

GAO

Report to the Chairman, Committee on
Ways and Means, House of
Representatives, and the Chairman,
Committee on Finance, U. S. Senate

April 1993

TAX ADMINISTRATION

IRS' Plans to Measure Tax Compliance Can Be Improved



148762

General Government Division

B-251493

April 5, 1993

The Honorable Daniel Patrick Moynihan
Chairman, Committee on Finance
U.S. Senate

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

Sound tax policy and administration decisions depend on comprehensive, reliable, and timely information on taxpayer compliance. For about 30 years, the Taxpayer Compliance Measurement Program (TCMP) has been the Internal Revenue Service's (IRS) primary program for gathering such information. IRS collects TCMP data by auditing a random sample of taxpayer returns in which every line on the return is to be examined.

IRS officials have been concerned that TCMP costs too much, is overly intrusive on compliant taxpayers, and produces untimely data for use in operations and research. Given these three concerns, IRS has been planning to redesign TCMP in ways that will affect the data's usefulness.

This report was prepared, not at your request, but as part of our continuing efforts to improve tax administration. The report discusses the uses of TCMP data, evaluates the merits of IRS' concerns with TCMP, and identifies ways to improve TCMP while it continues to meet valid user needs. The report also discusses how IRS' redesign of TCMP could affect IRS' strategic objectives for the 1990s—increasing voluntary compliance, reducing taxpayer burden, and increasing productivity.

Results in Brief

TCMP has produced information that IRS, Congress, and others rely on to carry out many tax policy and administration functions. IRS uses TCMP data to determine compliance levels, develop formulas for objectively selecting returns for operational audits, and allocate examination resources. Congress and federal agencies use TCMP data for policy analysis, revenue estimating, and research.

Despite the important role of TCMP in tax administration, IRS has been planning changes. Some of these changes, if implemented, will reduce TCMP's value. These changes include:

- downsizing the program by auditing about 50 percent fewer tax year 1992 returns (25,000 rather than 54,000), which will reduce the precision of any detailed estimates made from the audit results;
- no longer requiring auditors to examine every line on the return, which will lead to gaps in data on noncompliance; and
- changing the number and makeup of the taxpayer groups, which will preclude consistent comparisons with previous measures of voluntary compliance among these groups.

These proposed changes to the size and scope of TCMP do not appear justified. We found that little merit exists for two of IRS' concerns—that TCMP is too costly and intrusive. While the third concern—producing untimely data—does have merit, IRS can cut this time without downsizing TCMP. In addition, we found that implementing these proposed TCMP changes would be premature and would hamper IRS' ability to achieve its many strategic objectives for the 1990s. As a result, we believe IRS' implementation of these proposed changes would be a step in the wrong direction.

IRS' concern that TCMP is too costly has little merit. IRS' estimated \$83 million in direct costs for the most recent TCMP (tax year 1988) represents less than 1 percent of IRS' Examination Division budgets for the 5 fiscal years (1987 to 1991) when these costs were incurred. Even if IRS' estimated opportunity costs of \$142 million are considered, we believe that TCMP still is a good investment.¹ IRS has used past TCMP results to more efficiently allocate billions of dollars in enforcement resources over several years and recommend tax law changes, just one of which the Joint Committee on Taxation (JCT) estimated would generate \$300 million in a year.

IRS' concern that the audits are overly intrusive on compliant taxpayers has merit to the extent that any audit is more intrusive than no audit at all. However, the intrusiveness concern is not as significant when placed into a larger context. For the 1988 TCMP, IRS audited 54,000 taxpayers, or approximately .05 of 1 percent of the 104 million taxpayers filing those returns. Further, while IRS examiners have 367 questions that could apply to taxpayers, we found that taxpayers provided documentation or responded to an average of less than 10 percent of these questions.

¹Opportunity cost is the amount of revenue IRS estimates it will forgo because examiners are auditing TCMP returns rather than returns of potentially less compliant taxpayers.

We found that if IRS downsized TCMP, serious new problems would arise. If IRS did fewer audits and did not examine every tax return line, IRS' estimates of voluntary compliance will be less precise. By cutting the TCMP sample by about half, the margin of error on estimates made from audits on tax return lines would increase. For example, a 7.5 percent margin of error for a specific line will increase to 11 percent, reducing precision by 46 percent. This reduced precision would lessen IRS' and Congress' abilities to detect changes in the effectiveness of our voluntary tax system. A less precise sample may severely weaken IRS' ability to measure its progress in achieving the goal of improved voluntary compliance.

Finally, such a downsizing would reduce the accuracy of IRS' formulas for selecting returns to audit and allocating enforcement resources. This reduced accuracy could cause IRS to select more, not less, compliant taxpayers for operational audits. As a result, IRS' productivity may decrease, and burdens on compliant taxpayers may increase. IRS envisions having new programs to replace the formulas, but they have not been fully tested. While we support IRS' efforts to improve selection of returns for audit, we know that several years will pass before IRS can determine whether these new programs could work.

If IRS does not implement these new programs until after it makes its three proposed changes, IRS will have reduced its ability to objectively select returns for audit and to reliably measure voluntary compliance. As a result, we believe it is premature for IRS to make such major changes to TCMP until satisfactory substitutes are available. Further, we believe that the three proposed changes lessen IRS' ability to achieve its strategic objectives.

We believe that any changes to TCMP should produce data that (1) consistently measure nationwide compliance, (2) allow IRS to objectively select returns for audit and allocate audit resources, (3) provide statistical details on noncompliance in support of existing enforcement programs, and (4) meet the needs of various users.

Background

TCMP is designed to measure taxpayer compliance on all three dimensions of tax return filing responsibility—i.e., a return that is (1) accurately completed, (2) filed in a timely fashion, and (3) fully paid. TCMP began in 1962 when IRS recognized the increased importance of measuring compliance with the tax laws. Since then, TCMP audits have covered 11 different types of returns. TCMP audits of individual returns have been the

most frequent and generally take place every 3 years. Appendix I lists the various types of TCMP audits, their status, and the frequency with which they have been undertaken.

TCMP traditionally consists of comprehensive audits of a randomly selected sample of tax returns. This sampling allows the audit results to be projected nationwide. For example, in the tax year 1988 individual TCMP, IRS audited every line item on a random sample of about 54,000 individual tax returns, which represented 104 million returns filed during calendar year 1989.

IRS determined that it needed a sample of 54,000 returns to reliably measure voluntary compliance and to develop an objective way to select individual returns for audit. IRS segmented this population into 10 audit classes—or strata—that covered the different types of taxpayer returns. These 10 strata had over 30 substrata that delineated the income levels within each audit class. Having a sample of 54,000 returns allowed IRS to develop the objective formulas for selecting productive returns in each of the 10 audit classes, as well as to gain insight on compliance levels across IRS regions.

Examiners who audited these 54,000 returns recorded their results on a 12-page data collection instrument called a checksheet. The checksheet showed amounts that taxpayers reported on their returns and amounts that should have been reported. To ensure quality and reliability, the tax returns, audit workpapers, and checksheets were subjected to a technical review. After this review, the checksheet results were entered on a computerized database at IRS' Detroit Computing Center.

Typically, it takes IRS over 4 1/2 years to complete each TCMP. This time covers the planning phase that occurs before tax returns are filed to final data analysis, which includes estimating compliance levels and developing formulas for selecting returns to audit. For example, planning for the tax year 1988 individual TCMP began in July 1987, and IRS completed its data analysis in March 1992. Returns filed in 1993 will be the first to be scored and selected for audit with the formulas developed from the 1988 data.

Objectives, Scope, and Methodology

Our objectives were to (1) determine how TCMP data are used, (2) evaluate IRS' expressed concerns with TCMP, (3) identify ways to improve TCMP while it continues to meet valid user needs, and (4) evaluate IRS' plans for redesigning TCMP. We also attempted to determine how IRS' planned

changes to TCMP would help IRS to meet its strategic objectives for the 1990s.

To determine how TCMP is used, we solicited information from various user groups, both inside and outside the federal government, as identified by IRS. We invited the federal users of TCMP data to a 1992 conference to discuss how they used the data and the data's importance to them. Attendees represented IRS, the Department of the Treasury's Office of Tax Analysis, the Office of Management and Budget, the Bureau of Economic Analysis (BEA) at the Department of Commerce, JCT, the Senate Finance Committee, the House Ways and Means Committee, and the Congressional Budget Office. We also met with officials from the state of California—one of the three states that use TCMP data.

To evaluate IRS' concerns with TCMP, we interviewed IRS officials. We also reviewed TCMP procedures and data to understand IRS' concerns about costs, intrusiveness on taxpayers, and the time needed to complete audits and analyze data. To gain a perspective on the nature and impact of these IRS concerns, we reviewed about 100 randomly selected cases from the 1988 individual TCMP, analyzed IRS' 1988 TCMP database, and evaluated IRS' analysis of its TCMP results. We also used data generated on some of our recent assignments in which we used TCMP data.

To identify ways to improve TCMP, we analyzed information obtained from our meetings with the user groups and IRS officials and our review of TCMP data and cases. To evaluate IRS' plans for changing TCMP and whether those changes would help IRS to meet its strategic objectives, we discussed redesign efforts with IRS' Research and Examination Division staffs. Our work focused on the support for these changes and their statistical implications for reliability. We also reviewed IRS' plans for modernizing its computerized systems (i.e., Tax Systems Modernization) to determine whether they would affect TCMP.

We did our work between October 1991 and October 1992 in accordance with generally accepted government auditing standards.

TCMP Is Important to IRS and Others

TCMP is a unique tool in IRS' arsenal of strategies to measure and correct noncompliance. It is IRS' only program to measure noncompliance on a random basis, allowing IRS to make a statistically reliable estimate of compliance nationwide. TCMP data are also important to non-IRS users for policy formulation, research, and revenue estimation.

IRS Uses TCMP Data for Key Compliance Activities

IRS is the largest user of TCMP data. IRS uses the data for such important activities as (1) objectively selecting returns for audit and allocating audit resources to district offices and (2) reliably identifying emerging noncompliance trends and estimating the amount of taxes owed but not paid voluntarily (i.e., the tax gap).

TCMP plays an important role in deciding which tax returns are audited. IRS uses TCMP data to develop objective, mathematical formulas, which it uses to score returns for audit selection. The higher the score on a return, the more likely an audit will result in a change to the individual's tax liability. As a result, IRS can make more efficient use of its audit resources. For example, in 1968, the year before IRS started using this scoring system, about 43 percent of IRS' audits resulted in no change to an individual's tax liability. By using TCMP-based formulas, IRS has been able to more accurately target noncompliant taxpayers, thus reducing this no-change rate to less than 15 percent in 1991.

This TCMP-based return scoring system has also been used for many years to help allocate billions of dollars in Examination Division resources at the district office level. Each year, IRS planners set a minimum cutoff score to establish nationwide audit coverage levels for different types of returns. By using the portion of return scores above this minimum level, each district office has been able to determine the number of returns it will schedule for audit, given its available resources.

Over recent years, the portion of returns selected for audit solely through this objective scoring system has fallen below 50 percent. District offices have increasingly selected returns to audit under special programs to stem emerging types of noncompliance—such as tax shelters—or study specific types of noncompliance—such as taxpayers that appear to be underreporting a certain type of income. Even when IRS focuses audit resources on a special program, these district offices still may use this scoring system to help them select the returns that have the greatest potential for a change in tax liability.

Given TCMP's statistical validity and comprehensiveness, it is useful for identifying compliance trends for specific issues and groups of taxpayers. For example, by analyzing 1979 and 1982 TCMP data, IRS identified a significant compliance problem with the number of dependents claimed on tax returns. IRS reasoned that this problem could be mitigated if dependents' Social Security numbers were required to be entered on tax returns. The 1986 Tax Reform Act (P.L. 99-514) required this entry for

most dependents claimed, which the Joint Committee on Taxation estimated would generate \$300 million in 1 year. As a result of this requirement, taxpayers claimed 7 million fewer dependents on their returns between tax years 1986 and 1987 alone.

TCMP data also enable IRS to estimate the tax gap and its components. The tax gap is the difference between the amount of taxes owed and the amount of taxes voluntarily paid for 1 year. TCMP data are used to identify the compliance levels by type of income and deductions. The tax gap estimates have allowed IRS to identify changes in voluntary compliance over time.

Non-IRS Users Value TCMP Data

TCMP data are also valuable to users outside IRS. Non-IRS uses of TCMP data include (1) estimating revenue impacts of proposed legislation; (2) adjusting the national income accounts, such as the gross domestic product; and (3) researching tax compliance.² Few, if any, other sources can provide statistically reliable data on taxpayer compliance or meet these other uses.

Congressional tax writing committees use TCMP data to analyze the benefits of proposed legislation and estimate revenue impacts of tax policy changes. For example, JCT uses TCMP data to estimate the impacts of proposed tax law changes or revenue. Such estimates affect whether legislation is enacted.

Similarly, the Department of Commerce's BEA uses TCMP data to adjust the national income accounts. For example, when estimating the gross domestic product, BEA uses IRS' Statistics of Income data, which consist of information reported from a sample of filed tax returns, without regard to a taxpayer's compliance. BEA uses TCMP results on misreported income to correct these estimates, which improves the accuracy of the national income accounts by billions of dollars. BEA officials told us that without TCMP data, such adjustments would not be possible.

TCMP data are also used by some state tax authorities. According to IRS, three states—California, Florida, and Massachusetts—have used TCMP to help them develop state compliance programs. In addition, California tax officials said that TCMP data have helped them to prepare state tax gap estimates.

²According to BEA officials, national income accounts measure the value of goods and services produced in the country.

IRS' Concerns With TCMP

Despite the many benefits from TCMP, IRS' concerns make TCMP's future uncertain. In July 1991, the Commissioner of IRS said TCMP had to be changed to make it less costly, less intrusive on compliant taxpayers, and more timely in producing results. We agree that TCMP could be improved. However, our analyses of IRS' support and TCMP cases lead us to believe that these problems are not as significant as IRS asserts.

IRS officials believed that these concerns were significant enough for them to start a major effort to redesign TCMP. By September 1992, IRS had not made many detailed decisions on how the revised TCMP would look but had proposed some major changes.

For example, according to IRS officials responsible for the redesign effort, the sample size would be reduced by over half—from 54,000 tax returns to 25,000 tax returns—and not all tax return lines would be examined. If this change is implemented, the next TCMP would be the first one in 21 years to have a sample size below 50,000 tax returns. Further, IRS slated this TCMP to cover returns for tax year 1992 instead of 1991 as originally planned. In January 1993, these IRS officials we spoke with said this next TCMP may be further delayed to cover tax year 1993 returns.

In the following sections, we discuss IRS' concerns about the costs, burdens, and timeliness of TCMP; IRS' actions to address these concerns; and our evaluation of the significance of IRS' concerns, along with other options for addressing them.

TCMP Is a Good Investment

According to IRS, TCMP costs millions of dollars in direct and opportunity costs. For example, IRS estimated \$83 million in direct costs and \$142 million in opportunity costs for the 1988 individual TCMP. The major portion of direct costs was the staff required to audit returns. Opportunity costs represent revenues lost because the additional tax yield from auditing TCMP returns selected at random is normally lower than returns audited under IRS' other examination programs.

IRS' opportunity cost estimates may be misleading because they ignore potentially lower audit yields and productivity that would result without the formulas developed from TCMP. As noted earlier, these formulas have reduced the no-change rate on audited returns from 43 percent in 1968 to less than 15 percent in 1991. As a result, IRS spends less audit resources on returns that are compliant and produce no additional tax revenue.

Moreover, TCMP costs make up a small portion of IRS' Examination Division budget. The \$83 million in direct costs for the 1988 individual TCMP represent less than 1 percent of IRS' Examination Division budgets for the 5 fiscal years—1987 through 1991—during which these costs were incurred. Similarly, the \$142 million in opportunity costs represent less than 3 percent of the \$5 billion in proposed assessments from audits of individuals in 1990 alone.

IRS did not have data to show the cost savings from cutting the sample size in half. Regardless, we believe TCMP's costs can be reduced without changing the sample size. IRS' computer modernization program has the potential to increase the cost efficiency of TCMP audits by more quickly providing examiners with more and better information about taxpayers. For example, the modernization effort already allows examiners to access automated records that show data from a taxpayer's last three returns. This ability reduces the need to wait several weeks to locate the original returns, resulting in more cost-efficient use of examiners as well as reducing the investment of a taxpayer's time.

Further, Examination Division officials said they favor cutting the TCMP sample in half in order to shift resources to other compliance activities. These officials said they lost almost 3,000 revenue agent and tax auditor positions between 1989 and 1992. In deciding to favor a reduced TCMP sample, Examination Division officials said they weighed the relative benefits of using revenue agents for TCMP versus other alternatives. For example, IRS decided to allocate 2,000 additional Examination Division staff years to pursue nonfilers, which has almost exclusively been the responsibility of the Collection Division.

When considering the many important uses and benefits of TCMP data, we believe that the costs of periodic TCMP audits are not excessive. These costs represent a worthwhile investment in better tax administration.

TCMP Audits Are Not Overly Intrusive

IRS officials have criticized TCMP for being overly intrusive on taxpayers, who must provide large amounts of data and answer many questions. Further, IRS believes that many taxpayers selected for TCMP are unnecessarily burdened because they are compliant and would not otherwise be selected for audit.

IRS' concern about TCMP's burden on taxpayers usually refers to the effort required to respond to up to 367 questions on the checksheet. Our

evaluation of the 1988 individual TCMP database showed that, on average, taxpayers were required to provide documentation on or respond to less than 35 of the questions on the TCMP checksheet. Only one taxpayer had to respond to as many as 114 of the questions, while some responded to as few as 8. In sum, most of the questions and documentation requirements were not relevant to every taxpayer. And the requested information generally could be retrieved without much burden if the taxpayers maintained their tax records, as required.

Any audit is more intrusive than no audit at all. However, relatively few compliant taxpayers were subjected to TCMP audits. Of the 104 million taxpayers filing returns for 1988, fewer than approximately .05 of 1 percent, or 54,000, were audited through TCMP, of which about half fully complied. This level of intrusiveness is small compared to the benefits derived from TCMP audits. Further, TCMP may actually reduce overall taxpayer burden. To the extent that TCMP results in fewer no-change audits in IRS' operational programs, compliant taxpayers are less likely to be audited.

IRS also has considered mitigating the burden placed on taxpayers subjected to TCMP audits by paying a stipend for the amount of time taxpayers spent on the audit or forgo penalties on tax assessments below a certain level. These options would not be exceptionally costly. For example, forgoing all penalties on the 1988 TCMP would have reduced the \$75 million in proposed tax and penalty assessments by less than \$11 million.

TCMP Results Can Be Obtained in a More Timely Fashion

According to IRS officials, useable TCMP data are not produced in a timely fashion. On the most recent TCMP, IRS spent over 2 years from the time the last tax returns were filed in December 1989 until the audit results were available for revising the formulas in February 1992. We identified ways that IRS could reduce this period without having to audit fewer returns or skip lines on the return. IRS is planning some changes necessary to achieve better timeliness, and we suggest other changes.

First, IRS is considering giving examiners 12 months instead of 18 months to finish auditing all TCMP returns. IRS officials said cutting the sample size and auditing fewer tax return lines, among other reasons, would make this reduction possible. These officials also believe this reduction would make TCMP results more timely.

We acknowledge IRS' need to reduce the time it takes to produce useable TCMP data. However, we believe that reductions are possible by beginning the audits sooner. For the 1988 TCMP, IRS delayed the audits until all information return data were available, which was August 1989. According to IRS' TCMP schedule, the district offices did not begin receiving returns to audit until September 1989. We believe that IRS could obtain TCMP results more quickly if it began audits as soon as returns are processed and entered into the database. Although IRS examiners may not have information return data when they start doing the audits (e.g., late winter or early spring), these data could be reviewed before examiners formally close audits. In addition, IRS has been processing information return data more quickly, which reduces the gap between the start of an audit and the receipt of such data.

Finally, after the audit results are entered into a database, IRS could reduce the 12 months used to clean up the data and check their accuracy. For example, rather than waiting for all audit results to be entered, IRS could begin accuracy checks as soon as the first checksheets were processed. This would not only shorten the TCMP cycle but would also allow IRS to more quickly detect unclear TCMP instructions that may have caused examiners to make errors. Then, IRS could provide the examiners with clearer instructions before the remaining audits were completed.

TCMP Redesign Will Lessen IRS' Ability to Achieve Its Strategic Objectives for the 1990s

If IRS downsizes TCMP, serious new problems will arise, hampering IRS' ability to (1) detect changes in and improve voluntary compliance, (2) reduce taxpayer burden, and (3) increase productivity. In addition, such a redesigned TCMP would neither meet non-IRS user needs nor provide consistent measures of compliance. We believe that IRS needs to better plan its redesign efforts.

Smaller Sample Will Reduce Precision of Estimates

Doing fewer audits and not examining every line on returns would lower the precision of IRS' voluntary compliance estimates. If IRS reduces its sample size to 25,000 returns, the margin of error on estimates made from audits on any tax return line will increase from 7.5 percent to 11 percent. As a result, the estimates will be 46 percent less precise compared to those from a 54,000 return sample. This increased margin of error will lessen IRS' and Congress' abilities to detect changes in the effectiveness of our voluntary tax system.

A reduction in sample size also would limit IRS' ability to develop formulas to objectively select returns from different categories of taxpayers. For example, using existing TCMP data, IRS has been able to develop formulas for selecting returns for each of the 10 audit classes it uses to define the different types of tax returns. Under the redesigned TCMP, IRS indicated it could develop effective formulas for only 3 of the 10 classes. Given these potential effects of redesign, IRS would have to develop a basis for selecting returns for audit that will ensure the fair treatment of all taxpayers.

The use of these formulas to predict the probability that an audit will result in a change to tax liability also would be weakened, leading to less effective use of Examination Division resources. This situation could lead to more, not fewer, compliant taxpayers' being selected for operational audits, increasing their burden. To the extent that audits encourage voluntary compliance or correct errors on returns, they will be less effective when not directed to the returns with the greatest noncompliance.

In addition, a lowered precision in selecting returns for audit may diminish IRS' ability to know whether it achieved its third objective of improving voluntary compliance. In November 1992, the Commissioner of IRS announced a goal of increasing voluntary compliance, which has been about 84 percent, by 10 percentage points over the next 8 to 10 years. If IRS changes TCMP as it proposes, IRS and non-IRS users may not be able to make valid, consistent comparisons. As a result, IRS will not know whether it meets its voluntary compliance goal.

TCMP Changes Will Provide Less Useful Data for Compliance 2000

The proposed TCMP changes would provide less useful data for IRS' newest initiative to improve voluntary compliance. This initiative—referred to as Compliance 2000—will attempt to identify compliance levels for “market segments”—specific types of taxpayers within specific geographically limited areas. Then Compliance 2000 will attempt to identify the cause of any noncompliance so that IRS can apply the appropriate remedy.

Using a sample size of 54,000 returns, TCMP cannot provide the detailed compliance data required for Compliance 2000. However, TCMP can identify regional differences and suggest areas for objectively targeting more data gathering. Reducing the sample size to 25,000 and altering the audit classes will produce data that are even less likely to meet the needs of Compliance 2000.

IRS officials agreed that the smaller sample would generate less useful data for Compliance 2000. The officials said, however, that new data gathering efforts would be used to supplement TCMP and provide the data necessary to implement Compliance 2000. These IRS efforts include an automated classification program known as Automated Issue Identification System (AIIS), a geographically specific compliance database called the Voluntary Compliance Index, and a computerized summary of the results from all types of audits.

Although these new approaches may be promising, none is yet ready for operation. IRS officials do not know when the approaches will be operational or whether the approaches will provide the statistically based benefits that TCMP already generates. Nor do these officials yet know the full costs of these new efforts or whether these costs will exceed the costs of TCMP.

AIIS is being tested but cannot be implemented until IRS has computer systems that cost-effectively capture, store, and analyze much more data from the tax return. IRS officials responsible for this test are not sure how soon IRS will acquire such computer capabilities. The compliance index is being developed at IRS' Hartford District Office but will have little information on the accuracy of the taxpayer's return, concentrating on payment and filing returns instead.

Finally, cost-effectively capturing and analyzing the results of all types of audits depend on making laptop computers accessible to all IRS examiners. In January 1993, IRS officials informed us that they expect to be able to provide 9,800 laptop computers to its examiners during 1993. If IRS had such computer capability, examiners could more easily capture and categorize these results as they are generated. Further, IRS could analyze these results to help target future audit resources.

Redesigned TCMP Will Not Meet Non-IRS User Needs

IRS has not changed its TCMP redesign plans to account for users such as BEA and JCT. Officials from these user groups indicated that a reduction in the TCMP sample is likely to make the data less useful to them.

For example, BEA relies heavily on TCMP data to determine the compliance of sole proprietors. The revised TCMP would reduce the number of sole proprietors being audited from over 17,000 to less than 14,000. Moreover, the revised TCMP would combine all sole proprietors, regardless of their compliance, into one group, which will reduce the details available on

their compliance. These changes may reduce the precision of TCMP estimates and make comparisons with past TCMP results difficult, if not impossible. As a result, BEA may not have the detailed data on sole proprietors that it needs to correct national income accounts.

Similarly, JCT depends on TCMP to identify emerging areas of noncompliance (e.g. erroneous dependent exemptions). Under the redesigned TCMP, examiners would not be required to audit all line items on returns. Instead, each examiner would be allowed to select items to audit. Thus, IRS may not do enough audits of a tax return item to allow the results to be statistically reliable or estimated to the population. This examiner discretion could result in TCMP's missing some compliance issues and make the revised TCMP inconsistent with past measures of compliance.

We believe this inconsistency could limit JCT's ability to use TCMP data to make revenue estimates for legislation in areas such as sole proprietor compliance in reporting income or deductions. Such discretion also may raise questions about inequitable treatment of taxpayers subjected to TCMP audits.

Better Planning Needed for TCMP Redesign

When evaluating proposals to change TCMP, we believe IRS should approve only those changes that will lower taxpayer burden and increase compliance and productivity. To ensure that TCMP continues to provide the same benefits and meets emerging needs, IRS should consider the following four criteria in its evaluation:

- The change will help to satisfy the Compliance 2000 requirement by providing indications of noncompliance among major pockets of taxpayers (e.g., types of sole proprietors).
- The change will enable IRS to precisely and consistently measure changes in nationwide compliance levels in order to determine whether the goal of Compliance 2000 has been achieved and to detect changes in the tax gap.
- TCMP will continue to provide an objective method to select returns to be audited and allocate resources under the change.
- The changed design continues to meet the needs of the tax policy community and other external users.

If IRS uses these criteria to evaluate changes, TCMP is more likely to continue to have a vital role in improving tax administration.

Conclusions

TCMP provides the only data that allow IRS to objectively select returns for audit, allocate resources to field offices, and statistically measure voluntary compliance. TCMP is also important to other federal government units for tax policy analysis, revenue estimating, and research.

IRS' proposed changes to TCMP raise two concerns. First, we believe it is premature to make such major changes until IRS can show that its changes will work. Second, the changes do not appear justified by IRS' concerns that the program costs too much, is too intrusive on compliant taxpayers, and produces untimely data. While we agree that TCMP can be improved, we do not believe that it is wise or necessary to cut the sample size in half, allow examiners to choose to skip lines on an audited return, and change the taxpayer groups. Although recent TCMP results may not have been timely, future audit results could be available much sooner through other changes that do not require auditing fewer returns.

If IRS cuts the TCMP audit sample in half, the precision of the formulas used to select returns for audit and to allocate audit resources will be reduced significantly. As a result, examiners will be less productive, and more compliant taxpayers will be burdened with audits that do not change their tax liability. Thus, we believe IRS' decision to cut TCMP resources is unwise.

We believe that neither the needs of IRS or other users would be met if IRS implements its proposed changes. Results from the redesigned TCMP would provide less reliable data on which to base Compliance 2000 decisions and would hamper comparisons with previous audit results. Although IRS plans to implement new compliance programs designed to supplement TCMP, they are not yet on-line, and it is not clear how costly or effective these programs will be when they are operational. In short, IRS needs to proceed with caution.

We believe that all proposed changes to TCMP should be viewed in the context of IRS' three strategic objectives—lowering taxpayer burden, increasing taxpayer compliance, and increasing IRS productivity. IRS' proposed changes to TCMP fail to meet these objectives and thus, should not be implemented.

Further, our work confirmed IRS' concerns about TCMP's results being untimely. Reducing the time to make the results available is crucial, particularly when decisions about revenue estimates and tax law changes rely on TCMP data. During our analyses, we identified a few ways to expedite the TCMP process. Within the framework of the four criteria for

changing TCMP, we believe that IRS should consider these and other ways to expedite TCMP. We are also concerned about the additional delay of the next TCMP. Doing the next TCMP for tax year 1993 means that 5 years, instead of the traditional 3 years, will have elapsed since the voluntary compliance of individual taxpayers had last been measured.

Recommendations to the Commissioner of Internal Revenue

We recommend that the Commissioner:

- Not implement the three currently proposed TCMP changes.
- Ensure that any proposed changes to TCMP meet the four criteria we discuss.
- Shorten the time needed to produce final TCMP results.
- Not postpone the next TCMP beyond tax year 1993 returns.

Agency Comments and Our Evaluation

On January 29, 1993, the Acting Commissioner of IRS provided written comments on a draft of this report (see app. II). He said IRS has decided to defer making the three changes to TCMP for tax year 1992. He also agreed with our recommendation that any changes to TCMP meet our four criteria. Further, he said IRS still plans to revise TCMP to improve its efficiency and timeliness. As a result, he committed IRS to developing a new system, while also keeping its current system for selecting returns to audit.

We are pleased that IRS has decided to defer the changes to TCMP and to follow the four criteria, as we had recommended. We also support IRS' efforts to improve TCMP to better ensure that Congress and other users have reliable information on voluntary compliance.

We are concerned, however, about IRS' decision to defer TCMP for 1992. IRS had initially planned to do an individual TCMP for tax year 1991 before the planned downsizing delayed it until 1992. Delaying the next TCMP until 1993 only lengthens the amount of time that Congress and other users must wait for updated compliance information.

We believe that this delay should not go beyond tax year 1993 returns. TCMP information is needed periodically to capture changes in the compliance of taxpayers and provide a better basis for estimating compliance changes and revenue impacts from new legislation, as well as for other uses. The last TCMP measured compliance for tax year 1988 returns. The longer the interval between TCMP surveys, the less useful TCMP

is, given changes in the economy and the tax law. In TCMP's 30-year history, the gap between TCMPs for individuals has never exceeded 4 years.

Copies of this report are also being sent to the Joint Committee on Taxation, the Director of the Office of Management and Budget, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. It also will be made available to others upon request.

Major contributors to this report are listed in appendix III. Please contact me on (202) 275-6407 if you have any questions about the report.

Jennie S. Stathis

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Types and Sample Size of Completed TCMPs

Types of TCMPs	Sample size
Individual surveys	
Tax year	
1963	92,000
1965	50,000
1969	53,000
1971	26,000
1973	55,000
1976	50,000
1979	55,000
1982	50,000
1985	50,000
1988	54,000
Small corporation tax returns	
Processing year	
1969	16,000
1973	20,000
1978	33,000
1981	33,000
1988	19,000
Estate returns	
Processing year	
1971	4,600
Exempt organization returns	
Processing year	
1974	11,400
1979	20,000
1988	3,000
Fiduciary returns	
Processing year	
1975	8,900
Employee plans return	
Processing year	
1982	18,000
Partnership returns	
Processing year	
1982	27,000

(continued)

**Appendix I
Types and Sample Size of Completed
TCMPs**

Types of TCMPs	Sample size
S Corporation returns	
Processing year	
1985	10,000
Delinquent returns	
Non-farm business survey	
Processing year	
1963	27,000
1966	114,000
1969	70,000
Individual returns	
Processing year	
1979	25,000
1988	25,000
Surveys of delinquent accounts	
Processing year	
1963	178,000
1964	166,000
1969	1,800,000
1970	1,800,000
1971	1,800,000
1981	1,800,000
1984	1,800,000

Comments From IRS



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAR 29 1993

Ms. Jennie S. Stathis
Director
Tax Policy and Administration Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Stathis:

We have reviewed the draft report titled "IRS' Plans to Measure Tax Compliance Can Be Improved." We agree that the Taxpayer Compliance Measurement Program (TCMP) must meet the four objectives cited in the report: help satisfy Compliance 2000 data needs; enable the IRS to precisely and consistently measure changes in nationwide compliance levels; continue to provide a basis for objective selection of returns for audit and allocation of resources, and meet the needs of the Service's external users.

To consider these objectives properly and determine the most effective ways to meet them, we have decided to defer the downsized TCMP survey of TY 1992 returns. Our continuing objective is to devise a new system which will be more efficient and timely. Therefore we will continue our efforts to design a compliance measurement system which meets identified objectives while taking advantage of the best available technology. In the interim we will continue to maintain our current system for selecting examination workload.

We will work with your staff in a cooperative manner as we continue the design process.

Best regards.

Sincerely,

A handwritten signature in black ink, appearing to read "Mike Dolan", written over a horizontal line.

Michael P. Dolan
Acting Commissioner

Major Contributors to This Report

**General Government
Division, Washington,
D.C.**

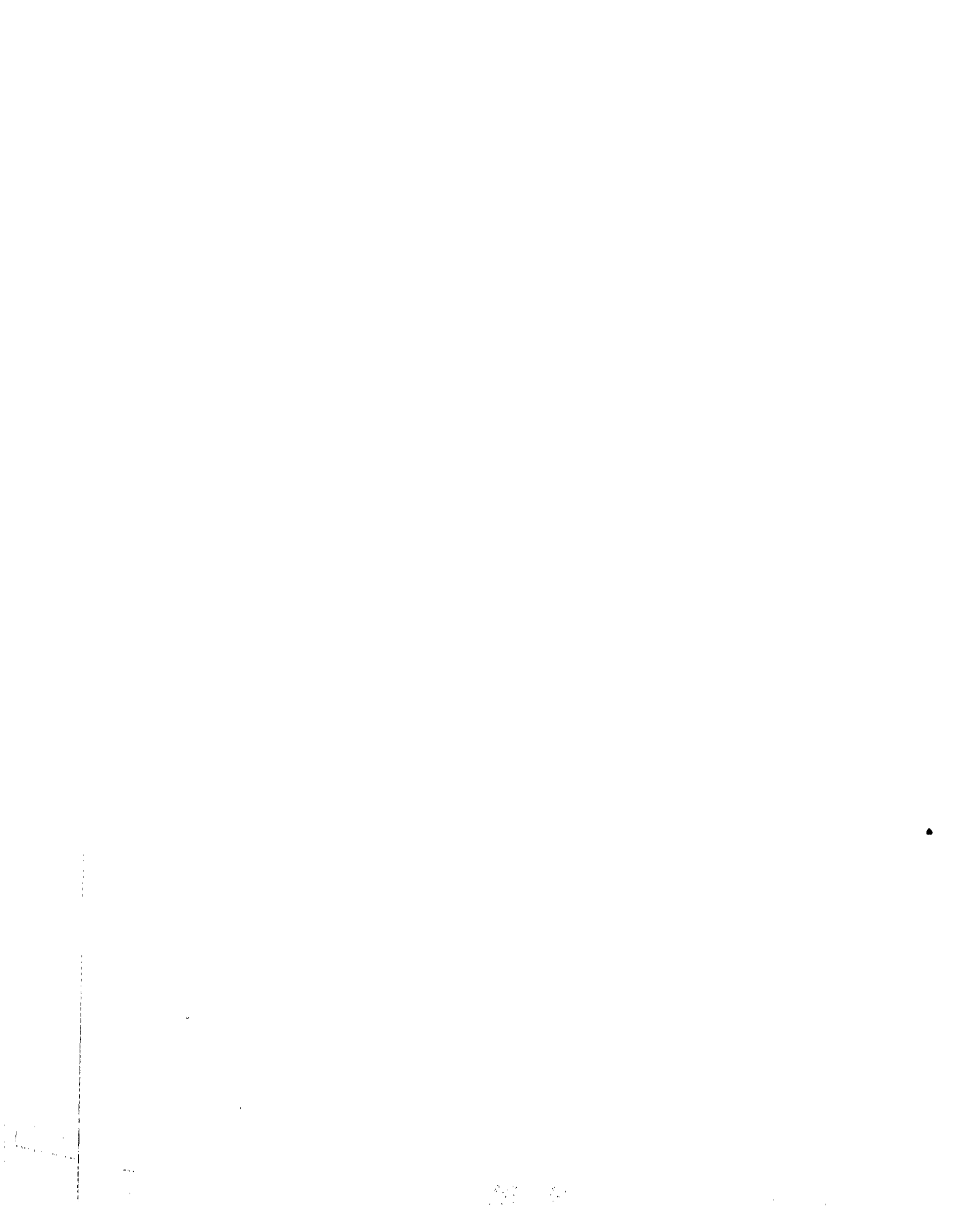
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