/89; GAO/T-GGD-89-12, 03/16/89; and GAO/T-GGD-90-26, 03/22/90

IRS Needs to Improve Distribution of Tax Materials to the Public

GAO/GGD-90-34, 01/10/90

In response to a request from the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO assessed the availability of tax materials at IRS distribution centers and walk-in offices during the 1989 tax return filing season.

Between late January and mid-April 1989, GAO visited 60 walk-in sites in 13 states and checked for the 79 items each site was required to stock and for a sample of optional items each site chose to stock. GAO found that (1) 18 of 24 walk-in sites visited early in the filing season (before February 12) were missing an average of 15 percent of the 79 required items and an average of 22 percent of the optional items; (2) availability improved later in the filing season—only 4 of the 36 sites visited after February 12 were missing at least 10 percent of the forms and publications; and (3) the tax materials most frequently missing at the sites visited were publications dealing with the supplemental Medicare premium, tax rules for children and dependents, pension and annuity income, and individual retirement arrangements.

GAO also found that tax materials were not always available at the walk-in sites because of (1) late deliveries from printers, (2) untimely shipments from the distribution centers, (3) the failure to automatically ship required items to the walk-in sites, and (4) inadequate inventory management at the sites. GAO also found that less than 50 percent of site inventory control personnel received IRS' inventory management training, and trained personnel did not always follow the procedures.

GAO placed 223 telephone and mail orders to IRS' three central distribution centers. GAO (1) received 80 percent of the 2,206 forms and publications it ordered by mail or telephone, (2) often did not receive the required explanation for missing items, and (3) found out through subsequent follow-up that many of the explanations it did receive were inadequate. IRS attributed these problems to processing errors, lost orders, and the fact that GAO's orders were different from the typical orders handled by the distribution centers and thus were probably more susceptible to error.

Recommendation(s)

IRS should

- make initial shipments of tax materials to walk-in sites within 48 hours of their receipt at the distribution centers,
- automatically include all required tax items in the initial shipments to each walk-in site,
- train all walk-in site personnel responsible for tax material inventories in reordering procedures and inventory management techniques and monitor walk-in site operations to make sure the procedures and techniques are implemented, and
- supplement the distribution centers' quality reviews to specifically assess performance on orders in which errors are most likely to occur.

Action(s) Taken and/or Pending

During the 1990 filing season, IRS (1) made faster initial shipments to walk-in sites, (2) automatically shipped all required items to each walk-in site, (3) did a better job training walk-in site staff and monitoring site inventory levels, and (4) increased quality reviews at the distribution centers.

Related GAO Product(s)

GAO/T-GGD-88-13, 02/23/88; GAO/GGD-89-2, 11/14/88; and GAO/T-GGD-90-26, 03/22/90

Other

Puerto Rico: Background Information on Applicable Federal Legislation, Its Governmental Structure, and Its Finances

GAO/T-HRD-90-07, 11/15/89 and GAO/HRD-90-70BR, 03/07/90

In testimony before the Senate Committee on Finance and in a report to the Chairman of the Subcommittee on Insular and International Affairs, House Committee on Interior and Insular Affairs, GAO provided information to assist Congress in its deliberations on the future political status of Puerto Rico.

GAO said that (1) federal spending totals about one-third of Puerto Rico's $18 billion gross national product; (2) islanders and U.S. corporations doing business in Puerto Rico are exempt from federal income taxes; (3) the U.S. Treasury would have received an estimated $2.4 billion in 1983 if Puerto Rico was federally taxed; and (4) federal funding for Puerto Rico's Adult Assistance, Nutrition Assistance, and Aid to Families with Dependent Children programs is capped and benefits are lower than comparable state programs.

GAO also said that Puerto Rico's (1) central government is its largest employer at 23 percent of the workforce compared to 7 percent for the 50 states, (2) municipalities provide fewer services and rely more heavily on the central government than U.S. localities, (3) public corporations provide more services than similar state enterprises, and (4) public debt is higher than the states' average and is largely attributable to its public corporations.

GAO noted that (1) although 24 percent of Puerto Rico's revenues are attained through federal assistance, the effect political independence would have on revenues is unclear; (2) an independent status would create new defense, postal, and other expenditure demands; and (3) statehood status could increase previously capped benefit program expenditures.

Related GAO Product(s)

GAO/GGD-81-48, 03/02/81; GAO/HRD-87-60, 09/05/87; and GAO/HRD-89-104FS, 08/09/89

Department of Justice's Response to Requests for Court Tax Decisions

GAO/GGD-90-29FS, 12/13/89

GAO provided information to the Chairman of the Subcommittee on Government Information, Justice and Agriculture, House Committee on Government Operations, on the Department of Justice's costs to provide copies of court decisions on tax matters, as required under the Freedom of Information Act.

In response to a Supreme Court decision, Justice had to make district court tax decisions available to requesters. To meet that requirement Justice set up a central reading room that was open to the public twice weekly. The estimated annual costs to operate the reading room included $7,500 for rental space, $6,000 for copies provided, $6,000 for the room monitor's salary and benefits, and $4,000 for incidentals. Revenues generated from making copies represented less than a third of the annual costs to operate the reading room.

Government Financial Vulnerability: 14 Areas Needing Special Review

GAO/OCG-90-01, 01/23/90

In response to requests from the Chairmen of the Senate Committee on Governmental Affairs and the House Committee on Ways and Means, GAO described its planned special audits of 14 federal programs, including IRS' accounts receivable program, which GAO believed to be particularly vulnerable to mismanagement, fraud, abuse, or major losses of funds due to poor internal control and financial management systems.

With respect to accounts receivable, GAO reported that (1) receivables were in excess of $60 billion and had grown about 300 percent since 1980, and (2) the potential for reducing or stabilizing the growth rate offered major dollar savings and therefore warranted special review and oversight.

Related GAO Product(s)

GAO/T-AFMD-90-09, 11/29/89; GAO/T-GGD-90-19, 02/20/90; GAO/GGD-90-111FS, 07/30/90; and GAO/T-GGD-90-60, 08/01/90

1989 Annual Report on GAO's Tax-Related Work

GAO/GGD-90-46, 03/16/90

This report was prepared in compliance with a legislative requirement and contains information on GAO's tax policy and administration-related work during fiscal year 1989. It includes (1) summaries of tax-related products issued in fiscal year 1989, (2) summaries of tax-related products issued before fiscal year 1989 with open recommendations to Congress, (3) descriptions of legislative actions taken in fiscal year 1989 in response to GAO recommendations, (4) a list of recommendations to Congress that were open as of September 30, 1989, (5) a list of recommendations GAO made in fiscal year 1989 to the Commissioner of Internal Revenue, and (6) brief descriptions of assignments for which GAO was authorized access to tax data in fiscal year 1989.

GAO reported that (1) IRS had taken, or planned to take, action on most of the tax-related recommendations GAO made during fiscal year 1989; and (2) congressional committees and members of Congress used GAO products in overseeing tax administration operations, considering tax policy issues, and enacting legislation.

Credit Management: Deteriorating Credit Picture Emphasizes Importance of OMB's Nine-Point Program

GAO/AFMD-90-12, 04/16/90

At the request of Congressman John R. Kasich, GAO reviewed the efforts of selected federal agencies, including IRS, to implement the Office of Management and Budget's (OMB) nine-point credit management program. That program's nine points include such things as (1) screening loan applicants, (2) reporting to consumer reporting agencies, (3) using collection firms, (4) offsetting federal income tax refunds, and (5) writing off delinquent debts. GAO focused on selected programs at the five primary credit agencies—the Small Business Administration and the Departments of Agriculture, Housing and Urban Development (HUD), Education, and Veterans Affairs.

GAO noted the progress agencies had made over the past several years in certain credit management areas and cited a number of problems. Among them were that agencies were not always (1) checking if loan applicants were delinquent in paying taxes or (2) reporting closed-out debts to IRS as income to the debtor.

Recommendation(s) to Congress

Because of the magnitude of the government's credit management problems, Congress should amend the Debt Collection Act in a number of ways. The tax-related changes should be used to (1) screen loan applicants to determine credit worthiness and ability to repay and determine if the applicants owe delinquent debts to the federal government, including IRS; (2) deny credit to applicants who owe delinquent debts to the federal government; (3) refer all appropriate debts to IRS for the purpose of offsetting delinquent debtors' tax refunds; and (4) report closed out debts to IRS as income to the debtor.

Congress should legislatively direct the Secretaries of Housing and Urban Development and Veterans Affairs and the Administrators of the Farmers Home and Small Business Administrations, in coordination with IRS, to test the use of consent forms for obtaining and using tax information in the loan making process. The affected agencies could designate selected programs, including those with guaranteed loans, for participation in the test.

Recommendation(s) to Federal Agencies

GAO made numerous recommendations to various federal agencies. Those relating to IRS were as follows:

- To improve loan origination procedures, the Director, OMB, and the Secretary of the Treasury, in conjunction with IRS and affected agencies, should resolve impediments to screening loan applicants against delinquent tax accounts.
- To improve debt collection and appropriately write off uncollectible accounts, (1) the Secretary of Education should require the guaranty agencies to temporarily assign delinquent accounts to Education so that those accounts can be referred by Education to IRS for federal income tax refund offset and (2) the Secretary of Housing and Urban Development and the Administrators of the Small Business Administration and the Farmers Home Administration (for its Rural Housing loans) should report closed-out accounts to IRS as income to the debtor.

Action(s) Taken and/or Pending

Although Congress has not yet acted on GAO's recommendations, the Chairman of the Senate Committee on Governmental Affairs has expressed an interest in pursuing legislation to improve management and oversight of the government's guaranteed loan programs. The need for credit management legislation was addressed during hearings before the Senate Committee on Governmental Affairs on September 18, 1990, and the Chairman plans to hold additional hearings on this subject in the spring of 1991.

Regarding the IRS-related recommendations, the following actions have been taken or planned:

- The President's Economic Policy Council Working Group on Federal Credit Policy, which is made up of high-level officials of each of the federal credit agencies, is studying the need for legislation to resolve the impediments to screening loan applicants against IRS' delinquent tax accounts.
- In March 1990, the Department of Education advised guarantee agencies to fully participate in IRS' Tax Refund Offset Program.
- In 1990, both the Small Business Administration and the Farmers Home Administration began reporting closed-out accounts to IRS as income to the debtor. HUD plans to begin reporting closed-out single family accounts at the end of tax year 1990.

Related GAO Product(s)

GAO/RCED-85-04, 05/13/85; GAO/AFMD-86-39, 05/23/86; GAO/AFMD-86-79, 09/25/86; GAO/RCED-87-13BR, 11/12/86; GAO/AFMD-88-24, 02/19/88; GAO/RCED-88-134BR, 05/20/88; GAO/RCED-88-214FS, 09/21/88; GAO/RCED-89-33BR, 10/18/88; GAO/OCG-89-7TR, 11/88; GAO/OCG-89-12TR, 11/88; GAO/AFMD-89-19, 01/11/89; GAO/RCED-89-9, 02/14/89; GAO/AFMD-89-26BR, 05/05/89; GAO/AFMD-89-69, 09/15/89; GAO/T-AFMD-89-17, 09/27/89; GAO/T-RCED-90-17, 11/16/89; GAO/HRD-88-52BR, 01/07/90; GAO/AFMD-90-37, 01/25/90; and GAO/AFMD-90-29, 09/18/90

Summaries of Tax-Related Products Issued Before Fiscal Year 1990 With Open Recommendations to Congress as of December 31, 1990

Congress Should Consider Alternatives to Increase Gas Guzzler Tax Compliance

GAO/GGD-87-85, 07/16/87

In a report to the Joint Committee on Taxation, GAO (1) discussed the need for improving taxpayer compliance with the gas guzzler excise tax, (2) evaluated IRS' efforts to enforce the tax, and (3) identified methods for improving taxpayer compliance.

The gas guzzler excise tax, enacted in 1978, applies to domestic and imported cars manufactured after 1979 that weigh 6,000 pounds or less and do not satisfy specified miles-per-gallon ratings. To measure compliance with the tax, GAO randomly sampled gas guzzler vehicles imported through four U.S. customs districts that accounted for about 80 percent of the independent imports from November 1983 through November 1984. Independent importers are those who import vehicles that have been manufactured for the foreign market and generally need to be modified to meet U.S. emissions and safety standards.

GAO found that (1) less than 1 percent of the independent importers paid the gas guzzler tax and (2) this noncompliance resulted in lost tax revenues of over $6 million. The Internal Revenue Service (IRS) believed that the primary reasons independent importers did not pay the tax, besides intentional tax evasion, were that (1) many liable taxpayers were unaware of the tax and (2) some importers who were aware of the tax did not believe that it applied to them.

GAO concluded that (1) although IRS has taken actions to enforce the tax, more needed to be done and (2) achieving a more acceptable compliance level could require additional resources or a diversion of scarce IRS resources from other IRS activities.

Recommendation(s)

As alternatives for collecting the tax more efficiently with a limited IRS resource commitment, Congress should consider (1) amending Internal Revenue Code section 4064, "Gas Guzzler Tax," to require importers to pay the tax to Customs at the time fuel-inefficient vehicles are imported or (2) amending the bonding requirement for independent importers to require proof of payment of the gas guzzler tax before the bond is released.

Action(s) Taken and/or Pending

Although no legislative action has been taken on this particular proposal, the Omnibus Budget Reconciliation Act of 1990 made it more expensive to buy a car that is fuel inefficient by doubling the excise tax imposed on gas-guzzling cars sold after December 31, 1990.

Related GAO Product(s)

GAO/RCED-87-29, 12/11/86

Congress Should Revise the Internal Revenue Code to Reduce the Level of Proof Needed to Apply the Penalty for Aiding and Abetting Tax Shelter Abuses

GAO/GGD-88-69, 07/25/88

In response to a request from the Joint Committee on Taxation, GAO examined IRS' legislatively mandated efforts to curtail abusive tax shelters.

Among other things, GAO found that (1) although Congress raised the penalty to deter promotion and sale of abusive tax shelters from 10 percent to 20 percent of the gross income derived or to be derived from the shelter, promoters continued to have financial incentives for promoting abusive shelters; and (2) although IRS assessed some penalties for persons who knowingly aided or abetted tax shelter abuses, it could have assessed more penalties if the law required a lesser burden of proof.

Recommendation(s)

To reduce the financial incentive for promoting abusive tax shelters and ensure that all abusive shelters are subject to penalty for aiding and abetting, GAO recommended that Congress modify

- Internal Revenue Code section 6700 to significantly increase the penalty above the then current 20 percent of gross income derived, or to be derived, by any party involved in promoting or selling an abusive shelter; and
- Internal Revenue Code section 6701 to reduce the level of proof from knowingly to "knows or reasonably should have known" that the investor would understate tax liability.

Action(s) Taken and/or Pending

The Omnibus Budget Reconciliation Act of 1989, enacted on December 19, 1989, among other things, revised section 6700 of the Internal Revenue Code by changing the penalty to the lesser of $1,000 or 100 percent of the gross income derived, or to be derived, from the promotion of an abusive tax shelter. However, even with the change, financial incentives remain that could encourage additional abusive tax shelters, as promoters can retain income from the promotion of the abusive tax shelter in excess of $1000.

The act also revised a part of section 6701 of the Code, but not the part that would have to be revised to implement GAO's recommendation. Section 6701 still says that a person must know that an understatement of liability would result.

Related GAO Product(s)

GAO/GGD-89-81, 09/06/89

Congress Should Require IRS to Include in Its Annual Budget Submission Information on Actual Revenues Derived From Audits

GAO/GGD-88-119, 08/08/88

In response to a request from the Chairman of the Senate Committee on the Budget, GAO addressed the following two questions: (1) Can Congress rely on IRS' estimates of examination yield? and (2) Were the expected results of an increase in examination staff in 1987 realized? For fiscal year 1987 Congress had provided IRS funds to add 2,500 examination staff—an increase that IRS said would enable it to audit 120,000 more returns and assess, as a result of those audits, $829 million in additional taxes, penalties, and interest.

GAO said that future estimates of revenues to be gained from audits would be more reliable if IRS used more realistic assumptions. GAO cited as unrealistic, for example, IRS' assumption that data on the results of audits closed in 1972 were still reliable. IRS used that same outdated data to compute the "actual" assessed amounts shown in its budgets, but did not disclose in those budgets that the "actuals" were only estimates.

With respect to the yield realized as a result of the staffing increase authorized for fiscal year 1987, GAO noted that (1) IRS estimated the yield to be $847.5 million in assessed taxes, penalties, and interest even though it did not achieve the examination staffing levels authorized for fiscal year 1987 and did fewer audits than anticipated; and (2) IRS' estimate was significantly overstated because, among other things, IRS failed to take into account the amount of potential revenue lost because experienced examination staff were used to train and coach new staff and thus were unavailable to audit returns.

Recommendation(s)

Congress should consider requiring IRS to include in its annual budget submission information on the actual amount of revenues derived from its audits.

Action(s) Taken and/or Pending

No steps have yet been taken to require the inclusion of information on actual revenues in IRS' budget, primarily because IRS has yet to devise a methodology for generating such information. IRS has an ongoing effort directed at developing an integrated enforcement management information system that will eventually provide data on the actual revenues generated by its enforcement efforts. IRS expects to implement that system in phases, with the final phase scheduled to be operational by October 1, 1993.

Since it did not have data on actual results, IRS revised the wording in its budget requests for fiscal year 1990 and 1991 to make it clear that its examination yield figures are actually estimates. IRS also revised its estimating methodology for use in projecting the revenues associated with the examination staffing increase authorized for fiscal year 1991. GAO's assessment of that revised methodology is summarized on page 39.

Related GAO Product(s)

GAO/GGD-88-16, 12/02/87; GAO/GGD-90-77, 04/06/90; GAO/GGD-90-85, 06/20/90; and GAO/GGD-90-119, 09/05/90

Congress Should Revise the Reporting Requirements to Better Assess the Effects of Section 127 of the Internal Revenue Code Dealing With Employer-Provided Education Assistance

GAO/GGD-89-76, 06/23/89

In a report to Congressman Frank Guarini, GAO (1) evaluated data that Treasury used to assess the effect of section 127 of the Internal Revenue Code and (2) assessed the availability and reliability of certain information relating to section 127. This section allows individuals to exclude from their gross income the value of educational assistance provided by an employer through an employee educational assistance program.

In June 1988, Treasury concluded that section 127, which was due to expire on December 31, 1988, should not be extended. GAO reported that the information on which Treasury relied, although the best available, was insufficient to support its conclusion. GAO explained that the information came from surveys that were not specifically focused on gathering information to evaluate the success of section 127, had low response rates, or were not representative of the population being surveyed. GAO said that (1) in 1984, Congress enacted a reporting requirement (section 6039D of the Internal Revenue Code) to provide a basis for assessing section 127, but the information required of employers was not sufficiently specific; and (2) information that would be useful in assessing section 127, such as the average income of participants and the average benefit at each salary level, was unavailable from reliable sources.

Recommendation(s)

When GAO issued its report, section 127 had expired. GAO recommended that if Congress decided to reinstate the provision, it might want to revise the reporting requirement to better assess the provision's effects. This could be done by requiring information on the salary level of participants and the average benefit at each salary level. To help make any further assessment of section 127, Congress could also specify that the data be reported for a sufficient length of time to adequately measure any effects.

Action(s) Taken and/or Pending

Section 127 has been extended twice since GAO issued its report, most recently in the Omnibus Budget Reconciliation Act of 1990. That act extended section 127 through December 31, 1991, but did not revise the employer reporting requirement. Thus, the same issue will arise this year because Congress will not have sufficient information to measure section 127's effects and decide whether or not to extend it.

Congress Should Further Revise Civil Penalty Provisions in the Internal Revenue Code

GAO/GGD-89-81, 09/06/89

In a report to the Chairman of the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Senate Committee on Finance, GAO (1) provided information on concerns voiced by tax administrators, practitioners, and others about various civil tax penalties; (2) analyzed proposals that have been made in response to those concerns; and (3) made recommendations for reform in penalty policies.

The proposals analyzed in the report were those contained in the Improved Penalty Administration and Compliance Tax Act of 1989 (H.R. 2528, 101st Congress) and in a 1989 IRS civil penalty task force report. The penalties discussed included (1) the penalty for failure to file an income tax return; (2) various information return filing penalties; (3) the penalty for failing to timely deposit employment and other taxes; (4) several taxpayer accuracy/conduct penalties, such as those for negligence, fraud, and substantial understatement; (5) return preparer accuracy/conduct penalties; and (6) the penalty for promoting abusive tax shelters. For each of those penalties, the report discusses (1) current law, (2) concerns with the current system, (3) the proposals for change, and (4) GAO's analysis of those proposals.

Recommendation(s)

The Omnibus Budget Reconciliation Act of 1989 reformed civil penalties in ways that coincided with recommendations in GAO's report. Those reforms involved such things as uniform treatment of information returns, elimination of stacking in the accuracy/conduct penalties, targeting of the negligence penalty, and increased preparer penalties. The following recommendations remain open:

- Congress should establish a time-sensitive failure to file penalty that would be assessed against all delinquent taxpayers whether or not they have a tax liability, unless the failure is due to reasonable cause.
- Congress should reinstate an underreporting penalty similar to the former presumptive negligence penalty that would penalize taxpayers failing to report income disclosed on information returns.
- Congress should consider setting higher penalty rates or reducing the threshold of understated tax liability. This action would at least partly restore the economic value of penalties, eroded in recent years by lower tax rates.

Action(s) Taken and/or Pending

By the end of the 101st Congress, no other legislative action had been taken.

Related GAO Product(s)

GAO/T-GGD-88-24, 03/31/88; GAO/GGD-88-69, 07/25/88; GAO/T-GGD-88-55, 09/28/88; GAO/GGD-90-80, 04/13/90; GAO/GGD-90-92, 08/15/90; and GAO/GGD-90-99, 09/28/90

Congress Should Repeal Legislation That Restricts IRS' Authority to Prospectively Reclassify Employees Who Have Been Misclassified as Independent Contractors

GAO/GGD-89-107, 09/25/89

In response to a request from the Chairman of the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, GAO assessed whether matching independent contractors' information returns with their tax returns would provide IRS with a systematic method for identifying employers who misclassify employees as independent contractors.

From information returns, GAO identified about 191,000 independent contractors who had received all of their income from one of about 32,000 employers. IRS revenue officers (1) interviewed a sample of 408 of those employers and determined that 157 may have misclassified their employees as independent contractors; (2) completed detailed examinations of 95 of those 157 employers and confirmed that 92 had misclassified 17,347 employees; and (3) recommended, for those 92 employers, taxes and penalties of $16.7 million in 1986 and 1987.

GAO noted that (1) IRS would not have to create a new matching process to identify misclassifications because it already matched information returns and income tax returns to identify unreported income; and (2) although IRS could use information returns to better identify misclassified employees, section 530 of the Revenue Act of 1978 prohibits IRS from assessing back taxes that should have been withheld and paid and restricts IRS' authority to require certain employers to reclassify workers, even for future years.

Recommendation(s)

In view of the equity issues and tax revenues involved, Congress may want to consider repealing the restriction against requiring employers to prospectively reclassify employees who have been misclassified as independent contractors.

Action(s) Taken and/or Pending

No congressional action with respect to section 530 had been taken by the end of the 101st Congress.

In a November 1990 report, Tax Administration Problems Involving Independent Contractors, the House Committee on Government Operations made several recommendations regarding the misclassification of workers. For example, the Committee recommended that the tax-writing committees consider eliminating the prior audit "safe harbor" protection of section 530 as a reasonable basis for not requiring an employer to reclassify workers. Under that provision, an employer is protected from reclassification if there had been a prior IRS audit that did not successfully challenge the employer's classification practices.

The Committee also recommended that IRS establish a matching program to systematically identify employers who are most likely to be misclassifying workers as independent contractors along the lines suggested by GAO. IRS has been studying this issue and plans to implement such a program in 1991.

Related GAO Product(s)

GAO/GGD-89-63, 05/04/89; GAO/T-GGD-89-21, 05/16/89; and GAO/GGD-89-110, 09/08/89

Legislative Actions Taken in 1990 on GAO Recommendations

Congress Amended the Internal Revenue Code to Permit the Department of Veterans Affairs Access to Tax Information for Use in Administering Its Unemployability Compensation and Pension Programs

GAO/HRD-87-62, 09/21/87 and GAO/HRD-88-24, 03/16/88

In response to requests from the Ranking Minority Member of the Senate Committee on Veterans' Affairs, GAO reviewed the Veterans Administrations' (VA), now called the Department of Veterans Affairs, Unemployability Compensation and Pension Programs. GAO's work was intended to determine whether (1) veterans receiving benefits were reporting their earnings to VA as required and (2) access to tax information would enable VA to better administer the programs.

GAO found that (1) 90 percent of the veterans receiving unemployability benefits failed to report their earnings to VA; (2) veterans received potential overpayments of over $10 million during 1984 and 1985; and (3) rating boards used different criteria in determining marginal earnings, which could result in unequal and inconsistent eligibility determinations for unemployability benefits.

GAO also found that (1) of the 1.4 million 1984 pension recipients, 698,000 had their income reported to IRS and the Social Security Administration (SSA) by third-party sources and, of those, 549,000 had $947 million more income on their tax records than on records; (2) because VA did not include this income in its pension calculations, it made potential overpayments of $182.5 million; (3) more than 26,000 recipients reported no earned income to VA while tax data showed earnings of at least $1,000 each; (4) some recipients reported no earnings over several years while tax data showed significant earnings in those years; and (5) about 60 percent of the overpayments were solely attributable to unrecorded interest and dividend income.

Although access to tax information could improve payment accuracy, granting VA access to any tax information raises privacy concerns. Thus, GAO concluded that VA should be prepared to demonstrate that it is ready to comply with and implement privacy safeguards before access is granted.

Recommendation(s) to Congress

To improve VA's eligibility determination process, Congress should consider amending section 6103(l)(7) of the Internal Revenue Code to permit VA access to tax information. Congress would need to weigh the potential benefits of such disclosure with (1) privacy concerns and (2) IRS concerns that expanding access in this way could affect voluntary compliance with the tax system.

Action(s) Taken and/or Pending

The Omnibus Budget Reconciliation Act of 1990 granted VA access to IRS and SSA tax data to verify income for the needs-based Pension Program, the Unemployability Compensation Program, and certain other veterans benefits programs. In doing so, Congress set a termination date of September 30, 1992, for this access authority. Congress also mandated that GAO study the effectiveness of the enacted provisions and report, by January 1, 1992, its study results to the House Committees on Ways and Means and Veterans' Affairs and the Senate Committees on Finance and Veterans' Affairs.

Related GAO Product(s)

GAO/HRD-84-72, 06/05/84 and GAO/HRD-85-31, 05/21/85

Listing of Open Recommendations to Congress

Listing of Recommendations Made in Fiscal Year 1990 to the Commissioner of Internal Revenue

ADP and Information Technology

Compliance

General Management

Information Returns	Establish Procedures for Correcting Taxpayer Identification on Information Returns Without Disclosing Tax Data	68
	Collect Information on Problems Caused by Service Bureaus That Submit Information Returns in Order to Decide What Type of Regulation or Control, If Any, Is Needed	70
Pension Issues	Require Employers to Provide More Understandable Spousal Consent Forms and Develop Model Language to Help Employers Do That	76
	Revise IRS Publication 575 Dealing With the Reporting of Pension Income on Federal Tax Returns	78
Social Security	Work With the Commissioner of Social Security to Amend the Existing Agreement Governing the Exchange and Use of Tax Information to Provide for the Routine Sharing of IRS' Wage Report Resolution Data	84
Tax Policy	Take Various Steps to Make It Easier for Employers to Comply with Federal Tax Deposit Requirements and for IRS to Administer Them	98
Taxpayer Service	Improve Distribution of Tax Materials to the Public	102

Chronological Listing of GAO Products on Tax Matters Issued in Fiscal Year 1990

Testimony on Allocation of Taxes Within the Life Insurance Industry (GAO/T-GGD-90-3)	10/19/89
Report on Allocation of Taxes Within the Life Insurance Industry (GAO/GGD-90-19)	10/19/89
Private Pensions: Impact of Vesting and Minimum Benefit and Contribution Rules in Top-Heavy Plans (GAO/HRD-90-4BR)	10/23/89
Social Security: Alternative Wage-Reporting Processes (GAO/HRD-90-35)	11/08/89
Puerto Rico: Background Information on Applicable Federal Legislation, Its Governmental Structure, and Its Finances (GAO/T-HRD-90-7)	11/15/89
Pension Plan Terminations: Recapturing Tax Benefits Contained in Asset Reversions (GAO/HRD-90-51BR)	11/22/89
Department of Justice's Response to Requests for Court Tax Decisions (GAO/GGD-90-29FS)	12/13/89
Treasury's Efforts to Improve Its Payroll and Personnel Systems (GAO/IMTEC-90-4)	12/15/89
Tax-Exempt Bond Issuance Costs (GAO/GGD-90-9BR)	12/18/89
Need for More Management Attention to IRS' College Recruitment Program (GAO/GGD-90-32)	12/22/89
Private Pensions: Spousal Consent Forms Hard to Read and Lack Important Information (GAO/HRD-90-20)	12/27/89
Monitoring the Accuracy and Administration of IRS' 1989 Test Call Survey (GAO/GGD-90-36)	01/04/90
Monitoring the Accuracy and Administration of IRS' 1989 Test Call Survey (GAO/GGD-90-37)	01/04/90
IRS Needs to Improve Distribution of Tax Materials to the Public (GAO/GGD-90-34)	01/10/90
IRS Automation: Procurement Practices Need Strengthening (GAO/IMTEC-90-24)	01/12/90
Government Financial Vulnerability: 14 Areas Needing Special Review (GAO/OCG-90-1)	01/23/90
Tax Treatment of Life Insurance and Annuity Accrued Interest (GAO/GGD-90-31)	01/29/90
Perspectives on Potential Agricultural and Budgetary Impacts From an Increased Use of Ethanol Fuels (GAO/T-RCED-90-23)	02/01/90
Meeting the Government's Technology Challenge: Results of a GAO Symposium (GAO/IMTEC-90-23)	02/90
The Question of Rolling Back the Payroll Tax: Unmasking the Deficit Illusion (GAO/T-HRD-90-10)	02/05/90
Tax System Modernization: IRS' Challenge for the 21st Century (GAO/IMTEC-90-13)	02/08/90
IRS' Accounts Receivable Inventory (GAO/T-GGD-90-19)	02/20/90
Use of Housing Subsidies (GAO/T-RCED-90-34)	02/27/90
Puerto Rico: Background Information on Applicable Federal Legislation, Its Governmental Structure, and Its Finances (GAO/HRD-90-70BR)	03/07/90
IRS Senior Executives' Views on the Impact of the 1987 Reorganization (GAO/GGD-90-45)	03/08/90
Information on Timber Harvesting, Planting, Federal Assistance Programs, and Tax Provisions (GAO/T-RCED-90-45)	03/08/90
Social Security: Taxing Nonqualified Deferred Compensation (GAO/HRD-90-82)	03/15/90
1989 Annual Report on GAO's Tax-Related Work (GAO/GGD-90-46)	03/16/90
State Tax Officials Have Concerns About a Federal Consumption Tax (GAO/GGD-90-50)	03/21/90
Progress in Meeting the Challenge of Modernizing IRS' Tax Processing System (GAO/T-IMTEC-90-5)	03/22/90
IRS' Budget Request for Fiscal Year 1991 and Status of the 1990 Tax Return Filing Season (GAO/T-GGD-90-26)	03/22/90
Tax System Modernization: IRS' Efforts to Improve Taxpayer Correspondence (GAO/IMTEC-90-26)	03/22/90
Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income (GAO/GGD-90-35)	03/26/90
Profiles of Major Components of the Tax Gap (GAO/GGD-90-53BR)	04/04/90
Social Security: Taxing Nonqualified Deferred Compensation (GAO/T-HRD-90-21)	04/05/90
Potential Audit Revenues Lost While Training New Revenue Agents (GAO/GGD-90-77)	04/06/90
Taxation of Pension Income for Retired New Jersey Police and Firefighters (GAO/GGD-90-73BR)	04/13/90

(continued)

Testimony on Timber Harvesting, Planting, Federal Assistance Programs, and Tax Provisions (GAO/RCED-90-107BR)	04/13/90
Erroneous Penalties for Failure to File Returns or Pay Taxes Can Be Reduced (GAO/GGD-90-80)	04/13/90
Credit Management: Deteriorating Credit Picture Emphasizes Importance of OMB's Nine-Point Program (GAO/AFMD-90-12)	04/16/90
IRS Can Use Tax Gap Data to Improve Its Programs for Reducing Noncompliance (GAO/T-GGD-90-32)	04/19/90
Low-Income Housing Tax Credit Utilization and Syndication (GAO/T-RCED-90-73)	04/27/90
1987 Company Effective Tax Rates Higher Than in Prior Years (GAO/GGD-90-69)	05/10/90
Computer Security: Governmentwide Planning Process Had Limited Impact (GAO/IMTEC-90-48)	05/10/90
Status of IRS' Test of a Business Information Returns Program (GAO/GGD-90-38)	05/29/90
Nonprofit Hospitals: Better Standards Needed for Tax Exemption (GAO/HRD-90-84)	05/30/90
Information Returns: Correcting Taxpayer Identification is Possible Without Disclosing Tax Data (GAO/GGD-90-90)	06/05/90
IRS Can Improve Its Process for Recognizing Tax-Exempt Organizations (GAO/GGD-90-55)	06/08/90
Federal Government's Oversight of Pension and Welfare Funds (GAO/T-HRD-90-37)	06/13/90
Treasury's Office of Inspector General Properly Established (GAO/AFMD-90-70)	06/14/90
Rental Housing: Inefficiencies From Combining Moderate Rehabilitation and Tax Credit Subsidies (GAO/RCED-90-168)	06/19/90
IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85)	06/20/90
Testimony on the Need for Better Tax Exemption Standards for Nonprofit Hospitals (GAO/HRD-90-45)	06/28/90
Data Needed on Whether to Regulate Filers of Information Returns for Others (GAO/GGD-90-95)	07/03/90
Management Mistakes Caused Delays in Automated Underreporter System (GAO/IMTEC-90-51)	07/10/90
Pension Plan Terminations: Effectiveness of Excise Tax in Recovering Tax Benefits in Asset Reversions (GAO/HRD-90-126)	07/13/90
Alcohol Fuels: Impacts From Increased Use of Ethanol Blended Fuels (GAO/RCED-90-156)	07/16/90
Additional Petroleum Production Tax Incentives Are of Questionable Merit (GAO/GGD-90-75)	07/23/90
Pension Issues: Audits of Employee Benefit Plans Need to Be Strengthened (GAO/T-AFMD-90-25)	07/24/90
Trends in Growth and Age of IRS' Accounts Receivable (GAO/GGD-90-111FS)	07/30/90
Effects of the Fiscal Year 1990 Sequestration on the Internal Revenue Service (GAO/GGD-90-101FS)	07/30/90
Federal Tax Deposit Requirements Should Be Simplified (GAO/GGD-90-102)	07/31/90
IRS' Accounts Receivable Inventory (GAO/T-GGD-90-60)	08/01/90
Observations on the Low-Income Housing Tax Credit Program (GAO/RCED-90-203)	08/14/90
IRS Preparer Penalty Data Inaccurate and Misleading (GAO/GGD-90-92)	08/15/90
Private Pensions: Impact of New Vesting Rules Similar for Women and Men (GAO/HRD-90-101)	08/21/90
IRS Needs to Assess Options to Make Faster Deposits of Large Tax Payments (GAO/GGD-90-120)	08/31/90
RS Data Can Help SSA Credit More Wages (GAO/HRD-90-112)	08/31/90
IRS' Improved Estimates of Tax Examination Yield Need to Be Refined (GAO/GGD-90-119)	09/05/90
Recruitment and Retention: Inadequate Federal Pay Cited as Primary Problem by Agency Officials (GAO/GGD-90-117)	09/11/90
The Budget Deficit: Outlook, Implications, and Choices (GAO/OCG-90-5)	09/12/90
Pension Benefits: Processing of Applications By the Pension Benefit Guaranty Corporation (GAO/HRD-90-127)	09/25/90
Home Ownership: Limiting Mortgage Assistance Provided to Owners With High-Income Growth (GAO/RCED-90-117)	09/26/90
Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency (GAO/GGD-90-123)	09/27/90
Information Returns: Administration of Selected Filing Penalty Cases at Austin Service Center (GAO/GGD-90-99)	09/28/90

Listing of Assignments for Which GAO Was Authorized Access to Tax Data in Fiscal Year 1990 Under 26 U.S.C. 6103 (i)(7)(A)(i)

Subject matter	Objectives
Returns processing	To determine (1) how much IRS is expending on correction and inspection versus the actual processing of returns; (2) how IRS is monitoring the quality, timeliness, and efficiency of returns processing; (3) how IRS is dealing with the various impediments to returns processing quality that it identifies; and (4) whether IRS is effectively managing and institutionalizing its quality improvement process in the field.
Tax-exempt bonds	To (1) examine current practices and past actions regarding IRS' administration of bond provisions, (2) determine the extent to which IRS can currently identify noncompliance with bond provisions, and (3) identify the strengths and weaknesses of alternative regulatory systems.
Employment taxes	To determine (1) whether IRS information is adequate to identify the causes and extent of employment tax delinquencies, (2) what efforts IRS has underway to deal with this problem, and (3) whether any administrative or legislative changes are needed to better enable IRS to prevent the delinquencies from occurring and identify delinquent taxpayers or collect delinquencies once they occur.
Internal controls over accounts receivable collections	To examine and analyze (1) how IRS ensures that receipts are properly posted to taxpayer accounts, (2) methods that could be used to improve the current administrative system for depositing tax receipts, (3) how IRS ensures that tax receipts earmarked for various trust funds are properly reported to Treasury, (4) how IRS treats penalty and interest receipts associated with trust funds, and (5) how IRS monitors the Treasury Tax and Loan accounts.
Use of computers in collecting assessed taxes	To assess IRS' progress in improving its collection process through new or enhanced computer systems.
Recording and reporting accounts receivable	To assess (1) IRS' ability to identify receivables for financial reporting purposes, (2) the validity of receivables reported by IRS' financial systems, and (3) the collectibility of IRS' accounts receivable for financial purposes.

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