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Transition Series

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Internal Revenue Service Issues

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Comptroller General of the United States

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The Speaker of the House of Representatives
The Majority Leader of the Senate

In response to your request, this transition series report discusses major policy, management, and program issues facing the Congress and the new administration in the Internal Revenue Service. The issues include (1) devising structures, systems, and processes for administering the tax system in the next century; (2) modernizing computer systems to support redesigned processes; (3) strengthening human resources; (4) supporting IRS' strategic business process; (5) reducing the tax gap; (6) improving financial management; (7) managing criminal investigation resources; and (8) responding to calls for a consumption tax.

As part of our high-risk series on program areas vulnerable to waste, abuse, and mismanagement, we are issuing a related report, Internal Revenue Service Receivables (GAO/HR-93-13, Dec. 1992).

The GAO products upon which this transition series report is based are listed at the end of this report.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, the Secretary-designate of the Treasury, and the Commissioner-designate of Internal Revenue.

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IRS Issues

In our 1988 transition series report on the Internal Revenue Service, (IRS) we discussed four tax administration issues facing the agency. The most pressing overall issue then was to modernize IRS' outdated and inefficient tax processing system. It still is. Nonetheless, IRS has made substantial progress in the intervening years in addressing the problems discussed in our 1988 report. IRS took steps to alleviate an impending computer capacity problem, appointed a Chief Information Officer and a Chief Financial Officer to provide needed leadership, and produced a design plan for the systems modernization that it periodically updates as new elements of the design take shape. Today much more work remains to be done to ensure that this project—which is one of the largest of its kind and is expected to cost $23 billion through the year 2008—is successfully implemented.

The three other issues discussed in our 1988 report remain to be resolved. Although IRS can point to much work in those areas, the agency still needs to strengthen human resources, collect $30 billion in delinquent taxes, and reduce the $114 billion tax gap (the difference between what taxpayers owe and what they voluntarily pay).

In addition to the four areas noted above, this report discusses five other areas that will require the new Commissioner's priority attention—ongoing efforts to change the way IRS does business, the strategic business process, financial management, management of criminal investigation resources, and the need to respond to calls for a consumption tax.

Two themes cut across all these issues—the need to foster and manage change and the need for effective communication in such a large, decentralized organization.

Changing the Way IRS Operates

IRS is on the threshold of what could be the agency's most significant change in decades. IRS staff are at work reassessing the way the agency does business, reengineering major work processes, and rethinking the traditional functional and organizational alignment. We have long recommended this critical step in modernizing the agency. IRS has suffered from a fragmented organization, inefficient work processes, antiquated systems, and parochial views of its component work—all of which have frustrated IRS-wide efforts to improve taxpayers' satisfaction and maximize collections. The new administration will have to decide what IRS will look like in the next century and exert strong leadership to implement the needed changes.

The way IRS provides telephone assistance illustrates the agency's fragmentation. Over the years, in an effort to satisfy taxpayers' demands for assistance, IRS has established 32 telephone sites in the Taxpayer Service function to answer tax law and account questions, 23 telephone sites in the Collection function to handle calls on overdue accounts, and 3 telephone sites in the Human Resources and Support function to handle calls requesting copies of tax forms and publications. IRS also handles calls relating to document-matching issues and other matters at the 10 service centers managed by its Returns Processing function. As a result of this fragmented organization, callers seeking help from IRS are asked to use one of dozens of telephone numbers. When taxpayers call IRS, they are likely to get a busy signal and, once they get through, often find it necessary to speak to more than one person before getting the information they need.

IRS is now exploring the feasibility of consolidating its telephone sites and designating a common or single telephone number for taxpayer assistance nationwide. To really streamline its telephone service to taxpayers, IRS must look at having a single organization responsible for uniformly measured telephone service and organized to respond to taxpayers' questions in a way that reduces anxiety and eliminates the need for time-consuming, laborious written correspondence. Because taxpayers deserve from IRS the same level and caliber of service that they receive from world-class financial institutions, IRS must be able to give taxpayers accurate information with minimal delay.

Managing Tax Systems Modernization

Central to any change in the way IRS does business is Tax Systems Modernization (TSM)—the redesign of automated systems so critical to IRS' work. To provide the type of service taxpayers deserve, IRS must make taxpayer information quickly available to every employee who needs it. Recent IRS Commissioners, recognizing how important computer modernization is to tax administration, have built on their predecessors' efforts to bring TSM to fruition. This should be no less of a priority for the new Commissioner.

With an estimated cost of about $23 billion through the year 2008, TSM is perhaps the largest civilian computer modernization in history. IRS has developed a basic design concept for the modernization, but that technical design was developed before IRS had thoroughly reassessed its basic business processes. The details of the technical design may have to change to support the new vision of IRS. In that regard, the new Commissioner will need to give priority attention to the following:

- Finalize an operational strategy soon. Too many other decisions hinge on this one, and dollars may be wasted if IRS does not reach closure on this issue.

- Once an operational strategy has been finalized, verify that major procurements proceeding from the technical design fit the needs of the new operating environment. Contracts for several of these procurements have been awarded, and others are about to be. It is important to act quickly in order to avoid wasteful spending, even if this means putting the brakes on certain TSM initiatives.

- Give top priority to making on-line access to taxpayer information available to every IRS employee who needs to work with that information. Make that happen first and soon by putting the taxpayer file on-line to every workstation and implementing the kind of telecommunication network that can send this information anywhere, anytime. The new workstations and telecommunication networks put in place must be capable of handling features such as image, fax, and high-volume data transactions, even though those applications are not yet ready.

Because TSM is so large, it is expected to take more than a decade to complete. Getting the budgetary support and the right people to manage it will be a long-term concern. To avoid the kinds of project delays and procurement problems that have arisen in the past, IRS needs experienced senior and project managers to oversee and direct TSM. These managers must have technical expertise as well as management acumen and commitment to deliver results within agreed upon time frames.

Throughout the TSM initiative, IRS needs to ensure that its systems designs will produce good management information. Perhaps the most consistent theme over the past 2 decades of GAO reports is how often IRS managers do not have the right information to do their jobs. One significant effort to improve management information that needs continuing emphasis is the work being done to implement the Enforcement Management Information System. That system, when fully implemented, should provide management and the Congress with much needed information on the actual results and costs of IRS' enforcement efforts.

Strengthening Human Resources

The changes that are sure to come as IRS redesigns the way it does business will transform the agency into one that depends less on manual labor and more on technology-based skills. The technical implications of modernization have received most of the emphasis in IRS. It is critical that IRS also pay attention to the significant human resource implications. IRS must develop human resource strategies that support the new business direction and technical environment. As part of that effort, IRS needs to determine workforce levels, reassess skill needs, identify strategies for meeting those needs, and manage workforce adjustments.

Fulfilling IRS' policy of protecting employees' jobs from modernization-generated staff reductions will be a formidable challenge. IRS must bridge the gap between existing workforce skills and abilities and those that will be needed in the modernized environment. By planning far enough in advance and using the intervening years for training, IRS should be better able to meet that challenge. IRS has taken a critical step toward that end by recently drafting a much needed human resources plan. The new Commissioner will need to ensure that aggressive action is taken to implement that plan.

Another critical human resource issue facing the new Commissioner relates to employee ethics and integrity. IRS' record in this area has come under increasing scrutiny. IRS must continue vigorous efforts to promote open communication, strengthen employee awareness, and increase managerial accountability. IRS employees must recognize and accept the fact that they will be held to a high ethical standard to protect the integrity of this country's voluntary tax system.

Supporting the Strategic Business Process

IRS is building a strategic business process that could serve as a model for other federal agencies. The cornerstone of that process is a strategic plan, which is updated annually. As part of that plan, IRS has identified three broad business objectives—improving voluntary compliance, reducing taxpayer burden, and improving quality-driven productivity and customer satisfaction—and various strategies and actions to help IRS achieve those objectives. Annual plans are developed to guide headquarters and field office activities in support of the business plan, and annual business reviews are done to assess progress.

If IRS' strategic business process is to be effective, it is critical that IRS develop appropriate performance measures. Without the right measures, IRS will be unable to assess progress in achieving its business goals. The measures IRS now uses are focused largely on processes rather than outcomes. For example, IRS tracks the number of auditors and audits completed but does not track the effect of audits on voluntary compliance. IRS recognizes the need for better measures and has efforts under way in that regard. The new Commissioner needs to lead those efforts and to hold managers accountable for meeting outcome goals. Because IRS is so decentralized, holding managers accountable for agency goals is critical to IRS' operating with a shared understanding of its mission and direction.

Collecting Back Taxes

The new administration will have to give continuing priority attention to the collection of taxes owed the government. In general, IRS has reported accounts receivable that are significantly higher than could ever be collected; IRS itself estimated that less than $30 billion of 1991's $111 billion inventory was collectible. Yet because IRS does not know how many records are valid, no one really knows the true number of receivables, much less how many of them are collectible. In a separate high-risk report on IRS receivables, we discuss the steps needed to better manage this area—1 of 17 throughout the government designated by us as high risk.

That report discusses several problems that have interfered with IRS' ability to collect unpaid taxes, including (1) inaccurate and insufficient IRS records; (2) a lengthy, antiquated, rigid, and inefficient collection process; (3) difficulty in balancing collection efforts with the need to protect the taxpayer; (4) IRS' decentralized structure; and (5) inadequate information on how to allocate staff effectively. The report also summarizes our various recommendations for improvement.

Reducing the Tax Gap

IRS has estimated the tax gap for 1992 to be about $114 billion. That estimate is conservative because it only relates to income taxes and excludes taxes associated with illegal-source income. In an attempt to reduce the tax gap, IRS recently announced a goal to increase voluntary compliance with the tax laws from 84 percent to 94 percent in 8 to 10 years. To achieve that goal, important decisions will have to be made on research efforts, enforcement programs, and resource allocations. Those decisions need to be made cohesively, in ways most likely to improve overall compliance. The time is also right, as IRS goes about changing the way it does business, to rethink its entire approach to enforcement.

Measuring Compliance

An early decision facing the new Commissioner will involve the design of next year's Taxpayer Compliance Measurement Program (TCMP)—the only reliable measure of compliance and a program that provides data used in tax policy decisions, revenue estimating, and estimation of U.S. income accounts. The current direction appears to be toward eventual elimination of TCMP on the grounds it is too costly, too intrusive, and untimely. We believe that would be a mistake. TCMP needs to be fixed, not eliminated. TCMP is critical to IRS and the whole tax community. It should provide an important outcome measure for IRS' strategic business process, enough information to make informed decisions on enforcement program and resource allocations, and sufficient data for tax policy decisions.

TCMP did not provide an empirical base for IRS' latest enforcement strategy—Compliance 2000. Instead, IRS launched Compliance 2000 by asking the 63 district offices to nominate "taxpayer segments" as prototypes. Because TCMP has not provided estimates at that disaggregated a level, prototype selection necessarily depended on judgments. Thus, IRS has no assurance that it is working on the most noncompliant segments or that prototype results—however positive—will improve overall compliance levels. Had it relied on TCMP data that were valid at the regional office level, IRS would have had a firmer foundation from which to launch Compliance 2000.

Enforcement Considerations

Under Compliance 2000, more emphasis is being placed on the role of taxpayer education and assistance in improving compliance and reducing the tax gap. Even so, enforcement is still critical. Audit coverage, a key indicator of the level of IRS' enforcement effort, has shown a disturbing trend in the past few years. Overall coverage is only about 1 percent, and the coverage of corporations decreased from 5 percent in 1981 to less than 3 percent in 1991. Faced with this declining audit presence, the new Commissioner needs to determine

- the role of audits and the proper balance between auditing returns, doing computer matches, and tracking down nonfilers;
- acceptable audit coverage rates and whether those rates should be at similar levels around the country;
- the proper balance of coverage among corporate, individual, partnership, and other types of returns;
- whether audit quality is high enough and how quality should be measured; and
- whether and how IRS' traditional approach to doing audits should be changed to better serve both IRS and taxpayers.

Such issues are particularly pertinent with respect to the largest corporations—those

1,600 now covered by IRS' Coordinated Examination Program. Of continuing concern is IRS' capacity to collect the right amount of tax from these highly complex corporations. Much of the additional taxes recommended from IRS audits is not billed to the corporations after the appeals process. IRS has made changes in the last 2 years to better manage this program. In a forthcoming report, we will discuss more fundamental changes that may be warranted.

The new administration will also need to deal with various audit issues that recur time and time again, consuming significant IRS resources, often without realizing for the government the additional revenues proposed by its examiners. Audits of large multinational corporations, for example, are beset by transfer pricing issues that involve deciding whether related corporate entities have calculated correctly the arm's-length price for goods brought into or taken out of the United States. The Congress has legislated some changes in an attempt to deal with certain troublesome audit issues, and IRS has made other changes administratively, but the problem is likely to persist with the globalization of trade.

Rethinking the Enforcement Approach

Given intractable issues such as transfer pricing, worrisome compliance levels for some segments of taxpayers, and continuing resource constraints, it is a good time for IRS to rethink its enforcement approaches. Following are several questions the new Commissioner needs to ask:

- How could the design of the tax system be changed to produce higher compliance levels?
- Is there a need for more withholding at the source, incentives for cash businesses, or simplified ways to file returns and pay taxes?
- Does everyone have to file a tax return?
- Are there more opportunities to improve compliance through additional information reporting or increased information sharing among governmental entities?
- How could compliance checks be designed into TSM?
- Is IRS using the right enforcement tools at the right time?

IRS has determined that in order to achieve its three broad business objectives it needs, among other things, a strong financial management system. As discussed in our transition series report Financial Management Issues (GAO/OCG-93-4TR, Dec. 1992), IRS, like other federal agencies, has serious financial management weaknesses.

IRS' financial management systems were generally designed to track information on identified program objectives and were not integrated to ensure that agencywide activity was fully captured and reported. As a result, IRS is unable to accurately segregate and substantiate tax revenues collected and the related accounts receivable. For example, IRS cannot reliably identify the amount of taxes collected for Social Security or any of the trust funds for which IRS collects excise taxes. Also, IRS cannot identify the actual amount of accounts receivable because a large number of invalid accounts and errors are contained in the financial management systems used to track receivables.

IRS' ability to identify program costs is also significantly impaired. This limitation minimizes the agency's ability to properly evaluate program performance and identify needs. In addition, financial management weaknesses have resulted in accounting and control problems over assets and spending.

As the new administration seeks to reduce the budget deficit and improve federal agencies' performance, it will be important for the Commissioner of Internal Revenue to give urgent focus to converting these ineffective and often outdated financial management systems to systems that will provide accurate and reliable financial information for use in policymaking and other decisions that affect American taxpayers.

The Chief Financial Officers (CFO) Act of 1990, which represents the most comprehensive financial reform package in 40 years, provides a blueprint for change that, if fully implemented, would enable IRS to correct its financial management systems problems. Over the past 2 years, IRS has made important strides in establishing a CFO structure and in beginning to implement the full range of requirements in the CFO Act. But the process of change under the CFO Act has just begun.

Sustained support and top-level attention by the new administration, IRS, and the

Congress is needed to build on the efforts now under way at IRS to improve financial management through implementation of the CFO Act. The tone at the top will be critical to ensuring meaningful reform. As discussed in greater detail in our transition series report on financial management issues, among the key actions are the need to

- make clear that financial management reform is a continuing high priority and hold managers accountable for results;
- expand the role of the CFO to encompass the full range of duties and authorities in the CFO Act;
- promote and closely oversee efforts to build first-class financial management infrastructures—both people and systems;
- emphasize the development of cost systems and performance measures and the integration of accounting, program, and budget systems to develop more useful and relevant financial information; and
- foster continuing efforts to develop auditable financial statements and to expand financial reporting to encompass the full range of accountability contemplated by the

CFO Act and the Office of Management and Budget's implementing guidance.

Managing Criminal Investigation Resources

The new Commissioner will be faced with competing priorities for IRS' criminal investigation work. Other law enforcement agencies seek the financial expertise of IRS' special agents for cases that increasingly involve sophisticated financial transactions. This leaves IRS fewer resources to investigate criminal violations of the tax law. During congressional deliberations on the administration's fiscal year 1993 budget request for IRS, the criminal investigation area came under considerable scrutiny.

The Senate passed a provision, for example, that would have changed IRS' organization by providing the Assistant Commissioner for Criminal Investigation with direct line authority over tax fraud investigations. Although that provision was defeated in conference, IRS has been directed to study the Criminal Investigation Division to determine whether it is adequately funded and staffed.

The new Commissioner will also have to be concerned about the adequacy of controls over IRS' special agents. IRS is working to implement several of our recommendations for strengthening controls over one particular technique—undercover investigations.

Responding to Calls for a Consumption Tax

More groups this year than ever before have proposed that the United States adopt some type of consumption tax. For example, the first report of the Strengthening of America Commission, chaired by Senators Sam Nunn and Pete Domenici, proposed a consumption-based income tax. While IRS will not have to decide whether there should be such a tax, IRS will need to advise policymakers of its implications.

One important consideration is whether the proposed tax would be a fundamentally new federal level tax, such as a value-added or retail sales tax, or a variant of existing taxes, such as a cash-flow business tax or a personal expenditure tax. A new tax would potentially require a new enforcement approach with additional administrative resources. A variant of existing taxes, while presenting new and difficult enforcement challenges, might be more easily managed within existing approaches and resources. In any form, such a tax would have great ramifications for IRS. IRS needs to be in a position to quickly analyze how it would administer the various forms of such a tax that may be proposed. In that regard, we will report in several months on how a value-added tax would be administered and how much it would probably cost to administer it.

Related GAO Products

Internal Revenue Service Receivables (GAO/HR-93-13, Dec. 1992).

Tax Administration: Opportunities to Further Improve IRS' Business Review Process (GAO/GGD-92-125, Aug. 13, 1992).

International Taxation: Problems Persist in Determining Tax Effects of Intercompany Pricing (GAO/GGD-92-89, June 15, 1992).

Tax Administration: Compliance 2000—A Worthy Idea That Needs Effective Implementation (GAO/T-GGD-92-48, June 3, 1992).

Internal Revenue Service: Opportunities to Reduce Taxpayer Burden Through Return-Free Filing (GAO/GGD-92-88BR, May 8, 1992).

Tax Administration: One Stop Service: A New Concept of Assistance for Taxpayers (GAO/T-GGD-92-33, Apr. 28, 1992).

Tax Administration: IRS Undercover Operations Management Oversight Should Be Strengthened (GAO/GGD-92-79, Apr. 21, 1992).

Tax Administration: IRS' Efforts to Improve Corporate Compliance (GGD-92-81BR, Apr. 17, 1992).

Tax Systems Modernization: Progress Mixed in Addressing Critical Success Factors (GAO/T-IMTEC-92-13, Apr. 2, 1992).

Tax Administration: An Update on IRS' Progress on Accounts Receivable and Strategic Management (GAO/T-GGD-92-26, Apr. 2, 1992).

Tax Administration: IRS' System Used in Prioritizing Taxpayer Delinquencies Can Be Improved (GAO/GGD-92-6, Mar. 26, 1992).

Tax Systems Modernization: Factors Critical to Success (GAO/T-IMTEC-92-10, Mar. 10, 1992).

Internal Revenue Service: Status of IRS' Efforts to Deal With Integrity and Ethics Issues (GAO/GGD-92-16, Dec. 31, 1991).

Identifying Options for Organizational and Business Changes at IRS (GAO/T-GGD-91-54, July 9, 1991).

Management Challenges Facing IRS (GAO/T-GGD-91-20, June 25, 1991).

Managing IRS: Important Strides Forward Since 1988 but More Needs to Be Done (GAO/GGD-91-74, Apr. 29, 1991).

Tax Administration: IRS Does Not Investigate Most High-Income Nonfilers (GAO/GGD-91-36, Mar. 13, 1991).

Tax Administration: Profiles of Major Components of the Tax Gap (GAO/GGD-90-53BR, Apr. 4, 1990).

Internal Revenue Service Issues (GAO/OCG-89-26TR, Nov. 1988).

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Government Management Issues (GAO/OCG-93-3TR).

Financial Management Issues (GAO/OCG-93-4TR).

Information Management and Technology Issues (GAO/OCG-93-5TR).

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