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TAX POLICY AND ADMINISTRATION

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

The Honorable Daniel P. Moynihan
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 1992. It contains (1) appendixes that highlight agency actions taken on our recommendations as of December 31, 1992; (2) recommendations we made to Congress before and during fiscal year 1992 that remain open; and (3) 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

In recommendations to Congress and the administration, we suggested actions that could be taken to improve compliance, increase accounts receivable collections, simplify the tax system, improve the Tax Systems Modernization Program, strengthen management practices, and enhance the effectiveness of tax incentives.

Improve Compliance With Tax Laws

Increasing compliance and realizing the potential billions of dollars in additional tax revenues is constrained by continuing resource limitations, worrisome compliance levels for some taxpayer segments, and other such seemingly intractable issues as transfer pricing. The Internal Revenue Service (IRS) estimates the tax gap—the difference between what taxpayers owe and what they voluntarily pay—to be about $114 billion for 1992. We identified several legislative and administrative actions that could help improve compliance.

- **Independent Contractor Compliance.** IRS estimates that the tax gap caused by self-employed individuals, such as independent contractors who do not report all their income, was $20.3 billion in 1992. We reported that common law rules for classifying workers as independent contractors remain unclear and subject to conflicting interpretations. We suggested that Congress establish clear rules for classifying workers and consider legislation to improve independent contractor compliance through withholding of payments and/or improved information reporting (GAO/GGD-92-108, July 23, 1992 and GAO/T-GGD-92-63, July 23, 1992). (See p. 44.)
- **Transfer Pricing.** Whether foreign-controlled companies underpay income taxes by improperly using transfer pricing—prices companies charge related parties for goods and services transferred on an intercompany basis—is a controversial issue. Our study indicated that while foreign-controlled companies often reported lower gross profits, net income, and U.S. taxes as percentages of sales than their U.S.-controlled counterparts, those statistics do not prove widespread impropriety. We also reported on factors that affected IRS' ability to determine and recover possibly underpaid taxes and recommended steps IRS could take to better administer transfer pricing issues (GAO/GGD-92-89, June 15, 1992). (See p. 39.)
- **Fuel Excise Tax Compliance.** We reported that no reliable statistical information was available to estimate the current level of motor fuel tax evasion. We recommended that Congress explore the level of tax evasion with the responsible federal agencies and affected industry; if Congress finds the evasion level to be sufficiently high, the collection point of gasoline excise taxes should be changed (GAO/GGD-92-67, May 12, 1992). (See p. 36.)
- **Reporting Service Contract Payments.** Recent IRS data indicate problems in corporate tax compliance. However, neither tax law nor current regulations generally require information reporting—which fosters compliance—for service payments made to corporations. In June 1991, we recommended that Congress enact legislation to require private sector

payors to inform IRS of certain payments made to corporations. Federal agencies also awarded $68 billion for service contracts in 1990 of which we estimate 90 percent went to corporations. Requiring federal agencies to report such payments could improve corporate tax compliance and provide IRS with an important tool to detect unreported income or unfiled tax returns. We recommended, among other things, that the Director, Office of Management and Budget (OMB), require agencies to issue information returns on payments to corporations for providing services and that IRS use the information returns in enforcement programs. OMB and IRS agreed to explore the costs and benefits of requiring the information returns recommended (GAO/GGD-92-130, Sep. 22, 1992). (See p. 46.)

- **Compliance 2000.** Through Compliance 2000 IRS seeks to improve voluntary compliance with the tax laws by discerning the root causes of tax noncompliance and then applying the appropriate remedies. While recognizing that Compliance 2000 is a worthy idea, we testified that IRS needs to develop a structure to manage Compliance 2000 and align existing compliance measurement programs with the new initiative (GAO/T-GGD-92-48, June 3, 1992). (See p. 38.)

IRS is moving toward revising the Taxpayer Compliance Measurement Program, which is the only reliable measure of compliance and provides data used in tax policy decisions, revenue estimating, and estimation of U.S. income accounts. Prompted by concerns with the program's cost, intrusiveness, and timeliness, IRS appears to be moving toward its eventual elimination. Without an adequate replacement, we believe that eliminating the program would be a mistake because the data are critical to IRS and the whole tax community and should continue to be collected. We expect to report on these issues in the near future as well as on issues involving the effectiveness of IRS' large corporation examination program.

Increase Accounts Receivable Collections

IRS continues its struggle to stem the growth of the accounts receivable inventory and increase collections of delinquent accounts. The inventory was estimated to be about $131 billion at September 30, 1992, of which $28 billion is thought to be collectible. The inventory is not only growing but getting older, and collections of delinquent taxes have not kept pace with this growth. We suggested several ways to increase collection of IRS accounts receivable.

- **Federal Contractor Tax Delinquencies.** We testified that IRS could improve its use of government payments to federal contractors as a source of funds for payment of contractors' delinquent taxes. We said that IRS

should establish a mechanism to ensure that required information on all federal contracts is reported to IRS and see that collection staff know how to use the contract information. We also raised an issue—whether tax compliance should be a prerequisite to awarding a federal contract—for Congress' consideration (GAO/T-GGD-92-23, Mar. 17, 1992). (See p. 18.)

- **Priorities for Taxpayer Delinquencies.** We reported that IRS could improve the collection process by (1) analyzing the experience of private industry in selecting variables that set the priority for working delinquent accounts; (2) setting priorities on the basis of the likelihood of collection; (3) setting priorities for the prevention and identification components as well as the collection component of its delinquency workload; and (4) improving evaluation of the workload priority system (GAO/GGD-92-6, Mar. 26, 1992). (See p. 20.)
- **IRS-wide Collection Efforts.** We testified on the need for IRS to continue focusing on agencywide efforts to improve collection of delinquent taxes. As an example of such an effort, we cited IRS' proposal for examination staff to try to collect amounts that taxpayers agree to pay as a result of an audit, rather than establishing balance due accounts that collection staff have to collect later (GAO/T-GGD-92-26, Apr. 2, 1992). (See p. 22.)

We expect to report in the near future on additional ways in which IRS can increase collections of delinquent taxes, including using new collection strategies and improving its collection staff allocation system and its identification and management of accounts that it has deemed currently not collectible.

Simplify the Tax System

Simplification continues to be a key to controlling taxpayer burden and improving voluntary compliance. We identified changes that would improve tax administration and reduce taxpayer burden.

- **Earned Income Advance Payment.** We reported that the effectiveness of the earned income credit (EIC) advance payment system was difficult to determine since few low-income wage earners know about the option. We made several recommendations to IRS to ensure that eligible taxpayers are aware of the option and to improve compliance of those people who receive the advance payment (GAO/GGD-92-26, Feb. 19, 1992). (See p. 85.)
- **Return-Free Filing.** We reported that a return-free filing system that IRS had concluded was infeasible because of timing and cost considerations could be redesigned to use new technologies and be more cost-effective and more feasible. We also reported that many foreign countries use a system called final withholding under which the employee's withholding

becomes the tax and no return is required. Implementation of final withholding in the United States would require significant legislative and regulatory changes and would require taxpayers and businesses to accept a totally new approach to satisfying tax liabilities. But only through this kind of change can taxpayer burden really be reduced (GAO/GGD-92-88BR, May 8, 1992 and GAO/T-GGD-92-41, May 13, 1992). (See p. 75.)

IRS compliance data show that over 9 million individuals improperly claimed about 17 million dependency exemptions and 3 million claimed the wrong filing status. We are studying ways that rules for dependent exemptions and filing status could be simplified to reduce errors and resulting noncompliance.

Strengthen the Tax Systems Modernization Program

Tax Systems Modernization (TSM) is a long-term multibillion dollar program through which IRS will replace an antiquated IRS data processing system with a modern system using state-of-the-art electronic methods for receiving, processing, storing, and retrieving tax information. In 1992, we continued monitoring TSM progress and identified a number of issues.

- **Restructure IRS.** We testified that to take full advantage of opportunities offered by modernization, IRS needs to engage in a comprehensive reexamination of the way it does business. Redundancy and inefficiencies are fostered by IRS' current organizational structure, work processes, and program strategies—all of which are constrained by the technology IRS adopted over 30 years ago. We said it is important that IRS complete ongoing reviews of its business operations before locking itself into a particular technical contract or implementation (GAO/T-IMTEC-92-10, Mar. 10, 1992 and GAO/T-GGD-92-41, May 13, 1992). (See pp. 23 & 75.)
- **Critical Modernization Factors.** We assessed IRS' progress in addressing eight critical success factors that we believe are key to the modernization program's success. We said that, ultimately, the success or failure of the modernization will rest on IRS top management commitment to the program, including following through and making sure each of the success factors is appropriately addressed. While acknowledging the progress IRS had made in the past year, we expressed our concern with four of the critical success factors: (1) planning, (2) technological readiness, (3) procurement, and (4) systems development processes. We also remained concerned about some security and privacy aspects of the program. We recommended that IRS (1) complete a business plan and a strategy to integrate current and planned computer systems for the

modernization, (2) improve its procurement process, and (3) resolve certain security and privacy issues. IRS generally agreed with our recommendations (GAO/T-IMTEC-92-10, Mar. 10, 1992 and GAO/T-IMTEC-92-13, Apr. 2, 1992). (See p. 23.)

- **Data Processing Risks.** IRS' integrated input processing initiative is a critical component of TSM. We testified that some aspects of this initiative appeared to be that it was a high-tech, high-risk, and high-cost venture. We recommended that IRS analyze alternative processing strategies and structure its input processing initiative around the alternative determined to be most advantageous to the government. IRS is examining alternatives for filing taxpayer returns (GAO/T-IMTEC-92-15, Apr. 29, 1992). (See p. 23.)

At the request of several congressional committees, we are continuing to monitor IRS' modernization program.

Strengthen Management of IRS

IRS plays a crucial role in maintaining public confidence in the nation's voluntary tax compliance system and in shaping public opinion about the quality of services it renders and manages. Consequently, it is vital that IRS effectively manage its massive operations and ensure uniform and fair implementation of an ever-changing set of complex tax laws. We suggested several actions that IRS could take to strengthen its management.

- **Strategic Management.** IRS has developed a strategic management process to help it define and achieve its tax administration mission. We reviewed a key aspect of that process—annual business reviews—and noted that IRS had taken several positive steps to implement an effective review process. We made several recommendations to IRS to further improve the process (GAO/GGD-92-125, Aug. 13, 1992). (See p. 59.)
- **Ethics and Integrity.** In December 1991, we reported on IRS' responses to our recommendations on employee ethics and integrity issues. We characterized the actions taken as initial steps in a major long-term effort that can only be successful if IRS maintains a high level of effort to reshape its culture. We noted that IRS needs to improve employee communication and ethics awareness and change perceptions about IRS' disciplinary actions (GAO/GGD-92-16, Dec. 31, 1991 and GAO/T-GGD-92-62, July 22, 1992.) (See p. 50.)
- **Conflicts of Interest.** We reported that thousands of IRS employees who are vulnerable to conflicts of interest were not filing annual confidential statements. We recommended that the Secretary of the Treasury direct IRS to (1) require annual confidential disclosure statements from all revenue

agents, revenue officers, and criminal investigators; (2) determine whether other key employees should file; and (3) ensure that reviewing officials have adequate information to evaluate potential conflicts (GAO/GGD-92-117, Aug. 17, 1992). (See p. 61.)

- **Managing Undercover Operations.** In two reports, we examined the management and oversight of IRS' undercover operations. We recommended that IRS take a number of steps to strengthen management practices related to the initiation, cost control, and monitoring of undercover operations (GAO/GGD-92-79, Apr. 21, 1992 and GAO/GGD-92-80, Apr. 21, 1992). (See p. 54.)
- **Managing Seized Assets.** IRS seizes assets such as cars, machinery, furniture, real estate, and sometimes cash to collect delinquent taxes or because assets were bought with illegal money or used in criminal activities. We testified that IRS controls over seized property were weak and inadequate to protect against theft, waste, or misuse; and we suggested a number of options to improve seized asset management. IRS agreed the seizure process could be improved and is determining which option best meets its requirements (GAO/T-GGD-92-65, Sep. 24, 1992.) (See p. 65.)
- **Taxpayer Bill of Rights.** We concluded that IRS' implementation of major provisions of the 1988 Taxpayer Bill of Rights had been generally successful and suggested clarifications of the Internal Revenue Code that Congress may wish to consider. We also recommended that IRS ensure that its employees are able to recognize taxpayer hardship situations, encourage taxpayers to understand their rights, and improve administration of installment agreements for taxes due (GAO/GGD-92-23, Dec. 10, 1991 and GAO/T-GGD-92-09, Dec. 10, 1991). (See p. 70.)

Enhance Effectiveness of Tax Incentives

Congress often adopts tax preferences and incentives to foster certain social policy goals, such as improving access to housing or promoting employment for lower income workers. Our work contributed to congressional debate on the costs and benefits associated with tax incentives.

- **Fringe Benefits.** Except for pensions, benefit tax policy has not fundamentally changed in over a decade but estimated tax expenditures—revenues foregone as a result of preferential provisions—have increased significantly. Taxing all fringe benefits could raise substantial revenue and improve tax equity, but full taxation of these benefits could greatly increase income taxes employees have to pay and could reduce coverage. Alternatives to full taxation include imposing

ceilings on tax-free benefits provided or allowing credits against taxes paid rather than exclusions from taxable income (GAO/GGD-92-43, Apr. 7, 1992). (See p. 83.)

- **Company Effective Tax Rates.** 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 tax rates for the companies we reviewed were higher in 1989 (33 and 37 percent, respectively) than in 1986 (19 and 28 percent). Because of data limitations, however, we could not conclude that the act directly caused these changes. In our opinion, part of any increase in average U.S. effective tax rates due to the act may exist only temporarily as the companies go through a transition period (GAO/GGD-92-111, Aug. 19, 1992). (See p. 88.)
- **Pharmaceutical Industry Tax Benefits in Puerto Rico.** We provided information about the pharmaceutical industry's tax benefits obtained from operating in Puerto Rico. Section 936 of the Internal Revenue Code was enacted to help Puerto Rico obtain employment-inducing investments and provides a tax credit equal to the federal tax liability on certain income earned in Puerto Rico. We found that throughout the 1980s the pharmaceutical industry received a relatively large share of the tax benefits from section 936 compared to the number of jobs directly created and the amount of employee compensation the industry provided. Pharmaceutical industry representatives stated that other employment-related information needed to be considered and cited (1) the importance of examining the number of high-paying, skilled jobs that have been provided; and (2) indirect jobs created in other industries (GAO/GGD-92-72BR, May 4, 1992). (See p. 87.)
- **Tax Credit Effectiveness.** We reviewed the effectiveness of a tax credit proposed to facilitate the sale of Resolution Trust Corporation (RTC) property and concluded that the federal government would lose about $127 million on a present-value basis with the proposed $1 billion tax credit program. We said that overall we did not believe the tax credit proposal was an effective way for RTC to dispose of its real estate assets. However, if the proposal were to be enacted, we suggested changes to help minimize the losses and protect RTC's financial interests (GAO/GGD-92-14BR, Nov. 1, 1991). (See p. 79.)
- **Expiring Tax Provisions.** For congressional consideration of whether the provisions should be extended, we summarized our work on 5 of the 12 tax provisions that were last extended by the Tax Extension Act of 1991. First, we concluded that Mortgage Revenue Bonds were an inefficient and costly way to provide assistance to first-time home buyers. Second, we said that the Targeted Jobs Tax Credit goals were not achieved

to their full extent, and we found no substantial differences in participants' earnings before and after a targeted job compared to others not in the program. Third, we noted that the Low-Income Housing Tax Credit allowed building or rehabilitating housing in areas where adequate low-income housing existed, which is less efficient than providing low-income housing through certificates or vouchers. Fourth, we suggested that if the Research Tax Credit was permanently extended, Congress provide for a periodic adjustment to the base used in calculating the credit. Fifth, we said that sufficient information about the program's effect was not available to measure whether Employer-Provided Educational Assistance was meeting its objectives; we suggested modifying the provision's reporting requirement to establish a basis for evaluation (GAO/T-GGD-92-11, Jan. 28, 1992). (See pp. 80.)

- **Luxury Excise Taxes.** We examined the effect of the luxury excise tax on the luxury boat, car, aircraft, jewelry, and fur markets. About $168 million in luxury excise taxes was collected in 1991. We found that diverse factors interacted to affect both the demand for and supply of these luxury products. We could not disentangle the effects of these diverse factors from the effects of the tax and therefore could not quantify tax effects. Some portion of sales decline during 1991 in these products may have resulted from the price effect of the luxury excise tax, but it is likely that other factors significantly affected these markets (GAO/GGD-92-9, Feb. 26, 1992). (See p. 82)

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 VII. If you or your colleagues would like to discuss any of the matters in the report, please call me on (202) 512-5407.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

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Abbreviations

ADP	automated data processing
CEP	Coordinated Examination Program
EIC	earned income credit
ETEP	Employment Tax Examination Program
FEDTAX	federal tax deposit system
HUD	U.S. Department of Housing and Urban Development
IRS	Internal Revenue Service
OMB	Office of Management and Budget
QMB	Qualified Mortgage Revenue Bonds
RTC	Resolution Trust Corporation
RWMS	Resources and Workload Management System
TCMP	Taxpayer Compliance Measurement Program
SSA	Social Security Administration
TSM	Tax Systems Modernization
VA	Department of Veterans Affairs

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Accounts Receivable

Federal Contractor Tax Delinquencies

GAO/T-GGD-92-23, 03/17/92

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed two issues: (1) a component of the accounts receivable—tax delinquencies of federal contractors—and (2) the status of the 1992 tax return filing season. GAO's discussion of IRS' 1992 filing season is presented on page 72.

GAO said that over one-quarter of the 26,000 federal contractors it reviewed were delinquent on IRS' records for either the payment of taxes or the filing of tax returns. IRS' records showed that the contractors owed $773 million as of July 1991.

GAO pointed out that the 1986 Tax Reform Act required federal agencies to report information on federal contracts starting in 1987. But Treasury regulations were not finalized until December 1989, and the first submission of usable information was not made until July 1991. GAO found that IRS had not developed procedures to fully use the information received and had no procedure to ensure that all required information was properly reported.

GAO found that IRS had not fully used contract payments as a means to collect delinquent taxes. In those cases in which IRS used contract information, IRS either administratively offset contract payments or levied the payments due the contractor. IRS preferred the administrative offset because it remains in effect until the delinquency is satisfied, whereas a levy applies only to the amount due the contractor at the time the levy is received. A levy has to be reissued to remain in effect. GAO stated that it was unclear whether IRS has the authority to administratively offset contractual payments and suggested that Congress consider clarifying this issue by expressly authorizing administrative offsets of contractual payments.

GAO also pointed out that making tax compliance a prerequisite for awarding federal contracts had potential for preventing and collecting delinquencies. However, current procurement and tax laws preclude denying a contract solely because the contractor has a tax delinquency,

and tax law precludes IRS providing tax compliance information to the contracting agency.

Recommendation(s)

Congress should clarify the law by expressly authorizing IRS to use administrative offsets. Congress may also want to (1) specify the procedural protections to be afforded taxpayers when IRS uses the offset mechanism and (2) consider whether tax compliance should be made a prerequisite to awarding federal contracts.

IRS should (1) establish a mechanism to ensure that federal agencies and the General Services Administration's Federal Procurement Data Center report all required information on federal contracts; (2) work with the other federal agencies, including the Department of Defense, to ensure that all required information is shared; and (3) complete the project it has underway to provide guidance to its own staff on how to use federal contract information.

Action(s) Taken And/or Pending

Although there has been no congressional action on these recommendations, IRS revised its procedures regarding offset and levy in May 1992 to require the use of levies. Under the levy procedures, taxpayers are afforded the protections not provided for under administrative offset. IRS is also investigating the use of an interactive compliance alert response system that would allow for compliance checks prior to awarding contracts and disbursing payments.

IRS is designing a review instrument to learn what problems may exist in reporting by federal agencies. IRS intends to use the results of this review to develop solutions, including outreach efforts with other federal agencies. IRS has requested a system change to help ensure that information is shared with all those who need it. This change is expected to take place in 1993.

IRS' System Used in Prioritizing Taxpayer Delinquencies Can Be Improved

GAO/GGD-92-6, 03/26/92

In a report to the Commissioner of Internal Revenue, GAO discussed IRS' planned revision to its Resources and Workload Management System (RWMS), which was designed to improve the management of its inventory of taxpayer delinquencies and maximize collections. GAO reported that while it believed that IRS' approach to revising RWMS was sound, it also believed that IRS could further improve RWMS by seeking private industry's experience in collecting receivables to identify the variables to be tested and revise the scores assigned to delinquencies during the collection process as new information is obtained.

In addition, GAO pointed out that IRS should consider changing its basis for scoring nonfilers' delinquencies. While RWMS is designed to maximize collections, nonfiler delinquency scores are based on the probable amounts due, which may be substantially more than probable collections. GAO also believed that the RWMS formulas should be expanded beyond actual collection cases to cover the delinquency prevention and identification portion of the revenue officers' workloads to recognize the vital role prevention and identification can play in stemming the growth of the accounts receivable.

GAO found that IRS' latest evaluation of RWMS formulas contained limited analysis of the relationship between scores and collections or amounts due. IRS studied the relationship between scores and collections or amounts due for only a few broad types of unpaid tax and nonfiler delinquencies. This study showed that scores were generally related to actual collections or amounts due. However, scores and collections or amounts due might not have been related if more discrete, narrowly defined categories had been used. In addition, the evaluation results did not include statistical measures, such as sampling error or confidence level, that are needed to assess the validity and reliability of sample results. For these reasons, GAO believed that IRS' evaluation was not as useful as it could have been in assessing the RWMS formulas.

According to GAO, a sampling methodology would not be needed to evaluate RWMS formulas if IRS had a means of comparing delinquency scores with actual collections or amounts due for all cases worked. GAO believes that IRS should routinely include RWMS scores and collection or amount due information on its master file records and collection reports to provide a means for such comparison and thereby allow for continuous evaluation of RWMS scores. If, in the future, IRS wants to supplement such

	continuous evaluation with periodic analyses of some sample results, the samples should be drawn from more similar groups of delinquencies, and appropriate statistical measures should be calculated and reported.
Recommendation(s)	The Assistant Commissioner (Collection) should (1) seek the experience of private industry in identifying variables and prioritization practices affecting collections that IRS should consider, (2) consider scoring nonfiler delinquencies on the basis of probable collections rather than expected amounts due, (3) consider expanding RWMS to cover the employment tax delinquency prevention and identification components of revenue officers' workload, and (4) include RWMS scores on master file records and collection reports that track delinquency dispositions to provide the means for continuous evaluations of formulas and avoid the limitations of evaluations based on sample results.
Action(s) Taken And/or Pending	IRS generally agreed with GAO's recommendations and will contact private industry to identify variables and prioritization practices and test useful predictors for future prioritization efforts. IRS also plans to contract with private industry to test scoring delinquent returns based on yield and develop a database to track and score a sample of Federal Tax Deposit Alerts to develop a model to predict collections based on selected variables. Once IRS has completed its revisions to RWMS it will develop new reports based on population data to help evaluate equations and work to capture RWMS scores on the master file.
Related GAO Product(s)	GAO/GGD-91-36, 03/13/91 and GAO/GGD-91-94, 08/28/91

An Update on IRS' Progress on Accounts Receivable

GAO/T-GGD-92-26, 04/02/92

In testimony before the Senate Committee on Governmental Affairs, GAO updated its June 1991 testimony before the same Committee on IRS' progress in two areas: (1) slowing the growth and increasing collections of the accounts receivable and (2) implementing a strategic management process that relies on meaningful performance measures. GAO's discussion of the strategic management process is summarized on page 52.

GAO pointed out that IRS was continuing its struggle to stem the growth of the accounts receivable inventory and increase collections of delinquent accounts. The inventory not only continued to grow, it got older and collections of delinquent taxes did not keep pace with the growth. In fiscal year 1991, collections actually declined by 5 percent while the total accounts receivable inventory increased from $96.3 to $110.7 billion. IRS estimated that $29.1 billion of this amount was collectible.

GAO stated that in the past, it had supported staffing increases for collection as a short-term solution to curb these trends. However, even with the implementation of a fiscal year 1991 revenue initiative that provided additional revenue officer staffing and another initiative IRS was considering with its fiscal year 1993 budget request, IRS estimated that it would have fewer revenue officers than it had at the end of fiscal year 1991. As a result, GAO had some concerns about whether IRS was meeting Congress' intent to increase collection staff.

GAO also pointed out that IRS had initiated a number of efforts to address the accounts receivable problem that may help in the long term. For example, IRS was developing much needed information on the age of delinquencies, the types of taxpayers and taxes making up the inventory, and the sources of receivables. GAO stated that IRS should be able to use this information to better target its resources.

Related GAO Product(s)

GAO/T-GGD-91-20, 06/25/91; GAO/GGD-91-89, 09/30/91; GAO/T-GGD-90-19, 02/20/90; GAO/GGD-89-1, 10/14/88; GAO/GGD-90-111FS, 07/30/90; and GAO/T-GGD-90-60, 08/01/90

ADP and Information Technology

Tax Systems Modernization Issues Facing IRS

GAO/IMTEC-92-30, 03/02/92; GAO/T-IMTEC-92-10, 03/10/92; GAO/IMTEC-92-28, 03/12/92; GAO/IMTEC-92-27, 03/13/92; GAO/T-IMTEC-92-13, 04/02/92; GAO/T-IMTEC-92-15, 04/29/92; GAO/T-IMTEC-92-18, 05/13/92; GAO/IMTEC-92-55R, 05/22/92; and GAO/IMTEC-92-63, 09/21/92

During 1992, GAO continued to monitor IRS' Tax Systems Modernization Program. In several testimonies and reports to Congress, GAO provided an overview of the program and assessed IRS' progress in addressing eight critical success factors that are key to the program's success. GAO said that, ultimately, the success or failure of the modernization will rest on IRS top management commitment to the program, including following through and making sure each of the critical success factors are appropriately addressed. These success factors are:

- development and integration of a vision of how IRS intends to do business in the future using the new technology;
- completion of key planning components;
- implementation of a project tracking mechanism;
- development of a strategy for dealing with technological readiness risks;
- improvement of the procurement process;
- better management of the systems development process;
- implementation of a strategy for hiring, training, and retaining managerial and technical staff; and
- paying greater attention to security and privacy issues.

GAO had previously testified that these factors were not being fully addressed. In fiscal year 1992, GAO testified that IRS had made significant progress in addressing some of these critical success factors. For example, IRS had developed a business vision and published a Design Master Plan for the modernization. It was also making progress toward implementing a project-tracking mechanism. IRS was developing a strategy for hiring, training, and retaining the staff needed for carrying out the modernization and was giving priority attention to ensuring that security and privacy issues were appropriately addressed.

GAO remained concerned about IRS' planning, technological readiness, and procurement and systems development processes. In the planning area, for example, a transition plan describing how business functions of IRS would change from the currently slow, largely manual way of operating to the modernization's more rapid electronic methods is still not developed. Although IRS recognized that such a transition plan is needed, the agency had no timetable for its development and implementation.

IRS' plans to use "leading edge" technology as part of its modernized input-processing strategy was another area of GAO concern. IRS' input processing strategy, which relies heavily on electronic imaging to process tax returns, is a high-tech, high-risk, and high-cost venture. GAO testified that IRS lacked a sound analytical basis for proceeding with this technology.

While improvements had been made in the management of procurement and systems development processes, GAO said problems continue. For example, IRS missed opportunities to head off successful protests of its $1.4 billion Treasury Multi-User Acquisition Contract procurement. These protests had resulted in delaying IRS' ability to procure needed hardware and software items to move forward with the modernization. In addition, GAO attributed lengthy delays in developing a new remittance processing system largely to management's decision not to obtain early vendor input on the scope and complexity of the system and management's indecision concerning the system's requirements, costs, and benefits.

Finally, while IRS had made progress in addressing GAO concerns about security and privacy aspects of the program, GAO remained concerned with the independence among security administrators and software developers and the need to clearly delineate responsibility for protecting the privacy of taxpayer information.

Recommendation(s)

GAO made recommendations for four of the eight critical success factors: planning, technological readiness, procurement, and security and privacy. To fully address these critical factors, the Commissioner of Internal Revenue should (1) complete by the end of calendar year 1992 the integration strategy and business transition plan that are prerequisites for moving forward with the modernization and (2) take the following steps to ensure that IRS strategy for input processing is analytically sound before committing to its implementation.

- IRS should conduct a comprehensive analysis to determine the costs and benefits of alternative input-processing strategies. This analysis should, at a minimum, take into consideration anticipated technological advances; identify the different types of taxpayers and how they file returns; assess the current and projected filing media that would be suitable for each type; and determine the potential impact of various electronic filing incentives on the requirements for imaging and optical character recognition. This analysis should be updated periodically.
- On the basis of this analysis, IRS should structure its input processing strategy around the alternative, or mix of alternatives, that is determined to be most advantageous to the government.
- IRS should reexamine the functional requirements for two systems, the Document Processing System and Service Center Recognition/Image Processing System, and determine whether both systems will be needed and, if so, which system will be used for what so as to eliminate any potential overlap.

In addition, the Commissioner should (1) improve the procurement process by amending the Service's contracting procedures to require that all future solicitations clearly indicate that the software documentation requirements apply to all software for which IRS expects to assume maintenance responsibility, including preexisting and off-the-shelf software; (2) further improve the procurement process by developing guidelines—including appropriate methodologies and criteria—to be used in making price/technical tradeoff analyses and require that these guidelines be made an integral part of the planning documents for all such procurements; (3) separate the security administrators' and software developers' roles and designate responsibility for protecting the privacy of taxpayer information; and (4) establish a deadline for resolving these issues.

Action(s) Taken And/or Pending

IRS generally agreed with our recommendations to better address the critical success factors. IRS intends to complete its technical integration strategy and to develop its business transition plan after completing three ongoing reviews of its business operations. To better define its input processing strategy, IRS is examining the different alternatives for filing taxpayer returns and is performing an economic analysis of two input processing initiatives for meeting its tax processing needs. On the basis of these analyses, IRS may need to modify ongoing acquisitions.

IRS is also developing policies and procedures for making price/technical tradeoff analyses an integral part of the procurement process, and intends to require that its software documentation requirements be included in all future solicitations. Finally, IRS has agreed to ensure that the security and privacy responsibilities for the Tax System Modernization program are clearly specified and are independent of the systems development process.

Related GAO Product(s)

GAO/T-IMTEC-91-8, 06/25/91 and GAO/T-IMTEC-91-18, 07/09/91

Allegations Concerning Certain IRS Contracts for ADP Support Services

GAO/GGD-92-14R, 05/28/92

In response to a request from Congressman William E. Dannemeyer concerning several allegations made by a constituent, GAO provided information on IRS' negotiation and administration of certain contracts for ADP support services. GAO examined whether proper safeguards were implemented against contract abuse and the waste of tax dollars.

The contracts in question provided IRS and other Treasury bureaus with needed ADP support services. These services included requirements definition, systems analysis and design, software development, testing, maintenance, and program and project management.

The constituent alleged that (1) IRS contract administration practices did not ensure that the contractor's estimates of labor hours and skill levels required were reasonable and (2) IRS did not have the experienced staff to adequately review the contractor's task proposals even though the negotiation of proposals demanded that IRS have very technically qualified people to review them. IRS' Internal Audit staff identified similar weaknesses in the negotiation of task orders. In response, IRS managers revised procedures and increased the number of staff assigned to administer the contract, including the negotiation of task orders.

GAO interviewed IRS procurement staff who said that although much had been done to strengthen IRS administration of ADP support services contracts, further actions were needed. For example, (1) guidelines for acquiring ADP support services had been revised and (2) additional personnel had been assigned to administer the contract. However, one major remaining step was to acquire additional personnel with the necessary technical expertise to evaluate the number of labor hours and skill mixes required to perform a task.

Although potential weaknesses were alleged in certain related subcontracts, GAO did not review these subcontracts because IRS was making continuous changes in its procedures to negotiate task orders and related subcontracts.

Related GAO Product(s)

GAO/IMTEC-90-24, 1/12/90

Compliance

Millions in Savings Possible From VA's Matching Program With SSA and IRS

GAO/HRD-92-37, 12/23/91

In a report to the Chairmen, Senate Committee on Finance, Senate and House Committees on Veterans Affairs, and House Committee on Ways and Means, GAO reported on the progress the Department of Veterans Affairs (VA) had made in implementing its authority to verify beneficiary-reported income with IRS tax data and SSA earnings records. Section 8051 of the Omnibus Budget Reconciliation Act of 1990 granted VA access to tax records. Section 8051(d) required the Comptroller General to report on the effectiveness of using tax records to verify eligibility for VA benefits. This report responded to that requirement.

GAO reported that VA's first computer match of income reported under the improved pension and parents' dependency and indemnity compensation programs with IRS data on unearned income (such as dividends and interest) for tax year 1989 confirmed the potential for substantial savings. Initial results showed that nearly $340 million more in unearned income was reported to IRS than to VA by the same beneficiaries for that tax year. VA officials also expected additional savings to result from matches with SSA earnings data.

GAO reported that VA (1) was notifying beneficiaries of the discrepancies found in reported income and would take action to suspend or terminate benefits; (2) had taken appropriate steps to safeguard the data received from both the IRS and SSA; (3) was following the procedures established by law to protect the beneficiaries' rights and afford them due process; and (4) in disputed cases, was prepared to verify income discrepancies with third parties, such as financial institutions and past and present employers.

GAO told the committees that despite the promising initial results, start-up for the matching program had been slow. Nearly one-third of the time the law allowed VA to use IRS and SSA data had been spent gaining access to the data. VA and IRS completed their matching agreement in June 1991 and VA received initial IRS data in July 1991. VA finalized an agreement with SSA in July 1991 but did not receive Social Security data until March 1992. Finally, GAO reported that progress in matching had been limited to benefits programs. VA Health Administration officials had not notified beneficiaries of their intent to verify income and were still considering how to

implement the law most effectively. Health officials cite the lack of a systemwide database and staff for its lack of progress.

Related GAO Product(s)

GAO/HRD-89-24, 03/16/88

IRS' Implementation of Certain Compliance Initiatives

GAO/GGD-92-45FS, 01/30/92 and GAO/GGD-92-118, 07/31/92

IRS' fiscal year 1991 appropriation included $191 million for 3,476 additional staff to implement 9 compliance initiatives that were expected to produce an additional $5.7 billion in enforcement revenue during the 5 years ending with fiscal year 1995. At the request of the Chairman and Ranking Minority Member of the Senate Committee on the Budget, GAO monitored the results of three of those initiatives. The three were designed to (1) increase collection staff so that IRS could collect additional delinquent accounts, (2) increase examination staff so that IRS could audit more returns, and (3) revise IRS' training program for revenue agents so that experienced staff could spend less time training new staff and more time doing audits.

GAO reported that the fiscal year 1991 results for the three initiatives were mixed and that IRS' most recent revenue projection for the three initiatives (March 1992) was about 25 percent less than the revenue target in the President's fiscal year 1991 budget submission. Most of that reduction was attributable to the collection initiative. IRS could not provide complete documentation on how the original 5-year revenue target for that initiative was calculated. According to IRS, however, the reduction in the collection initiative resulted from a combination of staffing reductions, changes in productivity assumptions, and failure to account for the costs associated with using experienced staff to train new hires.

GAO concluded that the quarterly reports IRS prepared to track the results of the various initiatives did not provide Congress and other interested parties with enough meaningful information on the impact of those initiatives. That was because the tracking system focused on revenues gained from staffing increases authorized by the initiatives but did not account for reductions in revenue that occurred as a result of reductions to baseline staffing. As GAO has said in the past, it does little good for Congress to approve additional staffing with the intent of generating additional revenue if that benefit is eroded by reductions to baseline staffing.

Recommendation(s)

The Commissioner of Internal Revenue should report the net revenue effect of the staffing increases that Congress authorized in fiscal year 1991 to congressional oversight, budget, and appropriation committees. In doing so, IRS needs to revise its tracking approach so that it (1) compares the total examination and collection staffing levels that Congress

authorized in fiscal year 1991 and the total revenue Congress expected from that authorization to the total examination and collection staffing levels and revenue that IRS actually achieved and (2) explains the reasons for the differences in what Congress expected and what IRS actually achieved.

The Commissioner should direct the Assistant Commissioner for Collection to review the revenue estimation methodology for the collection function to ensure that its assumptions and the data that are used for computing revenue estimates are valid and adequately documented.

Action(s) Taken And/or Pending

IRS agreed that the needs of Congress and other interested parties would be fully met with a tracking approach that focuses on the net effect of staffing increases and the effect on total revenue. IRS also recognized the need to improve its standard for documentation.

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; GAO/GGD-90-85, 06/20/90; and GAO/GGD-90-119, 09/05/90

Federal Agency Tax Compliance Problems Remain: Improvements Are Planned

GAO/GGD-92-29, 02/18/92

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, GAO updated information provided the Subcommittee in 1990 on the status of federal agency accounts in IRS' accounts receivable inventory. GAO reported that tax payment and processing problems identified in its earlier review were still occurring. Of the $268.5 million in federal agency accounts receivable included in IRS' June 1991 accounts receivable inventory, at least $245.1 million, or 91 percent, was attributable to tax payment and processing errors and did not reflect money owed. GAO found that one agency's mistake caused a single erroneous assessment of $212.4 million. Available information indicated that 1 of the 12 federal agencies GAO selected for detailed analysis may have to pay about $200,000 in late tax payments to resolve its account balance.

GAO also reported that the late filing of employment tax returns was still prevalent. Of the 525 agency accounts in IRS' accounts receivable inventory on June 22, 1991, 270 accounts, or 52 percent, had 1 or more late-filed employment tax returns. In its earlier work, GAO reported that two-thirds of the agencies' accounts sampled had a late filed employment tax return. Not only is late-filing of tax returns a measure of noncompliance by the agencies, but late filing of tax returns also impairs IRS' ability to detect late and insufficient payments and errors because IRS does not complete processing and reconciling tax information until a tax return has been filed for the quarterly period.

GAO also reported that other problems previously identified continued to occur at the agencies and caused their accounts to show up in IRS' accounts receivable inventory. For example, checks issued by the Department of the Treasury for payment of agencies' taxes continued to get lost as they moved through the Federal Tax Deposit system. Agencies continued to make mistakes in paying their taxes and filing their quarterly tax returns, and mistakes eventually showed up in their accounts at IRS. Likewise, IRS' mistakes in processing agency payments continued to result in erroneous receivables.

GAO also pointed out that resolving erroneous receivables can take long periods of time. In fact, 17 of the 63 agency accounts with balances of $100,000 or more in IRS' accounts receivable inventory from the previous study still had unresolved amounts due a year later. The majority of the unresolved accounts had been part of IRS' accounts receivable inventory

for even longer periods. Many of them related to tax periods more than 5 years old.

Summary of Related Action(s)

IRS coordinated with Treasury's Financial Management Service to successfully pilot test its new Federal Tax Deposit system for federal agencies—FEDTAX. This system (1) allows federal agencies to pay their taxes and file their quarterly tax returns electronically and (2) is expected to enhance communications with agencies in regard to their account status. Final actions are pending on how to promote accountability by top agency management for tax compliance through appropriate reviews. It is expected that about 300 federal agencies (both defense and civilian) will be on line in early 1993. Training of agency staff in the use of FEDTAX is ongoing.

Related GAO Product(s)

GAO/T-GGD-91-2, 10/18/90; GAO/GGD-91-45, 04/16/91; and GAO/T-GGD-91-59, 07/24/91

IRS' Efforts to Improve Corporate Compliance

GAO/GGD-92-81BR, 4/17/92

In a report to the Chairman of the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, GAO discussed the second phase of its work on IRS' program to audit the nation's largest corporations—the Coordinated Examination Program (CEP). The report covered (1) trends in CEP examination results, (2) CEP audit coverage estimates, and (3) a profile of CEP taxpayers. GAO also reported on IRS' response to the drop in small corporation tax compliance.

GAO found that total CEP-recommended taxes from fiscal years 1987 to 1991 increased 167 per cent, from $7 billion to $18 billion, including one large $6.5 billion dollar case closed in fiscal year 1991. Excluding that case, total recommended taxes increased by 71 percent—from $7 billion to $11.5 billion. CEP-recommended taxes per direct examination hour remained fairly steady from fiscal years 1987 through 1990 and increased in 1991 due to the large case. The term "recommended tax" refers to the amount of additional tax that an examiner concludes should have been paid on the basis of the examination, together with any associated penalties. If the taxpayer agrees with this recommended amount, it is assessed; if not, the taxpayer may appeal it. For CEP, IRS estimated that taxpayers appeal about 90 percent of the taxes recommended and that about 25 percent of the appealed recommendations are actually assessed.

At the Subcommittee's April 1991 hearing on corporate tax compliance, the Commissioner of IRS testified that "with large corporations, we audit virtually every CEP taxpayer every year." GAO used IRS' method of calculating audit coverage for other groups of taxpayers to determine how widely CEP corporations were audited. GAO found that CEP audit coverage ranged from 66 to 69 percent for fiscal years 1987 through 1990 and 77 percent in fiscal year 1991. IRS officials said they do not believe that an audit coverage measure is applicable to the CEP program because every CEP taxpayer's return is reviewed for revenue potential before it is excluded from audit.

To create a profile of CEP corporations, GAO matched a list of CEP taxpayers in 1991 to IRS records of 1988 corporate income tax returns. On the basis of their 1988 returns, GAO found that the majority of CEP corporations in the sample were in manufacturing, finance/insurance, or transportation industries. Average reported assets were $6.5 billion. CEP corporations in the sample reported an average income tax of $61 million based on average taxable income of $179 million. After claiming tax credits and

other tax adjustments, they reported an average net tax liability of $42 million, or 23 percent of average taxable income.

IRS' most recent Taxpayer Compliance Measurement Program (TCMP) audit results showed that 2.3 million small corporations (about 80 percent of all corporations) voluntarily paid an estimated 61 percent of the tax they owed in 1987. For 1980, just 7 years earlier, IRS' TCMP audit results showed this voluntary compliance to be 81 percent. GAO found that IRS continued to study the data on the drop in compliance but had not yet initiated special compliance programs. IRS had begun four studies designed to provide information helpful in targeting such programs.

Summary of Related Action(s)

IRS is continuing to revise its CEP. GAO is completing the third phase of its CEP review and will be reporting on factors that affect the success of CEP audits and on the status of IRS' changes to CEP.

Related GAO Product(s)

GAO/T-GGD-91-21, 4/17/91

Status of Efforts to Curb Motor Fuel Tax Evasion

GAO/GGD-92-67, 05/12/92

In response to a request from Congressmen Downey and McGrath, GAO studied federal motor fuel excise tax compliance and administration. This report discussed (1) the lack of information to determine motor fuel excise tax compliance, (2) the effect of recent legislation on compliance, (3) the effectiveness of IRS programs in promoting compliance, and (4) state initiatives that could be adapted to bolster federal motor fuel excise tax collections.

GAO found that no reliable statistical information was available to estimate the current level of fuel tax evasion. IRS had recognized this problem and was investigating alternative methods for estimating motor fuel excise tax evasion. Although government and private officials involved in the motor fuel distribution and tax system agreed that the legislative changes that have taken effect over the last 5 years have reduced some forms of motor fuel excise tax evasion, disagreements existed about the extent of the reductions.

Because the level of evasion was unknown, GAO could not assess the effectiveness of IRS compliance programs. IRS was working with the Federal Highway Administration and selected states to determine whether joint enforcement efforts could improve compliance with motor fuel excise taxes. IRS was also developing a database containing information on all firms authorized to deal in tax-free motor fuel. The database was to be used by IRS and states in examining compliance and by terminal operators to determine whether firms they do business with are properly registered with IRS and thus eligible to purchase fuels tax-free.

GAO found that the applicability of states' compliance initiatives to federal motor fuel excise tax enforcement was difficult to gauge because of differences between state and federal taxes and collection systems. IRS was considering shifting the motor fuel excise tax collection point to the refinery level, which would be similar to New York State's collection point. GAO concluded that moving the collection point would reduce the number of liable firms and should help minimize the potential for evasion. Industry members, however, disagreed about the desirability of such a move.

Regardless of what the actual level of gasoline tax evasion may be, GAO found strong arguments suggesting that refinery-level taxation could curb evasion more than the current collection scheme. For example:

- Gasoline would change hands fewer times between production and taxation, resulting in larger volume transactions.
- Refiners are presumed to be financially more sound and to maintain better records than other parties in the distribution chain.
- The tax would be imposed on fewer taxpayers, thereby reducing the universe for IRS' examination efforts.

A key question, however, is whether refinery-level tax collection imposes competitive disadvantages. The American Petroleum Institute argued that the cost disadvantages would make the petroleum distribution system less efficient or more reliant on foreign imports. For example, increasing carrying costs for gasoline before it was marketed would create a disincentive to store gasoline, which could result in spot shortages.

GAO concluded that the differences in competitive costs that could be created by moving the point of taxation to the refinery would likely vary on average between 2 cents per barrel (.0005 per gallon) for U.S. competitors and 4 cents per barrel (.001 per gallon) between U.S. and foreign competitors. GAO did not know whether such cost difference could have a significant effect on competition. In contrast, depending on how extensive evasion is in a particular market, tax-paying firms could face a 14.1 cent per gallon disadvantage compared to tax-evading firms.

Matter(s) for Congressional Consideration

Congress should explore the level of tax evasion with the responsible federal agencies and affected industries. If evasion is sufficiently high, Congress should consider moving the collection of gasoline excise taxes to the point at which gasoline first leaves the refinery or is first imported.

Action(s) Taken And/or Pending

As of December 31, 1992, no congressional action had been taken.

Compliance 2000: A Worthy Idea That Needs Effective Implementation

GAO/T-GGD-92-48, 06/03/92

In testimony before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, GAO highlighted some key issues that may hinder effective implementation of Compliance 2000, IRS' most recent effort to improve voluntary compliance with the tax laws.

The goal of Compliance 2000 is to discern the root causes of tax noncompliance and then apply the appropriate tools to improve voluntary compliance in the future. It is based on the assumption that taxpayers fail to comply for different reasons and, therefore, IRS should be flexible in its approach to correcting the problem. Rather than focusing on audits and other enforcement resources to maximize short-term revenue yield, IRS says it wants to improve tax compliance by more effectively meeting taxpayer needs.

In its testimony, GAO said Compliance 2000 is a worthy idea, but it raised several issues that IRS needs to address in implementing this compliance effort. First, IRS had not yet developed a structure for planning, managing, and monitoring the Compliance 2000 effort to ensure that the program remains focused and objective. Second, the Taxpayer Compliance Measurement Program (TCMP), IRS' primary tool for measuring noncompliance nationwide, had not been integrated with the Compliance 2000 effort to provide objective data on noncompliance and measure the program's effectiveness. Finally, IRS had not yet determined how Compliance 2000 would affect already low audit rates. GAO concluded that although Compliance 2000 is noble in its intent, it requires careful implementation.

Recommendation(s)

GAO recommended that the Commissioner of Internal Revenue

- develop a structure for planning, managing, and evaluating Compliance 2000 efforts;
- integrate Compliance 2000 efforts with TCMP to ensure statistically based measures of compliance; and
- ensure that Compliance 2000 efforts do not erode already low audit rates.

Action(s) Taken And/or Pending

As of December 31, 1992, IRS had not acted on GAO's recommendations.

Problems Persist in Determining Tax Effects of Intercompany Prices

GAO/GGD-92-89, 06/15/92

In a report to the Ranking Minority Member of the Senate Committee on Foreign Relations, GAO discussed foreign-controlled companies and the use of transfer pricing. Intercompany transfer prices are prices companies charge related parties for goods and services transferred on an intercompany basis. IRS uses the authority provided by section 482 of the Internal Revenue Code to allocate income among related parties if it believes transfer prices have been inappropriate.

GAO found that foreign-controlled corporations often reported lower gross profits, net income, and U.S. taxes paid as percentages of sales than their domestically controlled counterparts did. Although statistics like these do not prove actual propriety, the dollar implications of the transfer prices that IRS did question in the late 1980s and early 1990s is significant.

Various factors affected IRS' ability to determine and recover section 482-related taxes possibly underpaid. Recent congressional and regulatory actions helped address such factors as access to records. GAO recommended doing more in the areas of staffing, management information, and the use of centralized transfer pricing expertise.

Despite the recent changes, GAO did not expect problems with section 482 to be resolved at any time in the near future. This was due, for instance, to the continuing fact-sensitive nature of section 482 cases, with each case presenting a unique set of facts and circumstances requiring consideration. Although GAO analyzed various alternatives to the current arm's length pricing approach, all presented problems.

Recommendation(s)

The Commissioner of Internal Revenue should (1) continually assess its international staffing needs to best meet its international workload; (2) formally plan how it will discern and act on trends in types of section 482 findings, in intercompany data submitted on information returns, and in section 482 case disposition; and (3) involve its newly appointed section 482 specialists and/or their administrator in continually analyzing international management information initiatives from a section 482 perspective, helping determine staffing needs for section 482 issues, and raising for discussion policies that conflict with an ongoing emphasis on transfer pricing.

Action(s) Taken And/or Pending

IRS' fiscal year 1993 Operations Annual Business Plan noted that by September 30, 1993, IRS will develop a resource model for allocating staffing to international enforcement. The plan also calls for (1) analyzing the profits of foreign- versus U.S.-controlled corporations, (2) determining the impact of transfer pricing issues on those profits, (3) making sure a case management system helps IRS track and coordinate international issues, and (4) working to collect and analyze information needed for determining proper transfer prices.

According to an IRS official, the section 482 specialists have access to the case management system, will participate in resource allocation decisions, and have been involved in proposed section 482 regulations.

Related GAO Product(s)

GAO/GGD-81-81, 09/30/81

Money Laundering Forms Could Be Used to Detect Nonfilers

GAO/T-GGD-92-56, 06/23/92

In testimony before the Subcommittee on Oversight of the House Committee on Ways and Means, GAO discussed IRS' efforts to use large cash payment reports (Form 8300) in its enforcement programs. Businesses must file Forms 8300 with IRS for any cash payments over $10,000 that are received in a single transaction or series of related transactions. The forms report information, including the name, address, and tax identification number of the purchaser. GAO used a sample of purchasers identified on 1,000 forms to test their usefulness in identifying potential nonfilers.

GAO testified that over one-third of the forms were of little or no use for identifying nonfilers because they either had no tax identification number or a number that may have been incorrect. Without correct identification numbers, IRS cannot use the forms in computer matches to identify nonfilers and underreporters. IRS is developing an automated method that will allow businesses to validate an identification before a purchaser leaves the business. Applying this tool to Form 8300 transactions should increase the number of correct identifications reported on the forms.

GAO said that the forms can be useful in identifying potential nonfilers when correct identification numbers are provided. For example, of the 578 persons who provided correct identification, GAO found that 21 percent did not file a 1990 tax return. Further investigation would be needed to determine whether their incomes were large enough to require a tax return. GAO also said that through an inadvertent change, IRS did not use 8300 forms in its 1989 or 1990 computer matches to identify potential nonfilers. During these years, the number of forms grew from almost 20,000 in 1988 to more than 30,000 in 1990. IRS recently corrected the mistake and will begin using the forms to identify nonfilers for tax year 1991.

Further, GAO testified that the forms can be useful in identifying taxpayers who file tax returns but underreport their income. In a 1989 study, IRS used a sample of the forms filed in 1985 and 1986 to select 855 returns for audit. IRS found unreported income in 50 percent of them. The unreported income totaled about $15.3 million, about $17,800 per return.

Related GAO Product(s)

GAO/GGD-93-1, 10/15/92; GAO/T-GGD-92-57, 06/30/92; GAO/GGD-92-46, 02/6/92; GAO/GGD-91-125, 09/25/91; and GAO/GGD-91-53, 03/18/91.

Urban Poor: Tenant Income Misreporting Deprives Other Families of HUD-Subsidized Housing

GAO/HRD-92-60, 07/17/92

In response to a request from the Chairman, Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing, and Urban Affairs, GAO did a study to determine whether the Department of Housing and Urban Development (HUD) has sufficient internal controls to ensure that families in federally subsidized public and Section 8 housing accurately reported their income. GAO found that HUD lacks sufficient information to ensure that federally subsidized housing units are occupied by needy low-income families and that those living in such units are paying correct rents. Public housing agencies and management agents cannot effectively verify the accuracy of most subsidized households' self-reported wage, interest, and dividend income.

GAO's computer match of approximately 175,000 HUD-subsidized households' records (less that 4 percent of such records) with federal tax data revealed that in 1989, 21 percent of the matched households may have understated their incomes to HUD by $138 million. This would have resulted in potential excess federal subsidies of $41 million. Of households that may have understated their incomes, 63 percent reported no wage, interest, or dividend income in 1989.

Recommendation(s) to HUD

To gain access to tax data, HUD should (1) incorporate in its assisted housing information systems appropriate data safeguards and (2) conduct a cost-benefit analysis of using tax data to identify subsidized households' misreporting of income and report the results to Congress.

Recommendation(s) to Congress

When HUD's centralized public housing information system is fully operational and data safeguards are in place, Congress should amend the Internal Revenue Code to allow HUD temporary access to federal tax data to validate its cost-benefit analysis. If HUD's use of tax data is indeed cost beneficial, Congress should further amend the Internal Revenue Code to broaden and make permanent HUD's access to federal tax data, including its use in the Section 8 program when that program's centralized management information system becomes fully operational.

Action(s) Taken and/or Pending

HUD generally agreed that its automated system should be designed to include appropriate safeguards and to permit effective use of federal tax data. But HUD did not agree on the need to conduct a cost-benefit analysis

before being granted access to tax data. Moreover, IRS opposes granting HUD access to federal tax data because of its continuing concern about the potential negative impacts of tax data being used for nontax administration of the nation's tax system. As of December 31, 1991, no administrative or congressional action had been taken.

Related GAO Product(s)

GAO/HRD-86-32, 03/12/86; GAO/HRD-87-79FS, 05/26/87; GAO/HRD-87-62, 09/21/87; GAO/HRD-88-24, 03/16/88; and GAO/HRD-92-37, 12/23/91

Independent Contractor Compliance

GAO/GGD-92-108, 7/23/92 and GAO/T-GGD-92-63, 7/23/92

At the request of Senators Max Baucus and David Pryor and Representative Doug Barnard, Jr., GAO reviewed the tax effects of the Internal Revenue Service's (IRS) Employment Tax Examination Program (ETEP). This program focuses on small business compliance with the common law rules for classifying workers as either "employees" or "independent contractors" (self-employed individuals who provide services).

GAO issued its report and testified at a hearing before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means. In both the report and testimony, GAO said the common law rules for classifying workers remain as unclear and subject to conflicting interpretations as GAO described in its 1977 report entitled Tax Treatment of Employees And Self-Employed Persons by the Internal Revenue Service: Problems and Solutions. Since then, no final action has been taken to clarify the common law.

GAO also reported that independent contractor compliance continued to be a concern. As early as 1979, GAO concluded that noncompliance among self-employed workers, such as independent contractors, was serious enough to warrant tax withholding on payments to them. Since the mid-1970s, IRS studies have documented the lower level of compliance of independent contractors compared to employees. IRS estimated that self-employed individuals (including independent contractors) would underpay $20.3 billion in 1992 taxes by not reporting income.

Because of the continual high tax noncompliance of independent contractors, IRS began the nationwide ETEP in 1988. IRS planned to reduce this noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. GAO reported that 6,900 ETEP audits through December 1991 proposed assessments of $468 million and reclassified 338,000 workers as employees. Since fiscal year 1989, IRS data show that 90 percent of ETEP audits found misclassified workers.

GAO found that while the classification rules still need to be clarified, IRS could use approaches in addition to ETEP to help improve independent contractor compliance. For example, IRS could require businesses to (1) withhold taxes from payments to independent contractors and (2) improve compliance in filing information returns on payments to

independent contractors. GAO concluded that either approach should help collect more of the taxes owed through means other than retroactive tax assessments under ETEP. While GAO acknowledged that both approaches would increase the burden on independent contractors and businesses that use them, GAO believed that both approaches have merit.

GAO reported on the pros and cons of each approach. For example, GAO said withholding provides the cornerstone of employees' tax compliance, as well as a gradual and systematic method to pay taxes. GAO also reported that withholding has several administrative problems that need to be resolved—such as ensuring that the tax withheld approximates the tax due.

GAO's second approach—improving information reporting—would shift emphasis to the clearer laws on information returns. IRS' data show that independent contractors reported 97 percent of the income that appears on information returns. Without these returns, contractors reported only 83 percent. GAO assessed eight options for strengthening information reporting, itemizing the various pros and cons of each. GAO identified the options largely through past and ongoing work.

Recommendation(s) to Congress

Congress needs to clarify the rules for classifying workers along the lines that GAO recommended in its 1977 report by amending the law to exclude certain classes of workers from the common law definition of "employee." Congress also should consider legislation to improve independent contractor compliance through withholding and/or improved information reporting.

Action(s) Taken And/or Pending

As GAO completed its report, H.R. 5011—the Employment Tax Improvement Act of 1992—was introduced to revise employment tax procedures and improve information reporting along with the compliance of independent contractors. This bill included many of GAO's eight options as well as others. No further action was taken as of December 31, 1992.

Related GAO Product(s)

GAO/GGD-89-107, 9/25/89; GAO/GGD-91-94, 8/28/91; and GGD-77-88, 11/21/77

Federal Agencies Should Report Service Payments Made to Corporations

GAO/GGD-92-130, 09/22/92

As part of its ongoing work on corporate compliance, GAO explored whether information reporting by federal agencies that pay corporations for services would help to improve compliance. In a report to the Director, Office of Management and Budget, GAO reported that IRS data have shown that corporate tax compliance is a problem. For example, among small corporations (those having less than $10 million in assets), (1) voluntary compliance declined from 81 percent in 1980 to 61 percent in 1987; and (2) income was underreported by $15 billion, including over $9 billion in gross receipts earned from providing services and goods.

GAO said that IRS estimated that small corporations will not pay $7 billion in federal income taxes and large corporations will not pay $24 billion in 1992. In addition, about 22 percent of 26,000 federal corporations, 90 percent of which were contractors, owed $773 million in federal taxes as of July 1991.

In 1990, federal agencies awarded $68 billion for service contracts of more than $25,000. Of this amount, GAO estimated that $61 billion (90 percent) went to corporations. Because information reporting generally excludes payments to corporations, federal agencies did not have to inform IRS of this $61 billion.

Requiring federal agencies to report such payments could improve corporate tax compliance and provide IRS with an important tool for detecting unreported income or unfiled tax returns. Considering the past problems in reporting payments made to individuals, GAO said that agencies need controls to ensure that they report all required payments made to federal contractors, as well as the correct tax identification numbers.

Recommendation(s)

The Director of the Office of Management and Budget should require agencies to

- issue information returns on payments to corporations providing services;
- validate taxpayer identification numbers for those contractors receiving federal contracts for services before making the first payment;
- withhold 20 percent of contract payments, under the terms of the contract, to contractors providing invalid identification numbers until these numbers are validated; and

- certify annually that the required information returns on payment have been issued.

If the Director implements these recommendations, the Commissioner of IRS should actively use the information returns in IRS' enforcement programs.

Action(s) Taken And/or Pending

The Office of Management and Budget and IRS have agreed to test GAO's recommendations at the General Services Administration. The test will focus on 1993 payments and will require the filing of information returns in 1994. IRS will use the information during 1995 and 1996 in its enforcement programs. Final test results should be available in 1996.

Related GAO Product(s)

GAO/GGD-90-90, 06/05/90; GAO/T-GGD-91-21, 04/17/91; GAO/T-GGD-91-40, 06/10/91; GAO/GGD-91-118, 09/29/91; and GAO/T-GGD-92-23, 03/17/92

General Management

Standards Adhered to in Issuing Revenue Ruling 90-27

GAO/GGD-92-15, 11/19/91

Revenue Ruling 90-27 deals with financial instruments known, generically, as auction rate preferred stock. In response to a request from the Chairman, Subcommittee on Private Retirement Plans and Oversight of the IRS, Senate Committee on Finance, GAO determined whether there were any violations of recusal statements,[1] conflict of interest law,[2] regulations, or Standards of Conduct (as set forth in agency regulations and Executive Order 12674) on the part of certain IRS officials in connection with the issuance of Revenue Ruling 90-27. GAO also reviewed the procedures used in the issuance of this revenue ruling to determine if they were proper.

GAO found no evidence of any violations of recusal statements, federal conflict of interest law, regulations, or Standards of Conduct on the part of the Commissioner of Internal Revenue, the Chief Counsel, or the former Acting Chief Counsel in connection with the issuance of Revenue Ruling 90-27.

GAO found, however, that the way in which the Commissioner's and Chief Counsel's recusal statements are written can lead to some uncertainty about the situations in which they apply. This is because the recusal statements are written so broadly they may lead to the impression that there is a violation when, in fact, none has occurred.

GAO found no instances in which IRS staff failed to follow procedures set forth in the Revenue Ruling Handbook. However, GAO expressed concerned that IRS' primary reliance on individuals representing only one brokerage house for consultations about the auction rate preferred stock and the market for it could be viewed as inappropriate, even though GAO found nothing improper about the actions taken by the representatives of the brokerage house.

[1]Recusal statements are part of a government official's ethics agreement to resolve potential or actual conflicts of interest. They contain lists of firms or organizations for which the official disqualifies himself or herself from official action.

[2]The applicable law is 18 U.S.C. 208, which prohibits a government employee from participating in any matter that may affect a personal financial interest.

Recommendation(s)

The Commissioner of Internal Revenue and the Chief Counsel, in consultation with Treasury's Designated Ethics Official and Office of Ethics, should (1) revise their recusal statements to make the language in them consistent with their ethics agreements and (2) determine the extent to which recusal statements for the Commissioner and Chief Counsel should list former clients when no current financial interest is involved.

For matters of broad applicability, the Commissioner, in conjunction with the Chief Counsel, should direct Chief Counsel staff to seek a range of views and opinions in cases where it is deemed appropriate to contact outside parties for information necessary to issue a revenue ruling. GAO said that such views and opinions could easily be obtained (1) by inviting additional people to meetings to discuss proposed rulings or (2) through telephone discussions with other interested parties.

Action(s) Taken And/or Pending

The Commissioner of Internal Revenue and the Chief Counsel agreed with the recommendations and said that they would take steps to implement them.

IRS' Progress on Integrity and Ethics Issues

GAO/GGD-92-16, 12/31/91 and GAO/T-GGD-92-62, 07/22/92

During 1992, GAO continued to monitor the status of IRS' efforts to deal with integrity and ethics issues. In a report to and testimony before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO said that IRS had made progress in dealing with certain ethics and integrity issues, but much more remained to be done.

GAO commented specifically on IRS' actions to implement recommendations GAO made in July, 1991, testimony. GAO had recommended that IRS should

- focus attention on improving communications with employees and encouraging ethics awareness,
- require its National Office Human Resource staff to oversee adjudication of disciplinary actions involving misconduct by its senior employees to eliminate perception of disparate treatment of these cases,
- publicize summary information about misconduct cases and sanctions taken against employees at all levels, and
- use its management information system for tracking the outcome of misconduct cases to periodically review adjudicative decisions to provide assurance that employee sanctions are adequately and equitably applied.

GAO concluded that IRS had communicated to its employees information on their ethical responsibilities, ways to report misconduct, and protections against reprisal for reporting misconduct. GAO also found that IRS had made some progress to dispel negative perceptions about its willingness to take appropriate disciplinary actions for employee misconduct. Despite these improvements, GAO said that IRS was still unable to fully use its management information system as a tool to help ensure that sanctions against employees were adequately and equitably applied. GAO said that IRS needed to move quickly to improve the system.

Action(s) Taken And/or Pending

IRS has taken several actions to implement the earlier GAO recommendations. For example, IRS has

- provided at least 8 hours of ethics training to almost 13,000 employees, published hotline numbers, and established ethics coordinators;

- consolidated the adjudicative process for misconduct of senior employees, with all such decisions coordinated by the National Office Human Resource staff;
- published an agencywide newsletter that provides examples of improper activities by employees, managers, and executives and the sanctions imposed; and
- issued instructions to field staff designed to improve the timeliness and accuracy of data in the management information system.

Related GAO Product(s)

GAO/T-GGD-91-58, 07/24/92 and GAO/GGD-91-112FS, 07/24/91

IRS' Progress in Strategic Management

GAO/T-GGD-92-26, 04/02/92

In 1984, IRS started a strategic management process in recognition of the need for improved central management direction and oversight. In testimony before the Senate Committee on Governmental Affairs, GAO discussed progress IRS had made in strategic management since GAO's June 1991 testimony before the same Committee.

GAO stated that IRS had (1) sharpened the focus of its strategic business plan, (2) improved its process for evaluating field office performance, and (3) started to identify mission-related performance measures. GAO said that the effort to identify mission-related measures was a key challenge facing IRS and represented a shift from a mindset in which IRS traditionally viewed its work along functional lines.

Focusing the Strategic Business Plan

IRS identifies long-term objectives and strategies in a strategic business plan that it revises annually. On the basis of experiences with earlier planning efforts, IRS has revised the plan's structure. As a result, the number of objectives was reduced from six to three: (1) increasing voluntary compliance, (2) improving quality and productivity, and (3) reducing taxpayer burden. IRS envisions these three objectives as being the ones most directly related to its mission.

Implementing an Improved Business Review Process

IRS has established an annual business review process. For fiscal year 1991, IRS' field offices were evaluated on, among other things, how well they performed on "corporate critical success factors." These factors represented actions IRS believed were needed during the year to ensure adequate progress toward meeting its long-term objectives. In 1991, there were 13 such factors. GAO evaluated IRS' fiscal year 1991 business review process and identified some areas that needed improvement. Overall, GAO said that the single most important step IRS can take to improve the business review process and make the reviews more useful to top management was to develop appropriate measures for assessing how well IRS is meeting its mission.

Identifying Mission-Related Measures

Traditionally, IRS' performance measures have been primarily functionally oriented. IRS has recognized the importance of developing broader, more mission-related measures. Thus, IRS is developing "corporate" or organizationwide measures of voluntary compliance, burden, and

productivity—reflecting the three business objectives. In addition, IRS is taking a nationwide sample of individual taxpayers to develop a baseline corporate measure of customer satisfaction.

During the same testimony, GAO also discussed IRS' progress on accounts receivable. That discussion is summarized on page 22.

Related GAO Product(s)

GAO/GGD-89-1, 10/14/88; GAO/GGD-91-74, 04/29/91; GAO/T-GGD-91-20, 06/25/91; and GAO/GGD-92-125, 08/13/92

Management of IRS Undercover Operations

GAO/GGD-92-79, 04/21/92 and GAO/GGD-92-80, 04/21/92

In two reports to Senators Harry Reid and Richard Bryan and Congressman James Bilbray, GAO examined the management of IRS undercover operations. One report reviewed a specific undercover operation, Project Layoff. The second report looked at IRS' current management of undercover operations in general.

IRS carried out Project Layoff in 1984 and 1985 to gather information about organized crime and illegal bookmaking in Las Vegas and other cities throughout the United States. In the operation, IRS agents established a Las Vegas bookmaking business in an attempt to identify unreported gambling income. GAO found that although Project Layoff had tangible enforcement results, it was costly in terms of IRS credibility because IRS did not have adequate records to keep track of about $22 million in bets and $2.5 million in cash that flowed through the operation.

In addition, GAO determined that IRS was not fully prepared to execute an illegal bookmaking operation of the magnitude of Project Layoff. For example, (1) IRS lacked specific guidelines for accounting for business receipts and disbursements at the time of the operation, (2) IRS undercover agents did not develop or use an adequate recordkeeping system or controls to track wagers and cash, and (3) IRS managers did not adequately oversee the operation's business activities.

In the second report, GAO reviewed 183 other undercover operations and found that although IRS had extensive controls to help minimize the risks associated with conducting undercover operations, these procedures were often not followed. For example, while IRS required that agents audit each undercover operation quarterly and at its conclusion, both quarterly and closing financial audits were frequently not completed in the operations in which federal funds had been expended.

On the basis of the results of its studies, GAO concluded that IRS had not adequately overseen the more costly and sensitive operations for which the Assistant Commissioner (Criminal Investigation) is accountable. The IRS National Office had little assurance that these projects were being carried out so as to minimize the potential for operational breakdowns and misuse of funds.

Recommendation(s)

The Commissioner of Internal Revenue should direct the Assistant Commissioner (Criminal Investigation) to undertake a number of steps to strengthen the management and oversight of IRS undercover operations. These steps should include

- reaffirming the importance of monitoring and auditing undercover operations,
- evaluating completed operations so that lessons learned can be applied to future operations,
- requiring that IRS' Controller be involved in planning financial recordkeeping for business-type undercover operations, and
- involving the National Office in planning and overseeing how intelligence gathering during large-scale operations will be used after the operations are completed.

Action(s) Taken And/or Pending

IRS generally agreed with GAO's recommendations and has taken steps or plans to take steps to improve the management of its undercover operations. For example, IRS

- has expanded its National Office staff to include five full-time analysts who will more fully monitor regional undercover operations,
- has revised its Internal Revenue Manual to require that the Criminal Investigation Division obtain advice from the IRS Controller on creation and maintenance of business records,
- has revised its Internal Revenue Manual to require additional documentation for undercover operations, and
- is currently setting up benchmarks in its Annual Business Plan to assist in the evaluation of undercover operations.

Related GAO Product(s)

GAO/T-GGD-92-16, 12/31/91

IRS' Budget Request for Fiscal Year 1993

GAO/T-GGD-92-34, 04/30/92

The administration's fiscal year 1993 budget request for IRS was for 115,798 full-time equivalent staff years and about $7.24 billion—414 staff years fewer and $562 million more than authorized for 1992. GAO's testimony on this budget request made several points:

- The budget included two initiatives that would provide more staff for IRS to examine more returns and collect more delinquent taxes. Although GAO supported such initiatives in the past, data in the budget and other IRS data raised questions about their long-term effect. Despite additional staffing authorized for Collection and Examination in fiscal year 1991 and the additional staffing being requested in the 1993 budget, IRS' projections for fiscal year 1993 showed minimal growth in Collection staffing and a decline in Examination staffing compared to fiscal year 1990. This was because IRS had been unable to sustain the funding needed to maintain increased staffing levels.
- IRS' inability to sustain any growth in Collection and Examination staff came at a time when the trends in accounts receivable were bad and audit coverage was projected to again fall below 1 percent.
- The fiscal year 1993 budget for another enforcement effort, the Information Returns Program, indicated a decline of 1,307 staff years since 1991. IRS projected that the number of underreporter cases worked under this program in 1992 would be about 38 percent less than the number worked in 1991.
- The fiscal year 1993 budget included about $50 million in expected productivity savings from new or enhanced computer systems. Most of these savings, like those in the fiscal year 1992 budget, appeared to be based on unrealistic assumptions. As a result, programs were being cut to reflect "savings" that were not really there.

Related GAO Product(s)

GAO/GGD-90-26, 03/22/90; GAO/T-GGD-91-17, 03/20/91; GAO/GGD-92-45FS; and GAO/GGD-92-118, 07/31/92

Performance Measurement: An Important Tool in Managing for Results

GAO/T-GGD-92-35, 05/05/92

In testimony before the Senate Committee on Governmental Affairs, the Comptroller General said that public officials must be able to better ensure U.S. citizens that our government can effectively account for where their tax dollars go and how they are used. Better information on program status and a change in management attitude are needed along with stronger incentives for agencies to account for their results. The Comptroller General cited the Chief Financial Officers' Act passed in 1990 as a foundation and suggested the following additional steps that agencies could take to improve accountability for program results:

- clearly articulate their missions in the context of statutory objectives and, with regard to services, citizen expectations;
- develop implementation plans for the goals and objectives and specific measures of progress toward achieving them; and
- report annually on their progress to Congress, which needs to carry out effective program oversight to demonstrate that it will use the information provided to hold the agencies accountable.

The Comptroller General said that progress in measuring performance was beginning to take place in some agencies, citing the Internal Revenue Service as an example. IRS had restructured its strategic business plan to focus on what it considered to be its most important objectives: reducing taxpayer burden, enhancing voluntary compliance, and improving quality and productivity.

IRS found that developing strategies for achieving these objectives was a challenging effort. For example, one strategy to increase voluntary compliance is Compliance 2000. This is an effort to identify the root causes of taxpayer noncompliance and complement IRS's traditional enforcement focus. One of the root causes for noncompliance may be the complexity of tax laws and regulations. To address this root cause, IRS is considering rewriting regulations to make them easier to understand and developing measures to determine their success. But even if law and regulations are simplified, an equally difficult change of Compliance 2000 will be increasing IRS' emphasis on taxpayer assistance, which may require different work roles and behavior on the part of IRS employees.

While these longer term actions are underway, IRS is developing the underpinnings by improving its ability to measure costs. IRS has identified and plans to report the overall costs of its various programs, such as

returns processing, examination, and taxpayer services. These data, when related to measurable outputs of the agency, will provide IRS, Congress, and the public with useful financial indicators while work proceeds on the program performance measures tied to its long-term objectives.

Opportunities to Further Improve IRS' Business Review Process

GAO/GGD-92-103FS, 05/29/92 and GAO/GGD-92-125, 08/13/92

Annual business reviews are a key part of IRS' strategic management process. They are the vehicle for assessing the agency's progress in implementing long-term strategies (like Compliance 2000) and meeting long-term business objectives (like reducing taxpayer burden and improving voluntary compliance).

IRS did its first business reviews of field offices in 1990. GAO reported in August 1992 that IRS had done a good job in getting the business review process under way and had shown the management commitment needed to make the process work. GAO also identified several steps IRS could take to further improve the process.

For example, GAO said that for business reviews to be most useful, they had to be expanded in scope to include the National Office and the results had to be reported in a way that gives management a bottom-line assessment of its progress in implementing long-term strategies and achieving long-term objectives—something akin to a state of tax administration. GAO also said that before IRS could provide meaningful bottom-line assessments, it needed to develop appropriate performance measures and integrate them into the business review process. GAO also discussed (1) the belief expressed by many IRS managers and executives that there were too many performance factors (called "critical success factors") being measured during the business reviews and (2) the need for IRS to expand communications about the business review process within IRS.

GAO's conclusions about the business review process mirrored, in many ways, the views of 50 senior IRS executives who responded to a GAO survey. GAO reported on the survey results in a May 1992 fact sheet. On the positive side, the executives commented on the commitment of IRS' top executives to the process and the fact that the process had (1) improved communications between senior IRS executives and the Commissioner and (2) helped to focus attention on IRS' most important activities. As for needed improvements, the executives said, among other things, that new and/or revised performance measures were needed, business reviews could be better focused, business review reports could be revised to better indicate what the review results mean, and paperwork could be reduced.

Recommendation(s)

The Commissioner of Internal Revenue should

- incorporate business review results into a bottom-line assessment of IRS' overall progress in implementing long-term strategies and achieving long-term objectives,
- do business reviews of the National Office,
- address concerns raised by many officials and executives about the number of critical success factors,
- incorporate appropriate measures into the business review process to better ensure that the reviews generate results-oriented information that will be most useful to IRS' senior managers, and
- look for opportunities to improve communications about the business review process.

Actions(s) Taken And/or Pending

IRS changed its procedures to require that each of the business review reports provide an overall assessment of tax administration in the specific region being reported on, but it is unclear how, if at all, those regional overviews will be aggregated into an IRS-wide assessment. IRS said that it (1) planned to develop a method for doing National Office reviews and (2) has developed crossfunctional annual plans that should facilitate crossfunctional reviews that include the National Office. IRS agreed that in the past, there had been too many critical success factors, and that its 1993 Business Plan has only 12 such factors as compared to 18 in 1992.

IRS is developing measures to, among other things, assess its progress in achieving overall agency objectives and its performance in major product lines, such as assistance and enforcement. IRS agreed that communications about the business review process need improvement and said that its new guidelines would ensure improved communication between headquarters and the field and would better define roles and responsibilities.

Related GAO Product(s)

GAO/GGD-89-1, 10/14/88 and GAO/GGD-91-74, 04/29/91

IRS Should Expand Financial Disclosure Requirements

GAO/GGD-92-117, 08/17/92

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 discussed the adequacy of IRS' procedures and practices to detect and prevent employee conflicts of interest. The review of annual employee financial statements is one way IRS can identify potential employee conflicts of interest. GAO said IRS needed to expand its financial reporting requirements.

GAO found that more than half of IRS' employees may be vulnerable to financial conflicts of interest due to their access to tax return information and their ability to make or influence tax decisions affecting corporate and private entities. GAO said that IRS is not likely to detect such conflicts unless employees are required to disclose their financial interests. Yet, in 1991, only 662 of IRS' 120,000 employees filed financial disclosure statements. Additionally, some of the 34 confidential statements GAO reviewed in 1 IRS region did provide adequate information to identify potential conflicts. For example, five of six IRS employees who reported having investments did not provide enough information for managers to identify potential conflicts. More important, the managers who reviewed the statements did not have information on specific employee assignments.

IRS' Internal Audit had found employee financial conflicts that went undetected. In its review of 1,200 employees who audit the tax returns of large corporations, IRS' Internal Audit found 23 employees who owned stock in companies they audited. In 16 of the 23 cases, the value of the investments exceeded $1,000—the Treasury regulation threshold above which such holdings are considered to pose the potential for conflict.

Recommendation(s)

GAO recommended that the Secretary of the Treasury direct the Commissioner of Internal Revenue to

- require annual confidential financial disclosure statements from all revenue agents, revenue officers, and criminal investigators;
- determine, with assistance from Treasury's Designated Agency Ethics Official, whether other employees are vulnerable to conflicts because of their duties and responsibilities, and decide whether they should file annual disclosure statements; and

- ensure that IRS reviewing officials have adequate information on employee investments and specific work assignments to enable them to determine whether reported financial interests conflict with employee duties and responsibilities.

Actions(s) Taken And/or Pending

As a result of GAO's work, IRS took action to comply with existing Treasury regulations by requiring over 5,000 more employees, grades 13 through 15, to file confidential disclosure statements in 1992. IRS is also reevaluating whether coverage should be extended to other IRS employees and who should review the disclosure statements to ensure that the reviewers have adequate information to assess work assignments and potential conflicts. IRS has also taken action urging management emphasis on conflict of interest issues and publishing a newsletter on employee ethics.

Social Security: Reconciliation Improved SSA Earnings Records, but Efforts Were Incomplete

GAO/HRD-92-81, 09/01/92

In a 1987 report (GAO/HRD-87-52, 09/18/87) GAO stated that employers had reported over $58 billion more Social Security wages to IRS for tax payment purposes than to the SSA for Social Security purposes. This meant that (1) millions of workers' earnings records—used for calculating their Social Security benefits—were not credited for wages they had earned and paid Social Security taxes on; and (2) billions of dollars provisionally credited by Treasury to the Social Security trust funds were not supported by SSA's records, as provided by law. In response to a request from the Chairmen of the House Committee on Ways and Means and its Subcommittee on Social Security, GAO reviewed the progress made by SSA and IRS in resolving the differences in the wages reported to them.

In its 1992 report GAO said that considerable progress has been made in addressing the differences between wages reported to SSA and IRS. In over 6 million cases, SSA had tried to contact employers and more than $44 billion of the $109 billion in earnings differences have been reduced for tax years 1978-86. Through such contacts, SSA has been able to correct millions of workers' Social Security records, reducing the chances that individuals' benefits will be affected by misused wage reports. Now that SSA has begun working the more recent 1987-89 cases, fewer of its letters go undelivered and employer response rates have improved. SSA has referred the unreconciled cases to IRS for tax years 1987-89, and IRS has begun to contact these employers. Its efforts have helped SSA to correct additional workers' records.

However, the reconciliation process would have been more successful had IRS met all of its commitments set forth in a 1978 SSA/IRS Memorandum of Understanding on the sharing of wage data. Delays in establishing a penalty program caused IRS to overrun a statute of limitations on using such penalties. Thus, IRS could not penalize all employers who did not respond to its letters. IRS (1) did not effectively institute the memorandum's provisions to help prevent known causes of reporting differences and (2) arbitrarily limited the number of referred SSA cases that it worked. SSA also needs to do more to prevent employer reporting problems.

Remaining unresolved is the trust fund problem arising from differences in SSA and IRS records. After reconciliation, over $65 billion in wage differences remain for 1978-86 cases. Thus, about $9 billion credited to the trust funds—Social Security taxes on the unreconciled wages—are not

	supported by SSA's earnings records. Given various options for resolving this matter, GAO concluded that funding of the trust funds should be based on the amount of Social Security taxes collected.
Recommendation(s) to IRS and SSA	IRS should fully meet its commitments under the Memorandum of Understanding with SSA, and the two agencies should amend that agreement to ensure that reasonable efforts are made to contact employers in undelivered cases. In addition, SSA should examine the clarity of wage-reporting instructions and consider how it can better respond to employer questions.
Actions(s) Taken And/or Pending	While IRS does not seem to disagree with GAO's recommendations, as of December 31, 1992, it had not prepared any formal response describing appropriate actions to implement them.

IRS' Management of Seized Assets

GAO/T-GGD-92-65, 09/24/92

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO said that IRS should seek another agency or contractor to manage the property seized by its Collection and Criminal Investigation divisions. GAO said neither division had adequate controls to protect the property it seized, leaving the property vulnerable to theft, waste, or misuse.

GAO found that IRS did not know the total amount of property in its possession because IRS lacks an adequate management information system. Also, GAO said that physical inventories were not conducted, seizures were not reported in a timely manner, storage receipts were not always obtained, and the physical condition of assets was frequently not reported.

GAO believes that storage and sales costs could be reduced and revenue increased if the seized property were consolidated instead of being handled independently. Each Collection Division revenue officer who seizes property is expected to find a place to store the property and to sell it. Since GAO found instances where storage costs for similar property varied within the same metropolitan area, this could lead to less economical storage costs than if the property were consolidated and stored at the less costly storage facility. Similarly, IRS does not generally reap the benefits that would be derived from combined sales because each revenue officer may independently decide when to sell the property, how to advertise it, and the time and place of the sale.

GAO concluded that IRS should turn over its seized asset management job to a contractor or one of the other federal agencies that already has a sizable asset management function, such as the Customs Service, the Marshals Service, or the General Services Administration.

Recommendation(s)

The Commissioner of Internal Revenue should (1) assess how well each of the agency or contractor options available fits IRS' operational requirements, choose one, and follow through to implement the change; (2) have each division inventory its property to identify what it has to turn over to another organization; and (3) provide guidance for revenue officers on what is a cost-effective seizure and ensure that they adhere to established procedures, such as checking a taxpayer's equity before taking property, reporting seizures promptly, and noting the property's condition.

Actions(s) Taken And/or Pending

IRS agreed that the seizure process could be improved and is meeting with other agencies and contractors to determine which option best meets its operational requirements. IRS also plans to automate its inventory tracking system.

Pension Issues

Private Pensions: IRS Efforts Underway to Improve Spousal Consent Forms

GAO/HRD-92-31, 12/20/91

This report responded to a request from the Chairman of the Subcommittee on Retirement Income and Employment, House Select Committee on Aging, for a follow-up study to a 1989 GAO report on the need for informative and understandable spousal consent forms for private pension plans (GAO/HRD-90-20, 12/27/89). Employers use these forms to obtain a spouse's written approval when a married retiring worker decides not to provide his or her spouse with a survivor benefit. In that report, GAO recommended that the Commissioner of Internal Revenue (1) require employers to provide certain information on pension benefits directly to spouses on consent forms; and (2) develop examples of understandable, nontechnical language for presenting the information. IRS generally agreed with the recommendations, and this report discusses IRS' progress in implementing them.

IRS developed two information booklets in an effort to inform spouses about survivor benefits, but it had not yet required employers to include the information we recommended on the spousal consent forms or developed nontechnical language examples.

In fiscal year 1992, however, after further GAO prompting, IRS (1) initiated a project aimed at changing its regulations to require that the forms contain the needed information—including the survivor benefit's estimated amount and the consequences of waiving the benefit; and (2) took action to develop understandable language examples.

Related GAO Product(s)

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

Women's Pensions: Recent Legislation Generally Improved Pension Entitlement and Increased Benefits

GAO/T-HRD-92-20, 03/26/92

Pension benefits have long been recognized as an important source of income for many retirees, often supplementing Social Security and private savings. Given the importance of pensions to retirement income and the amount of federal revenue foregone through tax expenditures to encourage and maintain pension plans—$48 billion in fiscal year 1992—Congress has acted to ensure that more participants receive benefits from pension plans. GAO studied the effect of recent changes to private pension provisions on women's pension entitlement and benefits.

GAO found that the recent changes will generally expand pension entitlement and increase benefits for working women and widows. In testimony before the Subcommittee on Retirement Income and Employment of the House Select Committee on Aging, GAO said the following:

- Pension benefit entitlement for women should improve substantially under the Tax Reform Act of 1986. For example, (1) about 75 percent of women in pension plans will be vested under the act compared to about 50 percent under pre-act vesting provisions; and (2) almost 1 million women will gain, on average, an additional $980 in annual vested pension benefits under the act's vesting provisions.
- The 1986 act will improve benefit equity between men and women, especially in pension plans sponsored by small employers. Before the act, although the majority of participants were in large employers' plans in which men and women earned equitable benefits, most defined benefit plans sponsored by small employers favored the higher paid, who were primarily men. Under the act, differences in benefit allocation between men and women will be dramatically reduced.
- Survivor pension benefit coverage for wives of private pensioners increased after implementation of the 1984 Retirement Equity Act. This act required private pension sponsors to obtain a spouse's written approval when a married retiring worker chose a payout option other than a joint and survivor annuity—the benefit payment option that automatically entitles widows to survivor benefits.
- Despite substantial gains in pension entitlement and benefit distribution for working women and widows, the private pension system alone will not markedly help to ease the economic plight facing poor widows. These women will continue to depend on Social Security as their major source of income in widowhood.

- IRS recently initiated actions to improve the quality of pension forms that document a wife's decision to agree to waive survivor benefits. IRS' efforts should better ensure that wives are adequately apprised of the economic effects of the decision.

Related GAO Product(s)

GAO/HRD-90-101, 08/21/90; GAO/HRD-91-58, 03/29/91; GAO/HRD-88-77, 07/11/88; GAO/HRD-90-20, 12/27/89; and GAO/HRD-92-31, 12/10/91

Taxpayer Assistance

Implementation of the 1988 Taxpayer Bill of Rights

GAO/GGD-92-23, 12/10/91 and GAO/T-GGD-92-09, 12/10/91

In a report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the IRS, Senate Committee on Finance, GAO assessed IRS' implementation of the 1988 Taxpayer Bill of Rights. GAO also testified on its findings at a Subcommittee hearing held December 10, 1991.

GAO found that IRS had implemented all 21 provisions of the Taxpayer Bill of Rights. GAO focused on seven key provisions and concluded that these provisions had generally been successfully implemented. Despite IRS' general success, GAO found that there were certain shortcomings. Specifically, GAO said that some taxpayers eligible to use the Taxpayer Assistance Order Program may be unaware of the program. Further, although IRS sends copies of a taxpayer's rights guide known as Publication 1, it does not emphasize to taxpayers the importance of reading the publication when contacting them before conducting an audit interview. GAO also said that IRS is inconsistent in notifying taxpayers when it cancels installment agreements, depending upon whether agreements are monitored by service centers or district offices. Finally, GAO pointed out issues that it believes need to be clarified in the Internal Revenue Code to facilitate IRS' implementation of the act.

Recommendation(s)

The Commissioner of Internal Revenue should take several actions to improve implementation of the Taxpayer Bill of Rights. These actions include

- developing testing procedures to determine whether IRS employees successfully identify and manage taxpayers' hardship situations and, when hardships exist, initiate applications for assistance on the taxpayer's behalf;
- emphasizing the importance of reading Publication 1 when contacting taxpayers by telephone or through correspondence before taxpayers have an audit interview; and
- developing standard procedures for district offices to use when advising taxpayers that their installment agreements are subject to cancellation.

Actions(s) Taken And/or Pending

IRS agreed with GAO's recommendations and has taken or plans to take action to implement them. For example, IRS is

- developing test questions to evaluate whether IRS employees successfully recognize taxpayers eligible for Taxpayer Assistance Orders,
- revising its audit notification letter to emphasize that taxpayers should read Publication 1 before an audit interview, and
- developing standard procedures for district offices to use when advising taxpayers that their installment agreements are subject to cancellation.

Matter(s) for Congressional Consideration

Congress may wish to consider clarifying the Internal Revenue Code to (1) specifically provide IRS authority to withdraw a notice of a lien when it is in the best interests of the taxpayer and the government and (2) eliminate the uncertainty over whether taxpayers should be given 21 days to correct an erroneous levy under section 6332(c).

Actions(s) Taken And/or Pending

In October 1992, Congress passed the Revenue Act of 1992, which, among other things, contained a provision giving IRS authority to withdraw a notice of a lien when it is in the best interest of the taxpayer and the government. On November 3, 1992, however, the act was vetoed by the President and as of December 31, 1992, no further action had been taken.

IRS' 1992 Filing Season Was Successful but Not Without Problems

GAO/T-GGD-92-23, 03/17/92 and GAO/GGD-92-132, 09/15/92

In a September 1992 report to the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' performance during the 1992 tax filing season. GAO assessed the processing of returns at IRS' service centers, the accuracy and accessibility of IRS' toll-free telephone assistance, and the availability of tax materials at IRS' distribution centers and walk-in offices. The report updated information on issues that GAO had raised in March 1992 testimony before the Subcommittee.

IRS indicators showed that IRS did a good job processing returns in 1992. For example, IRS reviews of samples of refunds showed that 9 of the 10 service centers met or exceeded IRS' 98 percent refund accuracy goal (the other center's rate was 97 percent) and that all 10 centers met IRS' goal of issuing refunds in an average of 40 days or less. Although IRS data also showed that IRS was able to process the great majority of returns accurately, one area—the Earned Income Credit (EIC)—caused particular processing problems in 1992. As in past years, IRS used information on tax returns to determine EIC-eligibility for taxpayers who appeared to qualify for the credit but did not claim it. IRS studies indicated that, as a result, IRS may have given the EIC to about 270,000 taxpayers who were not entitled to it. To avoid similar problems in the future, GAO said that IRS should not give the EIC unless it has the necessary information to make correct eligibility decisions.

Another measure of filing season performance is how accurately IRS' toll-free telephone assistors respond to taxpayers' tax law questions. IRS tests showed that assistors achieved an accuracy rate of 88 percent in 1992—4 percentage points above the rate in 1991. At the same time, taxpayers appeared to be having more difficulty getting through to an assistor. In the absence of an IRS measure of accessibility, GAO used IRS data on calls answered, busy signals, and calls abandoned by taxpayers and determined that 3 out of 10 phone calls made were being answered in 1992. That compared to 4 out of 10 in 1991.

GAO's visits to IRS walk-in sites and tests of IRS' responsiveness to mail and phone orders for tax forms and publications indicated that IRS' performance in that area had also declined compared to last year. The most significant decline was in the timeliness with which IRS filled GAO's test mail and phone orders. For example, GAO received only 33 percent of its mail-ordered items within IRS' 14-day delivery goal compared to

74 percent last year. Because of methodological problems, IRS' attempt to measure distribution center performance during 1992 produced unreliable data.

Recommendation(s)

The Commissioner of Internal Revenue should (1) gather the necessary information to make correct EIC eligibility determinations in the future and (2) develop reliable measures of toll-free telephone accessibility and distribution center performance in filling mail and phone orders.

Actions(s) Taken And/or Pending

IRS said that in 1993, taxpayers will be required to submit an EIC schedule in order to claim the credit. That schedule, if prepared correctly, contains the information IRS needs to make a correct eligibility determination. IRS also said that it (1) is exploring alternative approaches to measuring telephone system service, including a better measure of accessibility; and (2) will be contracting with an outside source to measure the performance of the tax material distribution centers in 1993.

Related GAO Product(s)

GAO/GGD-91-23, 12/27/90 and GAO/GGD-91-98, 06/28/91

One Stop Service: A New Concept of Assistance for Taxpayers

GAO/T-GGD-92-33, 04/28/92

In testimony before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, GAO evaluated the objectives of a new IRS initiative known as "One Stop Service." This initiative, intended to improve IRS' responsiveness to taxpayers who contact the IRS for assistance in resolving tax problems, is not expected to be fully operational until September 30, 1998.

One Stop Service is designed to address IRS' taxpayer assistance problems caused by fragmented taxpayer service delivery programs. IRS has spoken with many voices and shown many different faces to the public because its various functional areas have dispensed inconsistent information. Through a combination of new technology and expanded employee authority, One Stop Service is expected to coordinate taxpayer assistance to ensure more timely and more accurate response to taxpayer inquiries.

In the short term, IRS has focused its efforts on improving its telephone service, expanding the authority of telephone assistors to resolve taxpayer problems, and providing more equipment to better meet the demands of the taxpaying public. GAO found several things IRS needs to address as it moves forward with this initiative, including wider access to telephone assistance, better measures of the level and quality of telephone assistance, and more training for its employees.

IRS' long-term goal is to resolve 95 percent of all taxpayer inquiries through a single contact with the agency. GAO expressed the belief that to fully accomplish all One Stop Service objectives, IRS needs uniform implementation of the initiative across its field offices to provide consistent service to taxpayers nationwide. To do this, GAO noted the need for strong leadership to coordinate the One Stop Service goals. Finally, GAO pointed out that the ultimate success of One Stop Service will depend on secure and easy retrieval of comprehensive account data by assistors across the country, something that will not be fully realized unless IRS develops necessary computer and telecommunication systems under its Tax System Modernization program.

Related GAO Product(s)

GAO/T-GGD-91-54, 07/09/91

Opportunities to Reduce Taxpayer Burden Through Return-Free Filing

GAO/GGD-92-88BR, 05/08/92 and GAO/T-GGD-92-41, 05/13/92

Estimates of the time and cost it takes U.S. taxpayers to prepare their individual returns are as high as 3 billion hours and $30 billion annually. In a report to the Chairman of the Senate Committee on Finance and testimony before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO discussed the potential advantages and disadvantages of a return-free filing system and commented on the feasibility of a specific system IRS had studied in 1987.

In response to a provision in the Tax Reform Act of 1986, IRS studied the feasibility of a return-free filing system under which it would prepare tax returns using information received from third parties. For various reasons relating to timing and cost, IRS concluded that the system it studied in 1987 was infeasible. GAO thinks that the return-free system studied by IRS could be redesigned to use new technologies and be more cost-effective and more feasible. Even so, implementation of such a system might not be the best business decision. Although labeled "return-free," the system studied by IRS would still involve preparation of a return.

There is another version of return-free filing used by many foreign countries that eliminates the tax return altogether. Under this system, called "final withholding," an employee's withholding becomes the tax. If adopted by the United States, final withholding could significantly reduce the number of individual returns, thereby reducing taxpayer burden and resulting in savings to IRS. However, this system shifts some burden to employers and taxing authorities.

Improvement in IRS' Telephone Assistor Accuracy

GAO/GGD-92-139FS, 09/22/92

During each of the last several filing seasons IRS assistors who answer telephone calls from taxpayers improved their accuracy on a set of test questions. In a fact sheet to the Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO reported that IRS had improved its accuracy rate to 88 percent when answering tax law questions in the 1992 filing season—from 63 percent in 1989. GAO reported that increased management emphasis on accuracy and the assistors' use of a standard reference guide were the key reasons for the improvement.

GAO said that sustaining this level of accuracy would be difficult and costly unless IRS resolved its staffing and training problems, and that further substantial improvements were unlikely without long-term operational changes. Because assistor positions are seasonal or temporary, the work is stressful, and the salaries are low, some IRS managers had difficulty hiring and retaining qualified personnel. Also, even though IRS spent about $9.4 million on assistor training in 1991, assistors at some call sites told GAO that the training was inadequate.

GAO pointed out that the Tax System Modernization program offers IRS the opportunity to rethink the ways it assists taxpayers and the way it is structured to provide the assistance. For example, GAO cited the benefits achieved by IRS' earlier consolidation of call sites, including (1) greater uniformity of service, (2) more consistency in the quality of service, (3) more consistent assistor training, and (4) increased management control.

Summary of Related Action(s)

IRS has embarked on a long-range study of factors that affect accuracy and plans to use the results of this study to make decisions about further consolidation.

Related GAO Product(s)

GAO/GGD-91-98, 06/28/91 and GAO/GGD-92-132, 09/15/92

Tax Policy

Amortizing Purchased Intangible Assets

GAO/T-GGD-92-01, 10/02/91

In testimony before the House Committee on Ways and Means, GAO highlighted its concerns with the current tax rules for the treatment of purchased intangible assets. GAO first expressed these concerns in a report issued on August 9, 1991. In that report GAO cited legislation (H.R. 3035) that was introduced by the Chairman of the House Committee on Ways and Means on July 25, 1991. The bill contained intangible asset amortization provisions that would have helped solve the administrative and fairness problems that GAO identified in its August 1991 report. However, GAO cautioned the one recovery period applied to the purchase of individual intangible assets, apart from the acquisition of a business, would give rise to questions as to whether the recovery period matches the useful life of the asset.

GAO noted that the tax treatment of intangible assets is one of the oldest controversies between taxpayers and IRS. The tax rules are complex in application because they lack adequate standards for determining which purchased intangible assets can be amortized for tax purposes. In turn, this lack of clear guidance from IRS has resulted in (1) different treatment of similarly situated taxpayers, (2) improper measurement of taxable income for some taxpayers, and (3) protracted conflicts between IRS and taxpayers.

GAO stated that in August 1991 it reported that 70 percent of the unresolved purchased intangible asset issues in open audit cases as of mid-1989 involved disputes over whether taxpayers had purchased nonamortizable goodwill or some intangible asset eligible for amortization. The remaining 30 percent involved disputes over useful life and/or value determinations. The issues covered taxpayers in nine industries who had claimed amortization deductions for 175 types of purchased intangible assets valued at $23.5 billion. GAO concluded that an amortization scheme patterned after the current rules for tangible asset depreciation would improve tax administration and income measurement. Therefore, GAO recommended that Congress amend current law to allow amortization of all purchased intangible assets, including goodwill, over specific statutory cost-recovery periods.

Summary of Related Action(s)	In 1992, the intangible asset amortization provisions of the July 1991 bill (H.R. 3035) were incorporated into another bill (H.R. 11) and passed by Congress on October 8, 1992. However, on November 4, 1992, the President vetoed the bill. As of December 31, 1992, no further action had been taken.
Related GAO Product(s)	GAO/GGD-91-88, 08/09/91

Proposed Tax Credit Would Add to Government's Cost of Selling Assets of the Resolution Trust Corporation

GAO/GGD-92-14BR, 11/01/91

In response to a request from the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs, GAO reviewed a proposed tax credit program intended to facilitate the sale of distressed commercial real estate property held by the Resolution Trust Corporation (RTC). GAO also discussed RTC strategies to dispose of properties by lowering their price and using other available alternatives.

GAO evaluated the cost-effectiveness of the proposed tax credit program that would begin on January 1, 1992, and have a cap of $1 billion. The credit would be earned in five equal annual installments and would have a present value of up to 80 percent of the purchase price plus the cost of necessary rehabilitation of the property.

GAO found that this tax credit is not a cost-effective way for RTC to dispose of its commercial real estate assets. The federal government would lose about $127 million on a present-value basis with the proposed $1 billion tax credit program. Although the tax credit would increase sales revenue to RTC, these gains would be exceeded by the lost tax revenue to the Treasury. This result was obtained by comparing the proposed tax credit with RTC's current policy of obtaining sales by pricing real estate assets according to market values.

GAO reported that RTC has several programs in place to dispose of real estate properties. These include reducing prices to reflect current market values and providing seller financing. In March 1991, RTC approved new guidelines that gave officials more flexibility in setting prices for properties to reflect market values.

Summary of Related Action(s)

As of December 31, 1992, legislation authorizing the tax credit program had not been reported out of committee, and no further action had been taken.

Related GAO Product(s)

GAO/GGD-89-100FS, 07/10/89 and GAO/T-GGD-91-43, 06/11/91

Summary of GAO Work Related to Expiring Tax Provisions

GAO/T-GGD-92-11, 01/28/92

This testimony summarized GAO's work on 5 of the 12 tax provisions that were extended by the Tax Extension Act of 1991, The statement was provided to the House Committee on Ways and Means for its January 1992 hearing, which focused on whether the provisions should be extended.

Qualified Mortgage Revenue Bonds (QMB)—GAO concluded that QMBS (1) are an inefficient and costly way to provide assistance to first-time home buyers, (2) serve mostly buyers who could afford homes anyway, and (3) have done little to increase home affordability for low- and moderate-income people. Accordingly, GAO questioned whether bond issuance authority should be extended.

Targeted Jobs Tax Credit—About half of the employers GAO interviewed followed their normal hiring practices, but they were able to take the tax credit when those hired happened to be in the targeted groups. Thus, the targeted jobs program goals were not achieved to their full extent. GAO also found no substantial differences in participants' earnings before and after a targeted job compared to others who were not in the program. If Congress extends this program, GAO suggested it may wish to consider improved targeting.

Low-income Housing Tax Credit—Building or rehabilitating housing in areas where adequate low-income housing exists is less efficient than providing for low-income housing through housing certificates or vouchers. Earlier actions had reduced but not eliminated the potential to build housing where it was not needed. If Congress extends the low-income housing tax credit, GAO suggested it may wish to restrict its use to areas where vacancy rates are low for suitable units renting at or below the area's fair market rents. GAO also said that modifying the formula for allocating credits among the states also might be used to target states or localities that have the greatest low-income housing need.

Qualified Research Tax Credit—In 1989 Congress revised the base used in calculating the qualified research credit. This should generate a greater stimulus for research expenditures. Because the base is not subject to periodic reviews and many companies have had substantially different growth rates in their spending and sales over extended periods of time, the revised base may become deficient after a few years. Therefore, if the research tax credit is permanently extended, GAO suggested that Congress may want to ensure that the credit continues to provide an attractive

incentive to most taxpayers at an acceptable revenue cost by requiring that the base be periodically reviewed and adjusted as needed.

Employer-provided Educational Assistance—Sufficient information is not available to adequately measure whether the educational assistance provision effectively meets its objectives. If this provision is extended, GAO suggested that Congress may wish to modify the reporting requirement and maintain it for a sufficient period to establish a basis for evaluation.

Related GAO Product(s)

GAO/RCED-88-111, 03/28/88; GAO/RCED-88-190BR, 06/27/88; GAO/GGD-89-76, 06/23/89; GAO/GGD-89-100FS, 07/10/89; GAO/T-RCED-89-58, 08/02/89; GAO/GGD-89-114, 09/05/89; GAO/T-RCED-89-72, 09/29/89; GAO/T-RCED-90-34, 02/27/90; GAO/T-RCED-90-73, 04/27/90; GAO/RCED-90-168, 06/19/90; GAO/RCED-90-203, 08/14/90; GAO/RCED-90-117, 09/26/90; and GAO/HRD-91-33, 02/20/91

Luxury Excise Tax Issues and Estimated Effects

GAO/GGD-92-9, 02/26/92

In response to a request from several Members of Congress, this report provided information about the luxury excise tax. GAO examined the effect of the luxury tax on the luxury boat, car, aircraft, jewelry, and fur markets. The report provided information on the anticipated tax revenues, IRS' actual collections, and the costs and issues associated with administering this tax. It also discussed other products that have been taxed as luxury items in the United States or that are taxed as luxuries by other countries.

GAO found that diverse factors interacted to affect both demand for and supply of the five luxury products. GAO could not disentangle the effects of these factors from the effects of the tax and therefore could not quantify the tax effects. Boat, jewelry, and fur sales began declining before the luxury excise tax took effect on January 1, 1991. Sales of all five products were probably depressed by the 1990-91 recession. Luxury car sales were also affected by an increase in the gas guzzler tax, and airplane sales decreased in the 1980s due to product liability costs. Therefore, although some portion of the decline in sales during 1991 may have resulted from the price effect of the luxury excise tax, it is likely that other factors also significantly affected these markets.

IRS collected $168,404,000 in luxury excise taxes during fiscal year 1991. IRS estimated its administrative costs to collect these taxes were about $500,000. Thus, IRS' administrative costs were about 0.3 percent of the revenues collected in fiscal year 1991. IRS expected its administrative costs would decrease to about $200,000 annually in future years. IRS' initial information indicated that taxpayers had been informed about the luxury excise tax and were complying with it.

Effects of Changing the Tax Treatment of Fringe Benefits

GAO/GGD-92-43, 04/07/92

In a report to the Joint Committee on Taxation, GAO discussed employee benefit tax policy issues as they relate to four of the more common employer-provided fringe benefits—pensions, health and life insurance, and flexible benefits. For each of these benefits, the report discusses (1) historical and legislative background information, (2) data on employers who provided and employees who are covered by these benefits, (3) estimated tax expenditure data, and (4) implications of taxing these benefits.

In fiscal year 1992, tax preferences allotted these fringe benefits were estimated to cost the Department of the Treasury about $91 billion, equivalent to over 17 percent of individual income tax revenues. In a period of large budget deficits, this is a significant revenue loss. The benefits of the preferences are also unevenly distributed. Whether or not changes are considered, either to restrict the extent of subsidized benefits or to expand benefit coverage, GAO felt it was necessary to evaluate the current system of fringe benefit tax subsidies.

In addition to examining the background of the tax-preferred status, GAO described the type and extent of coverage available to beneficiaries and analyzed how changes in employee benefit tax policy might affect both tax equity and the level of benefits provided.

GAO found that large segments of the nation's working population receive fringe benefits although coverage varies substantially by type of benefit. In 1988, about 42 percent of full-time private-sector workers participated in pension plans. In 1989, about 73 percent of all workers had employer-provided health benefits. Of employees who worked for employers with 100 or more employees, 90 percent were offered life insurance, and about 24 percent were eligible to participate in flexible benefit plans in 1989.

Current tax treatment, which exempts health insurance premiums and life insurance premiums for coverage under $50,000 and allows postponement of taxes on pension contributions and investment income, works against tax equity because some workers receive these benefits from employers while others do not. With progressive tax rates, the implicit tax subsidy is larger for higher paid than for lower paid workers. Some analysts also argue that the tax preferences for employer-provided health benefits encourage employee "overspending" for health care.

Full taxation of fringe benefits would raise substantial revenue and improve tax equity. Taxpayers who are currently being treated the most favorably could find their income tax increased substantially. The result of these increased taxes could be a reduction in coverage. This could be especially true for low-wage workers who appear to be more responsive to the tax treatment than high-wage workers who would tend to purchase coverage even without a tax break.

Alternatives to full taxation exist that would raise less revenue but could improve equity and have a smaller negative impact on coverage. These alternatives include imposing a ceiling on tax- preferred benefits or allowing the preferences as credits against taxes paid rather than exclusions from taxable income.

This report was informational in nature and was meant to provide a framework for analyzing the issues. GAO made no recommendations and has taken no position on whether changes in fringe benefit tax policy should be adopted.

Earned Income Credit: Advance Payment Option Is Not Widely Known or Understood by the Public

GAO/GGD-92-26, 02/19/92

The Omnibus Budget Reconciliation Act of 1990 directed GAO to study the effectiveness of the earned income credit advance payment system. In a report to the Chairmen of the Senate Committee on Finance and the House Ways and Means Committee, GAO (1) identified why so few eligible workers take advantage of the advance payment option, (2) determined whether making advance payments imposes a burden on employers, and (3) identified problems IRS had in administering the option.

In 1975, Congress enacted the earned income credit to (1) assist low-income wage earners who were adversely affected by rising prices; (2) offset the effects of Social Security taxes paid by these workers; and (3) encourage these workers, who might otherwise receive welfare benefits, to seek employment. Beginning in 1979, workers could elect to receive the credit in advance payments from their employers along with their pay. In 1991, to qualify for the credit, workers had to maintain a household for at least one qualifying child and earn less than $21,250.

GAO concluded that since few low-income wage earners knew about the advance payment option, it was difficult to determine the effectiveness of giving the credit in advance. GAO said that a full evaluation of the option's effectiveness would have to await additional promotional effort by IRS.

GAO reported that less than 0.5 percent of those who received the earned income credit in 1989 got the credit in advance. GAO found that the low participation rate was due to a variety of factors. For example:

- Many eligible workers and their employers were not aware of the advance payment option.
- IRS outreach efforts emphasized the earned income credit but not the advance payment option.
- Employees preferred a lump sum payment instead of smaller periodic payments.

When advance payments were made, they did not appear to impose a major burden on employers. Among employers who provided the credit in advance to their employees, about 65 percent reported little or no burden. This percentage was about the same for participating small businesses with 100 or fewer employees. Those who did report difficulties cited such factors as software limitations and computations that covered temporary and part-time workers.

IRS, on the other hand, had problems with the advance payment option. GAO found that out of an estimated 8,000 individuals who filed a return and definitely received the advance payment, almost half did not report that receipt on their tax returns. Under IRS' returns processing procedures, these individuals could have received the credit again as a lump sum payment. GAO also estimated that about 45 percent of those who, according to IRS records, may have received the advance payment never filed a tax return.

Recommendation(s)

To improve awareness, GAO recommended that IRS (1) include information on the advance payment option in outreach materials, (2) notify credit recipients about the option, (3) encourage employers to notify employees who have no income tax withheld about the option, and (4) clarify instructions on the option in Circular E.

To improve compliance, GAO recommended that IRS send a notice to individuals who do not file a return, explaining their requirement to file. GAO also recommended that IRS explore ways to identify those individuals who claim the credit in advance, but do not report it, to keep them from receiving additional credit amounts.

Actions(s) Taken And/or Pending

IRS generally agreed with GAO's recommendations and has taken or plans to take action to implement them. For example, IRS has already begun to include more information on the advance payment in its outreach efforts. In addition, IRS has revised Circular E, Form W-2, and Publication 596 to include more and clearer information for employers and employees about the advance payment option. IRS has also added information on the advance payment option to the earned income credit reminder on the back of the employee's copy of the form W-2.

IRS has added a separate line to show the advance payments received on the forms 1040 and 1040A and is planning to highlight the box on the W-2 form in which the advance payment amount is shown. These changes plus better instructions are intended to improve compliance with the advance payment option.

Pharmaceutical Industry: Tax Benefits of Operating in Puerto Rico

GAO/GGD-92-72BR, 05/04/92

In response to a request from the Chairman of the Senate Special Committee on Aging, GAO discussed the pharmaceutical industry's tax benefits from operating in Puerto Rico under section 936 of the Internal Revenue Code. Section 936 provides a tax credit equal to the federal tax liability on certain income earned in Puerto Rico and certain U.S. possessions. Congress enacted section 936 to help Puerto Rico obtain employment-producing investments. The Department of the Treasury will lose about $15 billion in tax revenues during the 1993 through 1997 period due to section 936, according to the Congressional Budget Office.

GAO found that throughout the 1980s the pharmaceutical industry received a relatively large share of the tax benefits from section 936 compared to the number of jobs directly created and the amount of employee compensation the industry provided. GAO reported that (1) the pharmaceutical industry received about half the total tax benefits from section 936 and provided between 15 and 18 percent of the jobs of all section 936 corporations in Puerto Rico, (2) tax benefits received per employee by the pharmaceutical industry were three to four times greater than those received by the industry with the next greatest amount of benefits, and (3) tax benefits as a percentage of employee compensation also varied widely—267 percent of the compensation paid to pharmaceutical employees as compared to 98 percent of the compensation paid to employees in the electrical and electronic equipment industry.

Pharmaceutical industry representatives stated that other employment-related information needed to be considered in evaluating the benefits of section 936 and cited (1) the importance of examining the number of high-paying, skilled jobs that have been provided; and (2) indirect jobs created in other industries.

GAO also found that individual pharmaceutical companies differed markedly from each other in the level of taxes they saved by operating in Puerto Rico. We examined financial statements of 26 pharmaceutical corporations and estimated that 1 company saved more than $1 billion, another saved $987 million, 9 other companies saved more than $500 million but less than $1 billion, and the other 15 companies saved less than $500 million. These estimates are in 1990 dollars adjusted for inflation for the 11-year period from 1980 through 1990.

1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years

GAO/GGD-92-111, 08/19/92

In a report to Representatives Don J. Pease and Byron L. Dorgan, GAO found that the average U.S. effective tax rate for the 220 companies it reviewed increased from 18.6 percent in 1986 to 32.9 percent in 1989. During the same period, the average worldwide effective tax rate for these companies increased from 28.1 percent to 37.1 percent. In addition, the dispersion of company and industry U.S. effective tax rates around the average had narrowed considerably by 1989.

GAO reported that between 1986 and 1989, there was a shift from more companies and industry groups with low rates than high rates, to fewer with low rates than high rates. Six of the 29 industry groups (21 percent) and 63 of the 220 companies (29 percent) had U.S. effective tax rates below 10 percent in 1986. By 1989, none of the 29 industries and 18 of the 220 companies (8 percent) had U.S. effective tax rates below 10 percent.

In contrast, none of the 29 industry groups and 17 of the 220 companies (8 percent) had U.S. effective tax rates above the statutory rate in 1986. By 1989, 8 of the 29 industry groups (28 percent) and 64 of the 220 companies (29 percent) had U.S. effective tax rates above the statutory rate. The high effective tax rates for the eight industry groups in 1989 were associated with reversals of previously deferred taxes on installment sales, long-term contracts, and investment tax credits.

GAO also reported that these results were consistent with changes introduced by the Tax Reform Act of 1986. However, because of data limitations, GAO could not conclude that the Tax Reform Act of 1986 directly caused these changes. In GAO's opinion, a portion of any increase in the average U.S. effective tax rate from 1986 to 1989 that was due to the 1986 act may exist only temporarily as the companies go through a transition period.

Related GAO Product(s)

GAO/GGD-90-69, 05/10/90 and GAO/GGD-90-75, 07/23/90

Mass Transit: Effects of Tax Changes on Commuter Behavior

GAO/RCED-92-243, 09/08/92

In a report to congressional requesters, GAO examined the role tax policy plays in commuting decisions. Specifically, GAO focused on (1) contrasting the tax treatment of mass transit and parking benefits, (2) describing how current tax treatment influenced commuter behavior, (3) assessing whether proposed tax law modifications might encourage mass transit use, and (4) identifying alternative efforts to discourage drive-alone commuting and encourage mass transit use.

GAO reported that on the whole, federal tax law favors employer-provided parking over employer-provided transit benefits, thus encouraging driving rather than taking mass transit to work. Parking benefits were completely tax exempt for the employee, while transit benefits were taxable income to the employee if the monthly value exceeded $21. GAO said that the difference in the tax treatment of parking and transit benefits reduces the cost of commuting by auto relative to taking mass transit and thereby encourages people to drive to work.

Bills that were pending before Congress would, among other things, increase the tax-free limit for employer-provided transit benefits up to $100 monthly and/or begin taxing parking benefits. Employers that provided the increased benefit would effectively lower the cost of riding transit for those who received the benefit. GAO said that while such proposals could increase transit ridership, the size of the potential increase is unknown mainly because it is unclear how many additional employers would offer the benefit or how many employees would take advantage of it.

Some proposed changes in the tax law would treat the value of employer-provided parking that exceeds $145 or $160 per month as a taxable fringe benefit. GAO found that while these tax policy changes could effectively raise the cost of driving for commuters in some cities and might discourage them from driving alone, relatively few drivers would be affected because most parking benefits are worth less than $145 per month.

GAO reported that other efforts to discourage drive-alone commuting and encourage mass transit use were under way at the federal, state, and local levels. For example, (1) employers in some areas will be required by the federal Clean Air Act Amendments of 1990 to reduce drive-alone

	commuting by employees and (2) some areas have restricted the number of parking places available.
Matter(s) for Congressional Consideration	Because it is unclear how effective legislative changes in the tax treatment of transportation benefits would be in discouraging drive-alone commuting and encouraging greater reliance on mass transit, Congress may wish to consider including language in such legislation to direct the Secretary of Transportation to monitor the effects of increasing the tax-free limit on transit benefits and taxing parking. Congress may wish to use this information to determine if additional legislative changes are desirable.
Actions(s) Taken And/or Pending	As of December 31, 1992, no congressional action had been taken directing the Secretary of Transportation to monitor the effects of increasing the tax-free limit on transit benefits and taxing parking.
GAO-Related Action(s)	The Energy Policy Act of 1992 (P.L. 102-486, dated October 24, 1992) includes provisions to increase the tax-free limit on transit benefits from $21 per month to $60 per month. It also treats the value of employer-provided parking that exceeds $155 per month as a taxable fringe benefit. These actions could encourage greater use of mass transit.
Related GAO Product(s)	GAO/RCED-93-25, 11/13/92

Energy Policy: Options to Reduce Environmental and Other Costs of Gasoline Consumption

GAO/RCED-92-260, 09/17/92 and GAO/T-RCED-92-94, 09/17/92

Gasoline consumption by passenger cars and light trucks is a major source of air pollution. It also adds to the economy's dependence on petroleum and vulnerability to oil price shocks. Despite these environmental and other costs, called external costs, the price of gasoline, adjusted for inflation, has generally been declining since 1985, encouraging increased consumption. In a response to a request from the Chairman, Subcommittee on Environment, House Committee on Science, Space, and Technology, GAO assessed policy options for addressing the external costs of gasoline consumption.

GAO identified six major options and evaluated whether they addressed relevant objectives including economic growth, environmental quality, equity, petroleum conservation, visibility of costs, energy security, traffic congestion, competitiveness, and administrative feasibility. The six policy options were (1) a higher gasoline tax, (2) a tax on vehicles' tailpipe emissions, (3) subsidies for alternative fuels, (4) higher fuel economy standards for new vehicles, (5) a fee rebate program, and (6) a program to reward people who scrap older vehicles.

GAO said that all six options it reviewed could reduce the nation's dependence on oil. All of these options could also reduce air pollution from gasoline consumption. No option would satisfy all of the policy objectives considered, although two options—a higher gasoline tax and a tailpipe emissions tax—would address more objectives than others. On the other hand, both of these taxes could lead to slower economic growth and place a disproportionate burden on low-income and rural populations.

This summary discusses the two options GAO assessed that relate to tax policy. GAO said that a higher gasoline tax could encourage drivers to reduce gasoline consumption by driving less and at lower speeds, maintaining their vehicles better, commuting to work in carpools or by mass transit, or purchasing more fuel-efficient vehicles. This in turn would reduce the nation's dependence on oil, relieve highway congestion, and decrease emissions of gases that pollute air. However, a higher gasoline tax could slow economic growth. Moreover, because the tax would constitute a larger portion of the income of low-income groups, it would disproportionately affect that population.

GAO also said a tax on emissions from vehicles' tailpipes offers similar advantages and disadvantages. In addition, though, this tax could be more

cost-effective than the gasoline tax because it could reduce emissions from and the miles travelled by the most polluting vehicles. However, a tailpipe emissions tax could be hard to administer because of the complexities involved in measuring emissions.

GAO concluded that although every policy choice would involve trade-offs, ways exist to improve the effectiveness of many of these options. In particular, individual policies could be modified to avoid some trade-offs. For example, policies that impose taxes—on gasoline or emissions—could be structured to reduce any negative effects on the economy by "recycling" the tax revenues to reduce payroll or income taxes and by phasing them in gradually. Disproportionate impacts on low-income groups could also be addressed by recycling revenues.

Other

1991 Annual Report on GAO'S Tax-Related Work

GAO/GGD-92-57, 05/21/92

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 1991. It includes (1) summaries of tax-related products issued in fiscal year 1991; (2) summaries of tax-related products issued before fiscal year 1991 with open recommendations to Congress; (3) descriptions of legislative actions taken in fiscal year 1991 in response to GAO recommendations; (4) a listing of recommendations to Congress that were open as of December 31, 1991; (5) a listing of recommendations GAO made in fiscal year 1991 to the Commissioner of Internal Revenue; and (6) brief descriptions of assignments for which GAO was authorized access to tax data in fiscal year 1991.

GAO reported that (1) IRS had taken, or planned to take, action on most of the tax-related recommendations GAO made during fiscal year 1991; and (2) congressional committees and Members of Congress used GAO products in overseeing tax administration operations, considering tax policy issues, and enacting legislation.

Summaries of Tax-Related Products Issued Before Fiscal Year 1992 With Open Recommendations to Congress as of December 31, 1992

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Congress May Wish to Extend the Offset Authority for Expenses IRS Incurred in Undercover Operations, Which Expired on December 31, 1991, and Revise Current IRS Reporting Requirements

GAO/GGD-91-106, 07/03/91

This report responded to section 3301 of the Crime Control Act of 1990. Section 3301 required that GAO study IRS undercover investigative operations that were done using the authority provided in section 7608(c) of the Internal Revenue Code of 1986. This authority exempts IRS undercover operations from certain laws and allows IRS to use the proceeds from undercover operations to offset necessary and reasonable expenses incurred in the operations. The Crime Control Act required that GAO evaluate (1) IRS' use of the proceeds in these operations, (2) the operations' results, and (3) IRS' financial audits of the operations.

GAO reported that IRS had made limited use of the offset authority, which was due to expire on December 31, 1991. From November 1988 through May 1, 1991, IRS had approved the use of the offset authority in only 19 of its undercover operations—less than 5 percent of the total undercover operations initiated for the same period.

The 19 undercover operations using the offset provision had produced about $545,000 in income. Of the income earned, approximately $121,000 was used to offset operational expenditures; $269,000 had not yet been offset against expenditures; and about $155,000 had been returned to the general fund. IRS reported that as of May 1, 1991, undercover operations using the offset provision had resulted in the seizure of over $207 million in cash and significant amounts of drugs, including cocaine and heroin, and 75 convictions.

GAO noted that identifying a direct cause and effect relationship between the financing mechanism provided by the offset authority and the results of a given investigation was difficult, if not impossible, because many variables came into play. However, GAO concluded that the additional funds made available through the use of the offset provision allowed IRS to either undertake more investigations than it could without those funds or to expand the range of activities for each investigation.

GAO raised questions about IRS' control over funds. None of the operations involving the offset provision had met the statutory criteria requiring a detailed financial audit. In some cases, IRS Internal Audit might not have sufficient access to all the information needed to do a thorough audit because it did not have complete access to information on investigations done under the control of a grand jury. Thirteen of the 19 operations using the offset authority were grand jury cases.

Further, GAO believed that IRS' use of Internal Audit to audit undercover operations using the offset provision should not be limited to those operations meeting a specific dollar threshold. IRS' use of Criminal Investigation Division employees to do audits of offset operations in which activity fell below the prescribed dollar thresholds raised questions of organizational independence, a general standard for government auditing. GAO said that such questions could be avoided by having Internal Audit do all the audits. In addition, the sensitivity of the activities being undertaken and the exemption of the expenditures from normal controls over appropriated funds increased the need for the audits to be done by an independent entity.

GAO also said that Congress' understanding of the use and results of undercover operations involving the offset provision could be enhanced if IRS' reports to Congress contained additional details and were more timely.

Matter(s) for Congressional Consideration

Should Congress decide to extend the offset authority, it might also wish to revise the current IRS reporting requirements. GAO said that (1) expanding the information IRS is required to include in its annual reports to Congress and (2) requiring IRS to report the results of its detailed financial audits after the covert phase of the operation instead of when the operation is closed could provide Congress with more timely and complete information on undercover operations involving offsetting. Such reporting should not jeopardize undercover agents' safety or the success of criminal proceedings.

Recommendation(s)

The Commissioner of Internal Revenue should direct the Chief Inspector to ensure that Internal Audit expands its financial audits to include all undercover operations involving offsetting, regardless of the amount of expenditures or proceeds.

Actions(s) Taken And/or Pending

The offset authority expired on December 31, 1991, thereby rendering our recommendations moot. As of December 31, 1992, this authority had not been reinstated.

Congress Should Consider Modifying the Targeted Jobs Tax Credit Program by Imposing New Eligibility Requirements If It Wishes to Encourage Employers Using the Program to Take Special Actions That Benefit Members of the Targeted Group

GAO/HRD-91-33, 02/20/91

In 1977, Congress established the Targeted Jobs Tax Credit Program to induce employers to favor certain disadvantaged individuals facing barriers to employment. Over the past 10 years, employers had claimed an estimated $4.5 billion in tax credits under the program. Yet, little information was available on the employers using the program or the workers hired under it.

In a report to two subcommittees of the House Committee on Education and Labor, GAO provided descriptive information on employers using the program and the individuals for whom the tax credits were claimed. GAO discussed (1) the extent to which employers made specific efforts to identify, hire, or retain eligible workers; and (2) differences in participants' earnings before and after their involvement in the program.

This tax credit program is intended to increase employment opportunities for members of the targeted groups by providing a financial incentive to employers to recruit, hire, and retain target group members. GAO found that nearly half of the 60 employers it interviewed had made some special effort to do so. The other half had taken advantage of the tax credit without making special efforts to hire members of the targeted groups.

GAO also determined that work experiences had a positive impact on participants' earnings. GAO did not find any substantial differences, however, in earnings changes resulting from participants' work experience when compared with the experience of other workers who were eligible for the program but did not participate.

GAO's analysis of data from 13 states indicated that (1) retail stores and restaurants were the primary users of the tax credit program in 1988 and (2) most of the hirings under the program that year involved youths who were hired to fill entry-level jobs requiring minimal skills and paying low wages.

Matter(s) for Congressional Consideration

If Congress wishes a higher proportion of employers using the Targeted Jobs Tax Credit Program to take special actions that benefit members of the targeted groups, it could modify the program by imposing new requirements. For example, program requirements might involve employer outreach efforts to eligible populations, prescreening to determine

eligibility before the hiring decision, or providing additional training or supervision to eligible workers to increase the likelihood of retention.

Actions(s) Taken And/or Pending	No legislative action had been taken as of December 31, 1992.

Congress Should Consider Revising the Current Tax Law to Provide for Amortization of Purchased Intangible Assets, Including Goodwill, Over Specific Statutory Cost Recovery Periods

GAO/GGD-91-88, 08/09/91

One of the oldest controversies between taxpayers and IRS is the extent to which taxpayers can deduct the price they pay for intangible assets, such as customer or subscription lists. The general rule is that the cost of an intangible asset can be amortized over its useful life. Purchased goodwill and other intangible assets without determinable useful lives, however, are not amortizable. Taxpayers are supposed to determine the specific useful life for each intangible asset separately. The taxpayer's determination of useful life is questioned only when IRS performs an audit. IRS frequently contends that many intangible assets are in fact purchased goodwill and not amortizable. However, taxpayers assert that the assets are not goodwill, the determined useful lives are accurate, and the intangible assets are eligible for amortization.

The opportunities for disputes between taxpayers and IRS intensified during the 1980s, when business acquisition activity increased and led to a growth in the reported value of intangible assets from about $45 billion in 1980 to $262 billion in 1987. As a result, billions of dollars of potential tax deductions and, therefore, tax revenues were affected by decisions on whether tax deductions for intangible asset costs were permitted.

In response to a request from the Joint Committee on Taxation, GAO provided information on the types of deductible intangible assets, the asset values and useful lives claimed, and the industries affected. GAO also explored various proposals for revising intangible asset tax rules, which had not significantly changed since 1927.

GAO analyzed tax data IRS gathered in 1989 on all of its unresolved, or open, purchased intangible asset cases. Taxpayers in 9 industry groups had claimed deductions for 175 types of purchased intangible assets that they identified as different from goodwill and valued at $23.5 billion. In 70 percent of the cases in which taxpayers claimed that intangible assets had a determinable useful life, IRS claimed that the assets were in fact goodwill and not amortizable. In total, IRS proposed adjustments of about $8 billion on the basis of its evaluation of the value, useful life, or classification of intangible assets. The final outcome of these cases will depend on IRS' or the courts' interpretation of facts related to each asset.

GAO concluded that disagreements between taxpayers and IRS over which intangible assets may be amortized would continue unless changes were made in the current rules. GAO said that the current tax treatment of

	goodwill and similar intangible assets failed to recognize the economic benefits that wasting intangible assets contribute over time. These assets are consumed over time even if a precise period cannot be determined. Denying amortization deductions does not result in an accurate determination of taxable income since expenses are not properly matched to income generated. Recognition of these economic benefits over time for tax purposes could be accomplished, according to GAO, by establishing specific statutory cost recovery periods for purchased intangible assets similar to those used for tangible assets.
Matter(s) for Congressional Consideration	Congress should consider revising the current tax law to provide for amortization of purchased intangible assets, including goodwill, over specific statutory cost recovery periods.
Actions(s) Taken And/or Pending	In October 1992, Congress passed the Revenue Act of 1992, which, among other things, would have revised the tax rules to require that most purchased intangible assets, including goodwill, be amortized over 14 years. In November, however, the act was vetoed by the President and as of December 31, 1992, no further action had been taken.
Related GAO Product(s)	GAO/NSIAD-88-56BR, 12/28/87 and GAO/T-GGD-92-1, 10/02/91

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 with 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. For example, GAO cited as unrealistic 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.

Actions(s) Taken And/or Pending

This recommendation cannot be implemented until IRS has information on the actual amount of revenues derived from its audits. IRS is developing an integrated enforcement management information system that will eventually provide data on the actual revenues generated by its enforcement efforts. IRS is implementing that system in phases and expects it to become fully operational in about 3 or 4 years.

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 1 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.

Actions(s) Taken And/or Pending

In a November 1992 report, Improving the Administration and Enforcement of Employment Taxes, 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 limiting the previous 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 indefinitely from reclassification if there had been a previous IRS audit that did not successfully challenge the employer's classification

practices. The Committee's proposal would limit that protection to only until the next audit.

On April 29, 1992, H.R. 5011 was introduced by three members of Congress. The bill would limit the time frame for this audit protection of section 530. As of December 31, 1992, no further action had been taken.

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 implemented such a program in 1991 and is studying its results.

Congress Should Repeal Internal Revenue Code Section 809 Dealing With Policyholder Dividends Paid by Life Insurance Companies and Designate What Portion of These Dividends Consists of Distributed Earnings

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 on 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 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.

Actions(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. However, as of December 31, 1992, no legislative action had been taken.

Congress May Wish to Periodically Reconsider the Preferential Tax Treatment Given to Interest That Is Earned on Life Insurance and Deferred Annuity Contracts, Weighing Social Benefits Against Revenue Forgone

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) the 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.

Under current law, interest 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 that are targeted more 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 said it was 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.

Actions(s) Taken And/or Pending

As of December 31, 1992, no legislative action had been taken.

Congress Should Consider Restricting the Use of Low-Income Housing Tax Credits Generally to Areas Where Vacancy Rates Are Low for Suitable Units Renting at or Below the Area's Fair Market Rents

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 February 1990, GAO testified on one of those projects. In June 1990, GAO reported on eight specific housing 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, and (3) 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.

Actions(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 Program funds and to submit the results to Congress in 1993. Congress reauthorized the Low-Income Tax Credit Program through June 1992, requiring states to develop tax credit allocation plans that would include priorities for targeting the credits. Recently developed state allocation plans reflect this new requirement and provide a basis for GAO's current study to assess whether this alternative action responds to the recommendation. Tax credit reauthorization was included in the Revenue Act of 1992 which Congress passed in October 1992, but which the President subsequently vetoed. We anticipate such reauthorization will be sought during the next session of Congress. No further action had been taken as of December 31, 1992.

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 housing subsidies to geographic areas with low unit vacancies.

Congress Should Make Several Tax-Related Changes to the Debt Collection Act to Help Alleviate the Government's Credit Management Problems

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 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, Education, and Veterans Affairs.

GAO noted the progress agencies had made over the past several years in certain credit management areas. GAO also cited a number of problems. For example, agencies were not always (1) checking to see 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 would involve (1) screening loan applicants to determine creditworthiness and ability to repay and to determine if the applicants owe delinquent debts to the federal government, including IRS; (2) denying credit to applicants who owe delinquent debts to the federal government; (3) referring all appropriate debts to IRS for the purpose of offsetting delinquent debtors' tax refunds; and (4) reporting 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. Congress should also require IRS to disclose address information to agencies pursuing debt collection activities under authorities in addition to the Federal Claims Collection Act.

Actions(s) Taken And/or Pending

Although Congress has not yet acted on each of GAO's recommendations, the Unemployment Compensation Act of 1991 provides permanent

authority for collecting nontax debts by reducing debtors' tax refunds. Also, the Senate Committee on Governmental Affairs and the House Committee on Governmental Operations are interested in pursuing legislation to improve management and oversight of the government's lending programs. In addition, the administration submitted a legislative package to Congress that addresses many of GAO's recommendations relating to IRS. As of December 31, 1992, no further action had been taken.

Congress Should Consider Revising the Criteria for Tax Exemption If It Wishes to Encourage Nonprofit Hospitals to Provide Charity Care and Other Community Services

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

- nonprofit hospitals provided a smaller share of their states' uncompensated care than they provided of general hospital services;
- uncompensated care expenses were not distributed equally among the nonprofit hospitals but were disproportionately concentrated in large urban teaching hospitals;
- 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
- 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.

Actions(s) Taken And/or Pending

Although several bills to establish charity care standards for tax-exempt hospitals were introduced during the last session of Congress, none were enacted as of December 31, 1992. IRS, however, revised and strengthened its examination guidelines for examining large multi-entity exempt hospital systems and increased its tax-exempt hospital examination activities since GAO reported on the issue.

Legislative Actions Taken in Fiscal Year 1992 on GAO Recommendations

Congress Should Enact Legislation to (1) Require Buyers Who Deduct Seller-Financed Mortgage Interest to Report on Their Tax Returns the Name and Social Security Number of the Seller and (2) Authorize IRS to Penalize Buyers Who Fail to Provide the Seller's Identification Number Without Showing Reasonable Efforts to Obtain It and Penalize Sellers Who Refuse to Provide Their Numbers to Buyers 114

Expanded Reporting on Seller-Financed Mortgages Can Spur Tax Compliance

GAO/GGD-91-38, 03/29/91

This report responded to a request from the Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Senate Committee on Finance. It discussed how third-party information reports might help increase taxpayer compliance with the requirements for reporting interest payments made under seller-financed mortgages.

Under this mortgage arrangement, the individual seller finances all or part of the buyer's purchase of the property. The Internal Revenue Code requires that the seller pay tax on the interest income received from the buyer. IRS requires sellers to report on Schedule B (Interest and Dividend Income) of their Form 1040s the amount of interest income received from the buyer and the buyer's name.

The Internal Revenue Code stipulates that buyers who itemize deductions can deduct their mortgage interest payments to sellers. IRS requires that buyers report sellers' names and addresses on Schedule A (Itemized Deductions) of their Form 1040s. Federal law does not give IRS the authority to require buyers to provide sellers' Social Security numbers nor does IRS require buyers to send sellers a notice that IRS is aware of the interest payment made to them.

On the basis of its analysis, GAO concluded that as much as $200 million in 1989 federal taxes may not have been paid because of noncompliance in reporting seller-financed mortgage interest income and deductions. GAO believed that if legislation was enacted to require buyers to report sellers' Social Security numbers, most of this tax revenue would have been paid due to increased voluntary compliance. To pursue any remaining unpaid taxes, IRS could use the numbers as part of an enforcement program to identify sellers who fail to report mortgage interest as well as buyers who overstate mortgage deductions.

Recommendation(s) to Congress

Congress should enact legislation to

- require buyers who deduct seller-financed mortgage interest to report on their tax returns the name and Social Security number of the seller and
- authorize IRS to penalize (1) buyers who fail to provide the seller's identification number and cannot show that they made reasonable efforts to obtain it and (2) sellers who refuse to provide their numbers to buyers.

Recommendation(s) to the Commissioner of Internal Revenue	If Congress enacts legislation to require buyers to report sellers' Social Security numbers, the Commissioner of Internal Revenue should use the sellers' and buyers' numbers to study the extent of taxpayer noncompliance and, on the basis of the study's results, implement an enforcement program, such as computer matching, to pursue cases of potential noncompliance.
Actions(s) Taken And/or Pending	Congress implemented the GAO recommendation by including in the Energy Act of 1992 (P.L. 102-486, dated October 24, 1992) a provision requiring the reporting of seller-financed mortgage interest. The act, among other things, requires taxpayers claiming deductions for such interest to provide IRS with the name, address, and taxpayer identification number of the seller. Conversely, it requires sellers reporting such interest income to provide IRS with the same information regarding the buyer. The act also includes a provision that would penalize buyers or sellers who either refuse to provide their taxpayer identification numbers to the other party or who refuse to report the required information on their tax returns. These provisions became effective with taxable years beginning after December 31, 1991. As a result of this action, the Joint Committee on Taxation estimated an additional $565 million in revenue will be generated over the next 5 years.

Listing of Open Recommendations to Congress

Congress Should Clarify the Law by Expressly Authorizing IRS to Use Administrative Offsets. Congress May Also Want to (1) Specify the Procedural Protections to be Afforded Taxpayers When IRS Uses the Offset Mechanism and (2) Consider Whether Tax Compliance Should be Made a Prerequisite to Awarding Federal Contracts	18
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Congress Should Clarify the Internal Revenue Code to (1) Specifically Provide IRS Authority to Withdraw a Notice of a Lien When it is in the Best Interests of the Taxpayer and the Government, and (2) Eliminate the Uncertainty Over Whether Taxpayers Should be Given 21 Days to Correct an Erroneous Levy Under Section 6332(c)	70
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ADP and Information Technology	Complete, as Soon as Possible, the Integration Strategy and Business Transition Plan and Ensure That IRS' Strategy for Input Processing is Analytically Sound Before Committing to its Implementation; and Improve the Procurement Process Relating to (1) Software Maintenance Documentation; (2) Price/Technical Tradeoff Analyses; (3) Separation of Roles of Security Administrators and Software Developers; and (4) Responsibility for Protecting the Privacy of Taxpayer Information	23
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IRS' Implementation of the 1988 Taxpayer Bill of Rights (GAO/GGD-92-23)	12/10/91
Private Pensions: IRS Efforts Underway to Improve Spousal Consent Forms (GAO/HRD-92-31)	12/20/91
Veterans' Benefits: Millions in Savings Possible From VA's Matching Program With IRS and SSA (GAO/HRD-92-37)	12/23/91
Status of IRS' Efforts to Deal With Integrity and Ethics Issues (GAO/GGD-92-16)	12/31/91
Testimony on Summary of GAO Work Related to Expiring Tax Provisions (GAO/T-GGD-92-11)	01/28/92
IRS' Implementation of Certain Compliance Initiatives (GAO/GGD-92-45FS)	01/30/92
Federal Agency Tax Compliance Problems Remain; Improvements Are Planned (GAO/GGD-92-29)	02/18/92
Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26)	02/19/92
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IRS Procurement: Software Documentation Requirement Did Not Restrict Competition (GAO/IMTEC-92-30)	03/02/92
Testimony on Tax Systems Modernization: Factors Critical to Success (GAO/T-IMTEC-92-10)	03/10/92
Tax Systems Modernization: IRS Award to MITRE Corporation Violated the Competition in Contracting Act (GAO/IMTEC-92-28)	03/12/92
Tax Systems Modernization: IRS Could Have Avoided Successful Protests of Major Computer Procurement (GAO/IMTEC-92-27)	03/13/92
Testimony on Federal Contractor Tax Delinquencies and Status of the 1992 Tax Return Filing Season (GAO/T-GGD-92-23)	03/17/92
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Status of Efforts to Curb Motor Fuel Tax Evasion (GAO/GGD-92-67)	05/12/92
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Testimony on IRS' Management of Seized Assets (GAO/T-GGD-92-65)	09/24/92

Listing of Assignments for Which GAO Was Authorized Access to Tax Data in Fiscal Year 1992 Under 26 U.S.C. 6103(i)(7)(A)(i)

Subject matter	Objectives
IRS' Small Business Pension Audit Program	To analyze the (1) validity of the retirement age and (2) interest rate assumptions being used in IRS' Small Business Pension Audit Program.
IRS' Use of Information Returns	To obtain data on (1) the extent IRS uses information returns to detect overstated deductions and (2) related results.
IRS' Deficiency and Delinquency Notice Process	To determine adequacy of IRS' procedures to inform taxpayers of deficiencies and delinquencies.
IRS' Management of Its Correspondence	To determine whether IRS' servicewide effort referred to as "Action-61" sufficiently addresses taxpayer correspondence problems identified in the past.

Major Contributors to This Report

General Government Division, Washington, D.C.	Robert J. McArter, Assistant Director, Tax Policy and Administration Issues Joseph T. Valonis, Senior Evaluator-in-Charge

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