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TAX ADMINISTRATION

IRS' Budget Request For Fiscal Year 1994

Statement for the Record of
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General Government Division

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IRS' BUDGET REQUEST
FOR FISCAL YEAR 1994

SUMMARY STATEMENT OF
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The Internal Revenue Service's (IRS) fiscal year 1994 budget request is for $7.4 billion and 116,060 full time equivalent (FTE) staff--about $284 million and 792 FTEs more than authorized for 1993. The two largest increases are $145 million and 190 FTEs for Tax Systems Modernization (TSM) and $150 million and 2,000 FTEs for 11 compliance initiatives. These increases are offset, in part, by a decrease of $55 million and 1,219 FTEs due to estimated productivity savings from automation.

Of the TSM increase, $82.8 million is for synchronized deployment of four automated systems. GAO agrees with the concept of synchronized deployment. However, because much remains to be done before IRS will be able to develop and approve a detailed deployment plan, GAO questions the appropriateness and timing of this request.

The 11 compliance initiatives focus on areas that GAO agrees need attention. GAO believes, however, that the goals of some initiatives could be achieved without more staff. For example, IRS could collect more delinquent taxes by changing collection processes and reallocating existing resources. IRS also may have trouble delivering on some initiatives because of its continuing need to redirect resources to offset labor cost shortfalls. If estimated productivity savings prove unrealistic, for example, IRS' base operations would be eroded in 1994 and at least some of the growth intended through the compliance initiatives might go unrealized as resources are diverted to stem that erosion.

Another factor that could cause a diversion of resources from the compliance initiatives is the absence of any allowance in the budget for staff to implement tax law changes that are expected this year. If the laws are changed, for example, IRS can expect an increase in its telephone assistance workload in 1994 as taxpayers call with questions about the changes. With a budget that provides for 67 less Taxpayer Service FTEs than in 1993, an increased workload, without any redirection of resources, could exascerbate an existing IRS problem. As of March 28, 1993, IRS was only answering about 24 percent of the calls it was receiving. The rest of the callers were getting busy signals or were hanging up before an assistor got on the line.

This statement also discusses opportunities for IRS to become more efficient. GAO suggests some changes affecting IRS' regional offices and discusses some IRS initiatives to streamline its operations.

Mr. Chairman and Members of the Subcommittee:

At your request, we have reviewed IRS' budget request for fiscal year 1994. That request calls for $7.4 billion and 116,060 full time equivalent (FTE) staff--an increase of almost $284 million and 792 FTEs over IRS' authorization for fiscal year 1993. The two most significant increases are (1) $145 million and 190 FTEs for Tax Systems Modernization (TSM) and (2) $150 million and 2,000 FTEs for 11 compliance initiatives. These increases are offset, in part, by decreases for such things as productivity savings and nonrecurring costs.

Our statement the following six points:

-- We question the appropriateness of more than half of the requested increase for TSM because it is intended for implementation of a project for which critical plans have not been completed.

-- Although we generally support the direction IRS appears to be taking with many of the compliance initiatives, inadequate funding of IRS' base operations could prevent IRS from delivering on those initiatives.

-- The goals of some compliance initiatives could be achieved more efficiently without a further increase in staff.

-- The budget request provides for a slight increase in audit coverage, but that increase depends on IRS realizing certain productivity savings.

-- Tax law changes in 1993 could increase IRS' taxpayer service workload and exacerbate problems IRS now has meeting taxpayer demand for telephone assistance.

-- Operating efficiencies are available through TSM and changes in the way IRS does business.

TAX SYSTEMS MODERNIZATION

We question the appropriateness and timing of $82.8 million, or more than half of the requested $145 million increase in TSM funding for fiscal year 1994. The $82.8 million is being requested for the synchronized deployment of four interim systems: (1) the Totally Integrated Examination System, (2) the Integrated Collection System, (3) the Automated Criminal Investigation System, and (4) the Automated Inventory Control System.

While we do not question the concept of synchronized deployment, we have some general concerns with funding this deployment before completing critical plans. Deployment planning is in the early stages, and much remains to be done before IRS will be able to develop and approve a detailed deployment plan. For example, IRS has not yet (1) confirmed through thorough technical and economic analyses which interim systems should be deployed and when, (2) identified the sites where the systems will be deployed, or (3) performed a risk assessment of the plan and developed a risk-reduction strategy.

We are concerned whether IRS will be able to complete these tasks in time to allow synchronized deployment in fiscal year 1994. First, determining which interim systems will be deployed requires not only a thorough reassessment of their technical and economic merit but also a balance of available system development resources--the people who will actually develop these systems--between the interim and long-term TSM systems. Although IRS has shown that the Totally Integrated Examination System meets cost/benefit criteria for deployment, this is not yet the case for the other three systems. Second, identifying deployment sites depends on completing ongoing business studies. These studies could result in significant changes to IRS' field structure, including changes in the number and functions of field offices. Third, a risk assessment of the synchronized deployment strategy is needed to ensure that IRS identifies and addresses critical risks, such as increased complexity due to the large number of concurrent tasks that will need to be planned, coordinated, and verified.

To ensure that the requested funding is commensurate with IRS' ability to plan and execute the synchronized deployment of selected interim systems, the Subcommittee may wish to withhold its support for this funding until IRS presents a detailed deployment plan accompanied by an economic analysis and a risk assessment of the selected deployment strategy.

COMPLIANCE INITIATIVES

Many of the 11 compliance initiatives in IRS' budget request are targeted at critical issues (such as collecting delinquent taxes, increasing international tax compliance efforts, increasing audit coverage, and reducing electronic filing fraud) that we have reported on in the past. We generally support the direction IRS appears to be taking with many of those initiatives. We are concerned, however, that inadequate funding of IRS' base operations could prevent IRS from delivering on these initiatives. We also believe that the goals of some of the initiatives could be achieved more efficiently without a further increase in staff.

Need to Adequately Fund Base Operations

As we have discussed in past budget hearings before this Subcommittee and in other forums, IRS has had problems realizing or sustaining the growth intended by compliance initiatives authorized as part of previous years' appropriations. One of the major reasons for those problems has been IRS' need to redirect resources to offset budgetary shortfalls. Again in 1993, according to IRS' budget documents, IRS has had to scale back staffing and redirect resources from travel, training, and other support activities to offset unfunded labor costs of over $200 million.

There are certain aspects of the fiscal year 1994 budget request that could lead to a similar situation next year. For example, various factors that IRS has identified as contributing to labor cost shortfalls continue to exist. Those factors include ones, such as reduced attrition, over which IRS has little control and others that result from internal IRS management and program decisions. We were told that IRS is working to resolve these issues to the extent they are within IRS' power to resolve.

Productivity savings are another aspect of the fiscal year 1994 budget that could adversely affect IRS' base. The budget includes decreases of $55 million and 1,219 FTEs attributed to productivity savings associated with various systems being implemented as part of TSM. Those decreases offset a large part of the increase being requested for compliance initiatives. From what we know and what we have observed about some of these systems, such as the Totally Integrated Examination System and Corporate Files on Line, we would agree that they enable IRS employees to work more efficiently. We did not have sufficient information available to us, however, to assure the Subcommittee that the productivity savings estimated for fiscal year 1994 are realistic. If the savings are overstated, IRS' base operations would be eroded and at least some of the growth intended through the compliance initiatives might go unrealized.

The potential impact of unrealized productivity savings might best be demonstrated in the Information Reporting area. One of the 11 compliance initiatives calls for an increase of about $4.2 million and 107 FTEs to allow IRS to work additional underreporter cases. That increase is more than offset, however, by a decrease of $7.5 million and 252 FTEs for savings expected from implementation of the Automated Underreporter System. Despite the net decrease, IRS estimates that it will be able to issue about 2.6 million underreporter notices in 1994--up from the approximate 2.4 million IRS expects to issue in 1993 but still well below the approximate 3.8 million issued in 1992. Problems have been delaying implementation of the Automated Underreporter System. If those delays continue or if the expected savings from that system fail to materialize, IRS' enforcement presence in the Information Reporting area will most likely continue to decline rather than increase.

Various tax law changes are anticipated this year that could also contribute to a diversion of IRS resources in fiscal year 1994.

Although the budget request includes $19.6 million to help IRS implement tax law changes, it is impossible to assess the adequacy of that amount until specific tax law changes are enacted. Also, although the budget request provides funds for implementing tax law changes, it does not provide additional FTEs even though staff will be required to do such things as rewrite computer programs, revise forms and publications, and write regulations. Depending on the nature of any tax law changes, the impact on IRS' staffing could be significant and, with no provision for that impact in the budget request, could require IRS to divert authorized staffing from other areas.

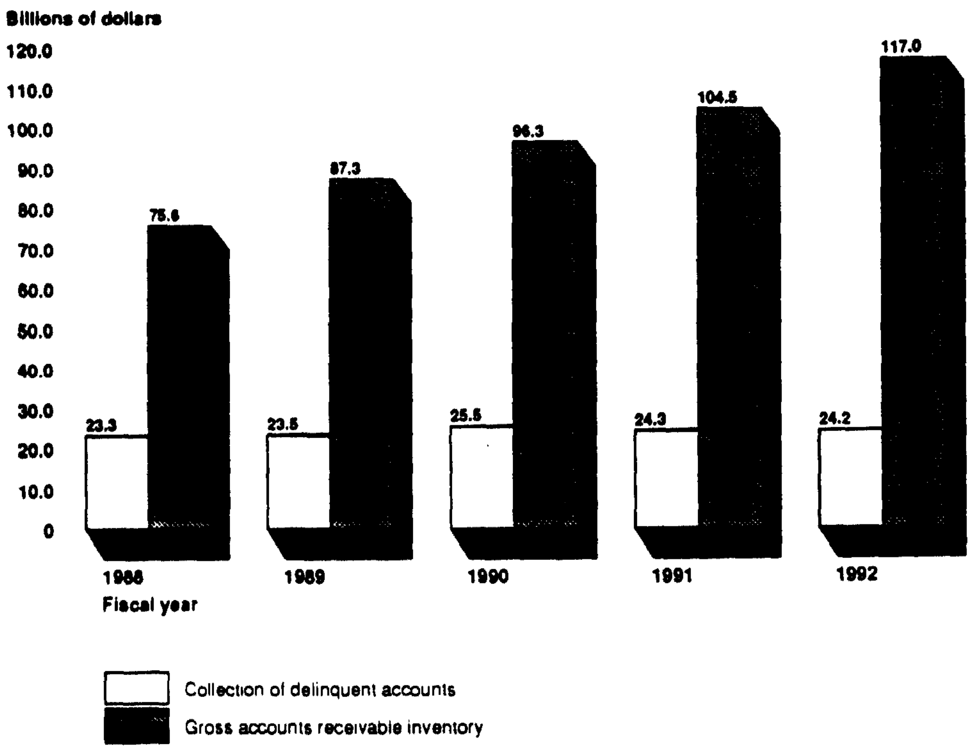
Goals of Some Compliance Initiatives Attainable Without Increased Staffing

As discussed below with respect to the collection of delinquent accounts, electronic filing fraud, and motor fuel tax evasion, we believe that the goals of at least some of the 11 compliance initiatives in the budget request can be achieved without an increase in staff.

Collecting delinquent accounts

Although IRS has been placing increased emphasis on reducing its accounts receivable, collection results are not very encouraging. As shown in figure 1, collections of delinquent taxes over the past 5 years have not changed very much; they actually declined in 1991 and again in 1992. Over the same 5 years, the gross accounts receivable inventory, adjusted to eliminate the increase caused by the change in the statutory collection period in fiscal year 1991 from 6 to 10 years, has been growing at a steady pace.

Figure 1: Comparison of Total Accounts Receivable and Collection of Delinquent Accounts, Fiscal Years 1988 Through 1992



Note 1: Accounts receivable values for fiscal years 1991 and 1992 have been adjusted from a 10-year to a 6-year statutory collection period.

Note 2: In 1992, IRS redefined the gross accounts receivable inventory by excluding certain amounts previously included. The 1992 inventory value was calculated on the basis of the old definition and, therefore, is comparable to prior years.

Source: IRS data.

IRS' gross accounts receivable balance does not mean much in terms of potential revenue, but does reflect the collection workload. Because of overstatements in the inventory and because of errors by IRS and taxpayers, much of the gross balance is invalid and does not reflect the amount of delinquent taxes actually owed. In addition, many of the valid accounts in the inventory are considered uncollectible because the delinquent taxpayers cannot pay or IRS cannot find them. After considering all of the above, IRS estimates that only $28.1 billion of the September 30, 1992, accounts receivable balance of more than $100 billion is collectible.

The compliance initiatives in the fiscal year 1994 budget request include an additional 777 FTEs and $49.5 million for IRS' Collection function. Most of these resources are to be directed toward reducing the accounts receivable inventory by:

--pilot testing the use of private collection agencies;

--extending hours at Collection call sites;

--expanding the role of the Service Center Collection Branch;

--establishing call sites in service centers for pre-notice contact on large dollar cases;

--extending Taxpayer Service hours for participation in installment agreements and other accounts receivable related work; and

--increasing the number of revenue officers in the field to collect delinquent taxes and secure returns from nonfilers.

We agree with the primary focus of these initiatives on IRS' collection activities at service centers and call sites. Indeed, work we are doing for the Subcommittee on alternative collection strategies suggests that IRS needs to place even more emphasis on collection activities at the service centers and call sites and less emphasis on field collection activities. Currently it can take up to 6 months after a delinquency arises before IRS attempts telephone contact with the taxpayer. In the private sector, most delinquent accounts are closed within that time. If telephone contact is not successful in resolving the delinquencies, IRS sends the accounts to the field where more experienced collection employees (revenue officers) attempt face-to-face contact with the taxpayers. IRS has allocated almost two-thirds of its Collection staff to this field collection activity, while other government and private collection agencies are relying more heavily on early telephone contact.

With that in mind, while we support the goals of the initiatives we do not support the new positions being requested to implement them. We especially do not support adding more revenue officers. Even with existing processes, IRS projects average revenues of $377,000 for each FTE requested for its call sites but only $89,000 for each additional revenue officer FTE requested. We believe, instead, that IRS should make fundamental changes in its collection processes and redirect existing resources from the field to the service centers and call sites.

Electronic filing fraud

As we recently reported, electronic filing fraud has been a growing problem.[1] IRS statistics for 1992, for example, show that IRS identified 12,725 electronically filed returns involving fraudulent refunds totalling $33.6 million and that one-third of those refunds were issued before IRS could stop them. IRS took various steps in response to our report and its own internal studies in an attempt to alleviate this problem in 1993. Preliminary statistics for 1993 indicate that those steps have had a positive effect. According to the statistics, IRS was able to stop 88 percent of $11.3 million in fraudulent refunds claimed as of March 31, 1993. At the same time last year, IRS had stopped 80 percent of $10.1 million in identified fraudulent refunds. We were also told by Criminal Investigation officials that about 240,000 "bad" returns were kept out of the system by

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[1]Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

up-front verification of taxpayer names and Social Security numbers.

IRS' budget request includes 81 FTEs and about $5 million to help expedite the identification and deletion of fraudulent claims for refund associated with the electronic filing program. Criminal Investigation officials told us that this request is to fund staff who are already assigned to questionable refund detection teams in IRS' service centers but who are currently being funded by other functions. Although the additional staff have apparently helped IRS combat electronic filing fraud, we believe that the use of manual labor is the least efficient way to deal with such fraud. It would be more efficient, for example, if IRS, as we recommended in our report, improved the criteria its computers use to screen electronic returns for potential fraud after the returns have been filed.

As demonstrated by IRS' experience with up-front verification of names and Social Security numbers, an even more efficient way to combat such fraud is to implement controls at the front of the process to help keep fraudulent returns from being filed in the first place. Because fraudulent refund schemes generally involve the preparation of false Form W-2s and the fabrication of wage and withholding information, the best up-front control would be for IRS to electronically match wage information received from employers with wage information on the electronic returns. Such a capability should become available, although not in the foreseeable future, as IRS implements its Tax Systems Modernization Program. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it processes taxpayers' returns because of the time it takes to verify the information and correct any errors.

Motor fuel excise tax evasion

Another of the compliance initiatives calls for providing IRS' Criminal Investigation function with about $2.6 million and 25 FTEs to pursue cases of motor fuel excise tax evasion. The required funding would come from the Federal Highway Trust Fund under a reimbursable agreement with the Department of Transportation. The additional staff would be used to expand criminal investigations of motor fuel excise tax fraud.

Although a criminal deterrent is a necessary component of tax enforcement, we question the need for the requested increase. Compliance with motor fuel excise taxes can be enhanced by reducing opportunities to evade the tax and by obtaining better information to target enforcement efforts. To the extent these can be achieved, the need for an increased criminal enforcement presence, which would carry over into future fiscal years, is decreased.

In a 1992 report, we said that reliable statistical information did not exist on the extent of motor fuel excise tax evasion.[2] Anecdotal information and the professional judgment of some industry and government officials, however, suggested that evasion was a significant problem. On the basis of recent meetings with federal officials and selected industry representatives interested in this issue, we understand that reliable statistical evidence is not yet available but concern about evasion continues, with a growing concern about diesel fuel evasion.

In our earlier work, we found strong arguments suggesting that refinery level taxation of gasoline, rather than taxation at the terminal rack, could reduce the potential for evading taxes. Because the level of evasion was not known and industry representatives had concerns about the desirability of such a move, we suggested that Congress explore the level of evasion. If evasion was found to be sufficiently high, we said the tax collection point for gasoline should be moved to the refinery level.

Developments since our report have reinforced the desirability of considering a revised collection point for excise taxes on gasoline and diesel fuel. The President has proposed a BTU tax

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[2] Tax Administration: Status of Efforts to Curb Motor Fuel Tax Evasion (GAO/GGD-92-67, May 12, 1992).

that for gasoline and diesel would be collected at the refinery tailgate (when products leave the refinery). If the BTU tax is collected at the refinery, efficiency arguments suggest that motor fuel taxes also be collected at the refinery.

In addition, the Environmental Protection Agency has adopted regulations under which high sulfur diesel equivalent products must be dyed. These products cannot be used on highways. The dyeing requirement provides an improved means to segregate diesel for on-highway use, which is taxable under the motor fuel excise tax, from diesel for off-highway use, which is not taxable.

The proposed BTU collection point is controversial, however. Some industry representatives have been working on a proposal to impose both the BTU and motor fuel excise taxes at the terminal rack. While this would not represent a change for gasoline, it would be a higher collection point for diesel fuels and, especially coupled with the dyeing requirement, could reduce the potential for evasion schemes involving this product.

Under the auspices of the Department of Transportation's Joint Federal/State Motor Fuel Tax Compliance Project, IRS has been working to make better use of data on taxpayers who are registered to deal in tax-free motor fuels and on motor fuel transactions among all types of motor fuel industry companies. IRS recently established a database of taxpayers who are registered to engage in tax-free exchanges of gasoline. This database is intended to enable industry members to check that a purchaser is validly registered to buy gasoline without paying the excise tax. IRS plans soon to incorporate diesel fuel companies into the database. Diesel vendors far outnumber gasoline vendors.

IRS is also working with the state of Michigan and oil industry members to test the feasibility of a system that would track motor fuel transactions between vendors. This system would be used to identify transactions that are subject to tax and assure that taxes are collected.

We believe that these initiatives to reduce the up-front potential to evade motor fuel taxes and better identify when taxes are not paid are likely to increase overall compliance more effectively than additional funding for criminal investigations. If additional funds are to be allocated to IRS from the Federal Highway Trust Fund, efforts to accelerate progress on the tax-free vendor database and the system to track motor fuel transactions should be considered.

Compliance Initiatives Expected to Increase Audit Coverage Slightly

Three compliance initiatives are expected to increase the number of tax returns examined over the next several years. These initiatives are directed at (1) high income nonbusiness returns, (2) employees misclassified as independent contractors, and (3) nonfilers.

The biggest of these initiatives (about $31 million and 400 FTEs IRS-wide) is directed at misclassified employees. The initiative would probably not be needed if Congress were to require either withholding or enhanced information reporting on payments to independent contractors. In addition to discussing these proposals, we reported last year that the common law rules for classifying workers are unclear and subject to conflicting interpretations.[3] As a result, small businesses, which are often the subject of employee classification audits, have difficulty classifying their workers and could end up having large tax assessments levied against them. The rules need to be clearer and the compliance incentives stronger to obviate the need for a compliance initiative like this one.

The compliance initiatives suggest added staffing for the Examination function. But, after considering projected

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[3] Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

productivity savings, the budget request provides for only a nominal increase in Examination FTEs over 1993 (+94) and less FTEs than in 1992 (-678). Almost all of the productivity savings are related to the Totally Integrated Examination System. This is one of the systems, however, that could be affected by delays in the synchronized deployment project discussed earlier. Although IRS anticipates examining more returns in fiscal year 1994, those expectations could go unrealized if deployment of the Totally Integrated Examination System is delayed. Even if the additional audits are done, audit coverage is only expected to increase from 0.91 percent in fiscal year 1993 to 0.95 percent in 1994.

Ideally--if the budget allowed--overall audit coverage should be higher than 1 percent. An economics study reported in the December 1990 issue of National Tax Journal[4] estimated that if IRS had kept its audit coverage rates at the 1977 level (about 2 1/2 percent for individuals and about 9 1/2 percent for corporations) through 1986, taxpayers would have reported about $16 billion more in taxes for 1986. The authors concluded that a greater likelihood of being audited induces taxpayers to report a higher tax liability on their returns. While voluntary compliance is partly based on taxpayer education and assistance,

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[4]Jeffrey A. Dubin, Michael J. Graetz, and Louis L. Wilde; "The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986", National Tax Journal, December 1990, pp. 395-409.

the fear of an IRS audit may also affect compliance levels and the size of the tax gap.

Thus, it seems prudent to maintain a certain level of audit coverage for all taxpayer groups. Beyond that, IRS' enforcement efforts should be targeted to more noncompliant populations. Between 1980 and 1987, small corporate compliance, as measured by IRS' Taxpayer Compliance Measurement Program (TCMP), dropped from 81 percent to 61 percent. Over the same time, IRS' audit coverage of small corporations dropped from 6.1 percent to 1.1 percent. This rate increased to 2.5 percent in 1992. Until IRS has evidence of improved compliance in the group, audit coverage should be maintained at least at this level.

We have been told that IRS' examination plans for 1994 do not include any detailed audits for a TCMP. For more than 30 years, TCMP has been IRS' only tool to objectively measure taxpayers' compliance and select tax returns for audit. In a recent report, we raised concerns about changes that IRS planned to TCMP.[5] IRS intended to make TCMP cheaper and quicker for IRS and less burdensome on taxpayers--goals that we support. However, we found that problems with TCMP were small when compared to its benefits. Further, IRS' planned changes would have severely hampered TCMP's ability to provide statistical data for varied

[5]Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993).

and crucial uses. As a result, we recommended that IRS not make these changes.[6]

In comments on a draft of our report, IRS agreed to defer the planned changes and use criteria we recommended in making changes. At the same time, however, IRS reiterated its intent to improve or replace TCMP. We are concerned that IRS will continue to delay the next cycle of TCMP audits and thus the data generated by those audits. The most recent cycle covered tax year 1988 and the next cycle would have covered 1991 had IRS not delayed it to make changes. As a result, our report also recommended that IRS cover 1993 tax returns in the next TCMP cycle. The longer IRS waits, the older and more unreliable the data on which IRS, Congress, and the Administration will base decisions on tax policy and administration.

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[6]For example, IRS had planned to cut TCMP's sample size in half. Such a cut would lower statistical precision and limit the usefulness of the results. Moreover, IRS was going to give TCMP examiners discretion on which tax return lines to audit, instead of requiring them to check all lines. Such discretion would leave users of the aggregated TCMP results in the dark on whether the taxpayers had indeed complied or whether many TCMP examiners had simply chosen to skip certain lines.

To guide any improvements to TCMP, we offered four criteria. We recommended that IRS ensure that any changes provide statistical data that allow IRS to (1) consistently measure tax compliance, (2) objectively select returns to be audited, (3) effectively decide how to structure its enforcement programs, and (4) meet the needs of tax policy and other users in the executive and legislative branches.

International Tax Compliance Initiative Focuses on Important Issues

One compliance initiative would provide about $31 million for international tax compliance. Many of the elements of this initiative address needs we have seen in our work on transfer pricing.[7] Funds for 50 extra international examiners should enable IRS to continue increasing the number of international tax returns examined although, as of March 1993, IRS had not yet adopted a staffing model to help allocate international staffing resources. IRS' plans to have the model in place by September 30, 1993. IRS will also be adding 82 FTEs to its international counsel's office. This will enable it to set a goal for advance pricing agreements at 75 per year and to increase its early counsel involvement with international cases, thus focusing on problems we have seen in sustaining examination findings.

In addition, IRS will use about half the funds for the international initiative on (1) more expert witnesses and consultants to also help sustain its findings and target cases and on (2) various information and automation systems.

Even with this international initiative, the challenges of dealing with transfer pricing will remain. This is because the

[7] International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992) and International Taxation: Updated Information on Transfer Pricing (GAO/T-GGD-93-16, Mar. 25, 1993).

growing global economy will increase the potential for underpayment of U.S. taxes through transfer pricing practices and the arm's length standard governing transfer pricing will continue to be difficult for IRS to enforce.

BUDGET REQUEST FOR TAXPAYER SERVICE MAY NOT IMPROVE TELEPHONE ACCESSIBILITY

To measure how accurately IRS' toll-free telephone assistors respond to taxpayers' tax law questions, IRS test callers place anonymous calls to assistors and score their answers to various questions. IRS statistics on the results of these test calls show that assistors answered 89 percent of tax law questions accurately from February 1 through March 27, 1993--a 1 percent improvement over the same period last year.

Although taxpayers are generally receiving accurate answers to tax law questions, they are having more difficulty reaching IRS to ask questions. According to IRS data through March 27, 1993, (1) IRS received about 55 million calls in 1993, about 15 million more than for the comparable period in 1992, and (2) assistors answered about 13 million calls, slightly less than for the comparable period in 1992. By dividing the number of calls answered by the number received, we computed an answer rate of 24 percent this year, down from 33 percent last year. We defined calls received as the sum of calls answered, busy signals, and calls abandoned by the taxpayer before an assistor got on the line. Busy signals continue to be a problem for taxpayers. IRS' data show that about 73 percent of callers this year got a busy signal, up 8 percentage points from 1992.

Accessibility is lower this year primarily because the demand for IRS' telephone assistance has increased sharply while the resources available to provide it decreased. To illustrate, from January through March 28, 1992, IRS had received over 40 million calls and had applied 1,027 staff years to answer about 13 million of them. For the comparable period in 1993, IRS had received over 55 million calls but only used 911 staff years--116 less than in 1992. Because of productivity gains, IRS was able to answer almost the same number of calls--over 13 million--in 1993 as it did in 1992 but the higher demand meant that more taxpayers received busy signals or were placed on hold and hung up before IRS could help them.

The fiscal year 1994 budget request provides for about $17.3 million in additional funds for Taxpayer Service but 67 fewer FTEs. Even with fewer staff, IRS expects to answer 880,000 more telephone calls. With new automated call routing equipment at 9 of IRS' 32 toll-free telephone sites, productivity should improve so that more calls are answered by each assistor at those 9 locations. IRS' Taxpayer Service staffing plan also envisions a continued trend toward more permanent and fewer temporary positions, which should also have a positive effect on productivity.

Despite the above, it seems rather optimistic to believe that overall productivity will jump 3 percent. If the tax laws are changed this year, it is reasonable to expect an increase in IRS' telephone assistance workload as taxpayers call with questions about those changes. Consequently, we doubt that this budget strategy will result in an improved answer rate in 1994.

EFFICIENCIES AVAILABLE THROUGH TSM AND CHANGES IN THE WAY IRS DOES BUSINESS

At the request of the Subcommittee, we have prepared a fact sheet that summarizes several examples of waste and inefficiency at IRS as cited in past reports issued by GAO, IRS' Internal Audit, and the Department of the Treasury's Office of Inspector General as well as various studies done by and for IRS. As noted in that document, a copy of which is being submitted for the hearing record, IRS' antiquated computer systems are a major contributor to waste and inefficiency. Modernization of those systems through TSM is expected to make IRS more efficient. We have already begun to see some of that promise in Corporate Files On Line (CFOL) and in the various filing alternatives now being offered taxpayers.

Corporate Files On Line

By providing on-line access to taxpayer account information, CFOL has helped IRS streamline operations and use current technology more efficiently. For example, the previously-discussed up-front verification of names and Social Security numbers that kept about 240,000 "bad" returns out of the electronic filing system was made possible through CFOL. Likewise, information we obtained from the Memphis Service Center indicated that implementation of one CFOL component that electronically verified name and address information enabled the center to save between 10,000 and 15,000 staff hours in manual verification.

Filing Alternatives

As of April 16, 1993, about 12.2 million taxpayers had filed their returns electronically. These taxpayers generally received their refunds faster than they would have if they had filed paper returns and had greater assurance that their computations were correct. IRS, on the other hand, was able to process and store electronic returns more efficiently and with less rework needed to correct taxpayer and/or processing errors. Two other filing alternatives were also available to some taxpayers in 1993.

One alternative being tested in Ohio, known as TeleFile, allows certain taxpayers to file using a touchtone telephone. Because

TeleFile returns are processed through the Electronic Filing System, they provide the same kinds of efficiencies for IRS as electronic returns. As of April 16, about 147,000 Ohio taxpayers had filed via TeleFile. The second alternative, known as 1040PC, allows users of tax preparation computer software to file a computer-generated answer sheet rather than the standard Form 1040. Because the answer sheets show only line numbers and amounts, they can be keyed by data entry clerks faster and with fewer errors than the standard Form 1040. As of April 16, about 3.6 million taxpayers had filed a 1040PC.

IRS Can Streamline Regional Office Operations

Although systems modernization should produce significant efficiencies, IRS needs to go beyond that. As we have been urging for some time, IRS needs to take advantage of the opportunities afforded by modernization to change the way it does business. One result should be an ability to streamline its organization and achieve even greater efficiencies. In 1992, IRS began to reexamine its organizational structure. In that regard and at the Subcommittee's request, we have been assessing one component of IRS' organization--regional offices. Appendix I includes general information about regional offices, including some historical information and data on regional office staffing and costs, along with details on the preliminary results of our assessment, including some preliminary data from questionnaires we sent district and service center managers.

As discussed in the appendix, our work, while identifying several positive aspects of regional office operations, has also identified opportunities for improved efficiency. For example:

-- One reason for establishing regional offices was to reduce the National Office's span of control. Span of control may be a valid consideration in managing 63 district offices. It seems less valid, however, when considering service centers and forms distribution sites, of which there are 10 and 3 respectively. We see no need to have layers of management between the National Office and those field offices.

-- Span of control could also become irrelevant if IRS consolidated the various telephone operations that take place in 32 taxpayer assistance call sites, 21 collection call sites, and the 3 forms distribution centers. Under IRS' current organizational structure, those telephone-based operations report through district and regional offices to the National Office. A consolidated telephone operation could report directly to the National Office.

-- Efficiencies could be achieved by consolidating administrative services (such as processing travel vouchers and recording accounting transactions), resource management activities (such as training and personnel management), and automated data processing activities.

IRS has several initiatives directed at achieving the kinds of efficiencies discussed above. Several regional offices, for example, have initiatives that focus on reducing duplication in administrative services and resources management. The National Office has initiatives that focus on reducing layers of management IRS-wide and diverting staff to front-line activities. In that regard, IRS has decided to reduce regional office staffing levels by December 1994 and to reduce the number of regional offices from 7 to 5 by December 1995. Whether further reductions are possible will depend on the extent to which (1) front-line operations can be streamlined and thereby provide opportunities for direct reporting to the National Office; (2) the National Office assumes a larger role in providing centralized leadership and direction, thereby minimizing the need for detailed regional office guidance; and (3) front-line managers have discretion to make decisions that formerly would have required consultation with the regional office.

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The Subcommittee also asked for information on (1) IRS correspondence; (2) IRS' forms, publications, and notices; and (3) the exchange of data between IRS and Customs. That information is in appendixes II, III, and IV.

IRS' REGIONAL OFFICE OPERATIONS

The Subcommittee has had a continuing interest in waste and inefficiency in IRS. When we testified on IRS' fiscal year 1993 budget we said that IRS' operation has much built-in waste. Two examples we cited were (1) the redundancies and inefficiencies that are fostered by IRS' field structure and (2) IRS' functional organization which results in a fragmented view of the taxpayer.[8] In 1992, IRS began to reexamine its organizational structure in light of the opportunities presented by Tax Systems Modernization. Before discussing some of IRS' planned changes, we will provide some specific information you requested on IRS' regional offices--a brief history, cost and staffing data, and our preliminary observations on (1) the regional offices' positive contributions, (2) areas where they contribute to duplication and delay, and (3) opportunities to streamline regional office operations.

A BRIEF HISTORY

In 1952, prompted by a corruption and embezzlement scandal that involved politically appointed local tax collectors,[9] IRS

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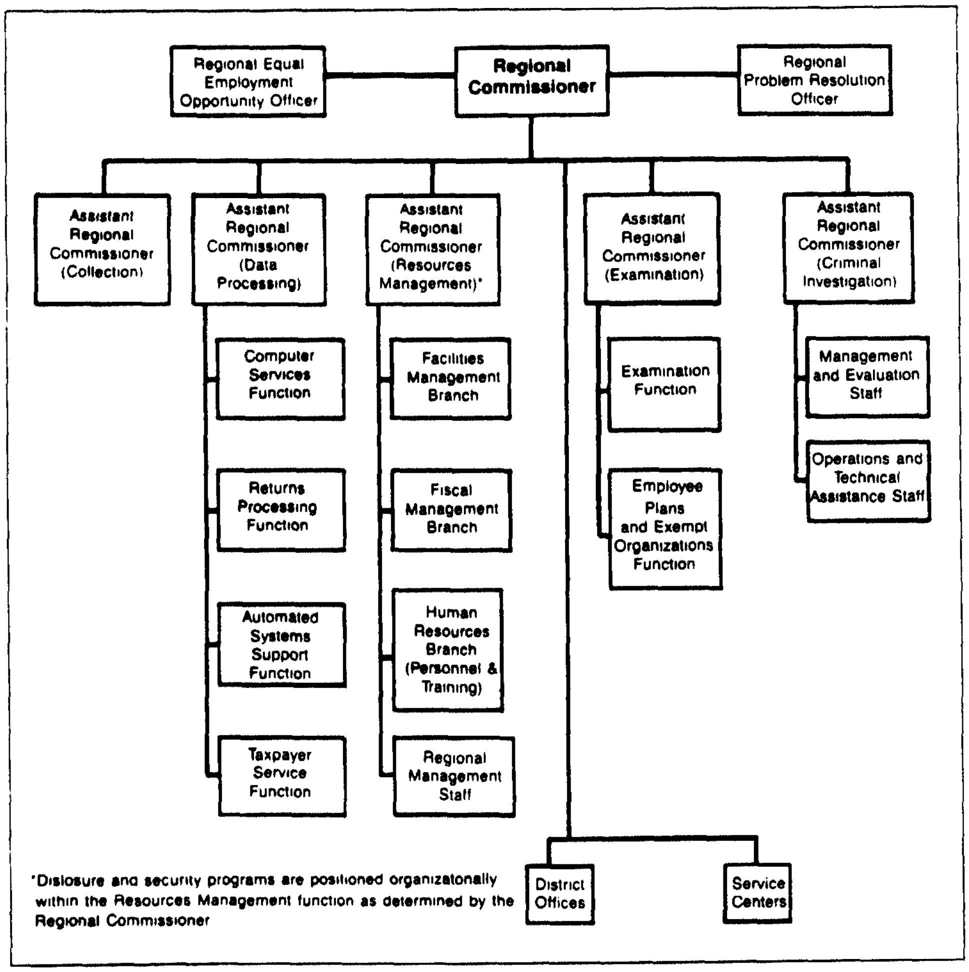
[8] Tax Administration: IRS' Budget Request for Fiscal Year 1993 (GAO/T-GGD-92-34, Apr. 30, 1992).

[9] Today, only two IRS officials--the Commissioner and Chief Counsel--are political appointees.

established a three-tier organization made up of a multi-functional National Office, 17 regional offices, and 64 district offices. Although the number of field offices has changed, that structure has virtually remained intact. IRS has reduced the number of regional offices three times since the reorganization. In 1953 the number was reduced from 17 to 9. In both 1964 and 1965, IRS eliminated one regional office.

The seven regional offices, each under the direction of a Regional Commissioner, have traditionally operated as autonomous entities. They report to IRS' Chief Operations Officer and execute National Office policy and oversee the functions and activities of the district offices and service centers within their geographical boundaries. As shown in figure I.1, IRS' regional office structure generally mirrors the National Office functional structure (i.e., collection, examination, returns processing, etc.)

Figure I.1: Regional Office Organization



Source: IRS' Planning Division.

IRS also has seven Regional Inspectors and seven Regional Counsels that have separate management structures, although they may be housed in the same space as the Regional Commissioners. The rest of our discussion about regional offices focuses only on activities under the direction of Regional Commissioners.

REGIONAL OFFICE STAFF ACCOUNT FOR A SMALL PORTION OF TOTAL IRS STAFFING

Of the 136,865 IRS employees on board as of March 6, 1993,[10] about 2 percent (2,428) were in the regional offices. Table I.1 shows a breakout of those staff by position title. Of the 2,428 regional office staff, most (1,360) were involved in resources management, which includes activities such as budget and financial management, procurement, training, facilities management, and personnel management. Besides doing these activities for their region, regional office staff may also support similar functions in district offices and service centers. In a few instances, regional office staff will do these activities directly for district offices and service centers under a consolidated authority. For example, staff in the Central Regional Office provide procurement services for the regional office, one service center, and six district offices.

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[10]This number is higher than the average number of staff on board during the year because it includes temporary staff who are hired for the filing season.

Table I.1: Number of Regional Office Staff by Position Title as of March 6, 1993

Regional office occupation	Number	Percent
Managers	192	7.9
Analysts	661[a]	27.2
Technicians/Specialists	676[b]	27.8
Administrative	455	18.7
Other	444	18.3
Total	2,428	100.0

[a]Regional analysts are tasked with helping field offices understand program requirements, monitoring performance, solving problems, and elevating field office concerns to the National Office.

[b]The technician/specialist category includes staff working in accounting and personnel functions in the resources management area or as computer specialists.

Source: IRS' Automated Financial System.

Regional office staff are not on the "front line" in administering the tax laws. Instead of directly serving taxpayers, they provide support to front line staff in service centers and district offices. Regional office staff are graded more highly than IRS staff overall. About 56 percent are GS-12s or higher compared to 24 percent IRS-wide.

REGIONAL OFFICE COSTS

IRS' total fiscal year 1992 costs were about $6.7 billion. Field offices, including regional offices, accounted for about $4.7 billion of that cost. Regional offices alone accounted for only about $209 million. However, these costs overstate the true cost of operating a regional office because they include some costs incurred by district offices. IRS' Automated Financial System, the primary system IRS uses for reporting costs, does not readily separate regional office costs from district office costs for certain activities such as training, supplies and services, and printing. To get a better idea of what it costs to operate a regional office, we asked IRS to provide this information for two regions. According to budget officials in the Mid-Atlantic and Southwest Regions, fiscal year 1992 obligations for those two regions were $22 million and $26 million, respectively.

CONTRIBUTIONS OF IRS' REGIONAL OFFICES

The National Office has traditionally relied on regional offices to develop guidance needed to execute National Office policy and otherwise help reduce the span of control over a field structure that includes 10 service centers, 63 district offices, and about 600 posts-of-duty. It is not surprising, therefore, that district office and service center managers we talked to said that the regional offices act as their advocates with the National Office and provide assistance and evaluation.

IRS field managers also told us that regional office staff, many of whom had worked in district offices and service centers, are in a better position to provide a field perspective on program operation and policy development. Some managers told us that National Office staff do not always have the field experience necessary to develop realistic guidance when implementing new programs. District office managers also said that regional offices act as advocates for the districts.

To assess the regions' role in implementing National Office policy and to gain a broader perspective on district office and service center managers' views of IRS regional offices, we (1) have been reviewing how three regional offices implemented the nonfiler initiative that began this fiscal year and (2) sent a questionnaire to all service center directors, district office directors, and service center division chiefs and to a sample of district office division chiefs.

The nonfiler initiative, which is part of IRS' Compliance 2000 strategy, is aimed at bringing nonfilers into the tax system and preventing others from becoming new nonfilers. The Regional Commissioner of the Southwest Region, acting on behalf of the

National Office, is responsible for implementing the program over a 2-year period beginning October 1, 1992.

Preliminary information indicates that the regional offices have generally had a positive effect on the nonfiler program. In one region, regional office staff from different areas responsible for implementing the program formed a nonfiler working group to clarify National Office policy and guide district office and service center implementation. Staff from three district offices in the region commented favorably about the working group and mentioned, as an example, the group's role in developing a uniform nonfiler data sheet.

Staff use this data sheet to help ensure that they have all the information they need from taxpayers to help them file their returns. These data sheets also provide information for IRS to use in following up with taxpayers who had called IRS and had their nonfiler information recorded by a Taxpayer Service employee. The sheets are also important if IRS is to have reliable data on such things as the results of its nonfiler program and the reasons for not filing. In the absence of a data sheet from the National Office, some districts had been developing their own, and the information required by those sheets was not consistent from district to district. 'A data sheet that will be used universally by all regions was finalized by the National Office in March 1993--5 months after the program started.

REGIONAL OFFICES CONTRIBUTE TO DUPLICATION AND DELAY

Although regional offices do several things that contribute to IRS' mission, they also contribute to duplication and delay.

In our questionnaire to district and service center managers, we asked them to identify the least useful services provided by regional offices. In responding to the questionnaire, some managers said that:

-- Regional office reviews are duplicative and do not contribute to problem solving. (Some IRS managers we spoke with also complained about duplication in the quality review area.)

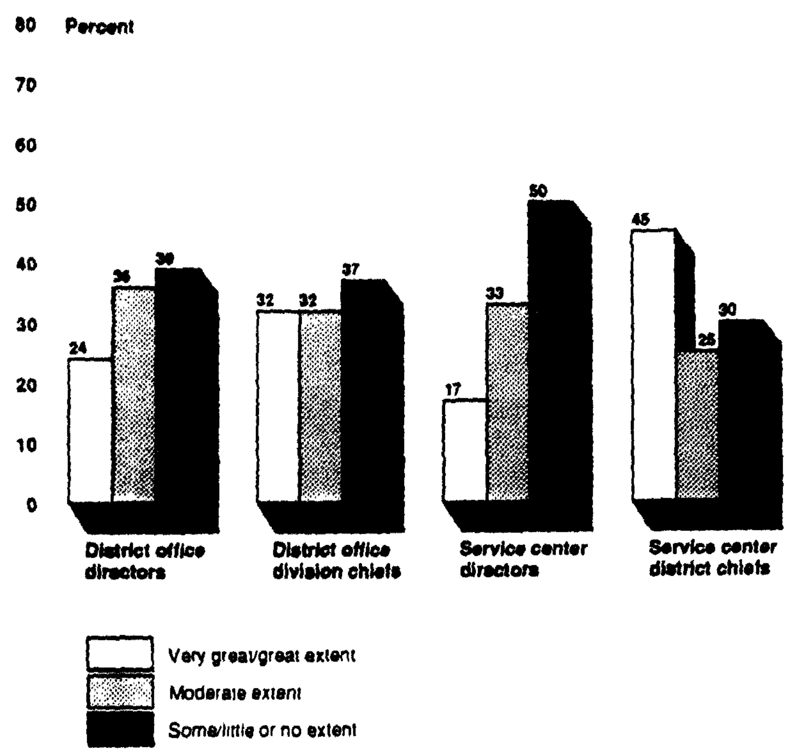
-- Regional offices sometimes act as a paper conduit between the National Office and the districts/service centers without adding any value to communications between the two levels of the organization.

Our review of the regional offices' role in the nonfiler program also identified examples of the regional office serving as a conduit. For example, on September 1, 1992, a National Office assistant commissioner sent a memo to an Assistant Regional Commissioner for Criminal Investigation asking him to have his district chiefs discuss IRS' nonfiler efforts with local U.S. Attorneys in preparation for implementing the program in fiscal year 1993. About 3 weeks later, the Assistant Regional Commissioner sent a similar memorandum to the district office directors. The attorneys may have been contacted earlier if the National Office had sent the memo directly to the districts.

In a separate review of offers in compromise being done for the Oversight Subcommittee, we encountered a delay in receiving data from some district offices because communications between the National Office and the districts were funneled through the regional offices. The district offices in one region never received the communication and several weeks went by before the problem was identified and resolved.

In our questionnaire, we also asked district office and service center managers about the extent to which regional offices duplicate activities of other IRS offices without adding value. Figure I.2 shows their responses, by position title, based on our analysis of about 50 percent of the returned questionnaires.

Figure I.2: Field Managers' Perceptions on the Extent to Which Regional Offices Duplicate Activities of Other Offices



Source: Analysis of about 50 percent of the responses to a GAO questionnaire.

OPPORTUNITIES TO STREAMLINE REGIONAL OFFICE OPERATIONS

We believe that IRS could achieve efficiencies if certain existing oversight responsibilities were removed from the regional offices. Reducing the National Office's span of control was one of the primary reasons for establishing the regional offices. Although the span of control issue may be valid considering the current number of district offices, it seems less a factor for oversight of service centers and forms distribution centers. For example, since there are only 10 service centers, span of control should not be a significant factor. Span of control is even less an issue for National Office oversight of the three forms distribution centers. Currently, the distribution centers are located within the facilities management branch of a district office. As a result, requests for resources and other support must pass through a district office and regional office to reach the National Office. Guidance to the distribution centers filters down through the same chain.

In July 1991, we testified on several options for changing IRS' field structure that could reduce redundancies and inefficiencies.[11] Some of these options would further reduce the need for a regional presence. For example, we suggested that

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

IRS could consolidate the different telephone operations that currently take place in 32 taxpayer assistance call sites, 21 collection call sites, and the 3 forms distribution centers. Under IRS' current organizational structure, these telephone based operations report through district and regional offices to the National Office. A consolidated telephone operation could report directly to the National Office, eliminating the roles of the district and regional offices.

As we discuss below, within the last year, IRS began taking some important first steps in considering some of the options we raised in our July 1991 testimony.

IRS' Plans for Reorganizing Its Field Structure

IRS has several initiatives underway that involve reorganizing its field structure. Local initiatives in regional offices focus on reducing duplication in resources management and administrative functions. National Office initiatives focus on reducing the layers of management IRS-wide and diverting more staff to front-line activities. Both of these efforts will affect the future role of IRS' regional offices.

Local initiatives

Several regional offices have undertaken initiatives to reduce duplication within or across their regional boundaries. One target of opportunity is administrative services (such as processing travel vouchers, processing personnel actions, and recording accounting transactions). These functions are performed to varying degrees by staff at district offices, service centers, and regional offices. Some regions have consolidated or plan to consolidate these types of administrative functions at the regional level or at a particular district office. The Central Region, for example, expects to reduce its managerial positions by 33 percent by consolidating all of its resources management activities. The North Atlantic Region plans to consolidate its accounting functions in West Virginia and is looking at the possibility of consolidating additional administrative functions. It has also agreed with the Mid-Atlantic and Southeast Regions to consolidate administrative functions across regional boundaries.

Information services (automated data processing activities) provide another opportunity for consolidation. For example, in the past, the Central Region and its districts each maintained a cadre of computer specialists who managed office computer resources. The Central Region recently sought National Office approval to consolidate its information services at the regional level. It expects to improve its service to district and regional office customers while reducing the number of managers at each office and the inefficiencies associated with maintaining expertise at each office. It also expects the streamlined organization to react more quickly to technology changes and the changes anticipated from TSM.

National Office initiatives

In March 1993, the Deputy Commissioner briefed IRS field offices on decisions about structural realignments for the National and regional offices. According to IRS officials, three guiding principles were used in making these decisions: (1) reducing the number of executives, (2) reducing the number of layers of management in IRS, and (3) reducing regional and National Office positions by 2,000 and redeploying them to the front line to improve customer service. Using these principles, IRS has decided to (1) downsize the regions by December 1994 by reducing the number of regional analysts, (2) establish consolidated sites (the number yet to be determined) to provide resources management and information services, and (3) reduce the number of regions from 7 to 5 by December 1995.

IRS is also considering changes that could affect the number and roles of service centers and district offices. Such changes, when decided, could further affect the roles of regional offices. IRS plans to announce these changes sometime in 1993.

IRS' CORRESPONDENCE

In an August 21, 1992, letter to IRS, the Subcommittee expressed concern about a particular type of correspondence sent to taxpayers. The Subcommittee's concern was that the correspondence, which IRS calls "interim letters", was inappropriate for the situation and likely to generate additional taxpayer inquiries. Specifically, the taxpayers had sent payments to IRS, but IRS' interim response did not acknowledge that a payment had been made. Instead, the interim response contained language thanking the taxpayer for their "inquiry". In a September 15, 1992 reply, IRS agreed with the Subcommittee's concern and said that it was taking immediate action to change the interim letter. You asked us to determine if IRS had solved the problem.

To respond to your request, we reviewed the examples of interim letters you provided us and IRS' response to you describing the corrective actions taken. Then, at IRS' Cincinnati Service Center, we sampled interim letters sent after IRS made its changes to see if the problem had been corrected. We reported the results of our work to you in an April 27, 1993 letter.

The problem has not been solved, primarily because IRS directed only one of several service center functions that correspond with taxpayers to correct its procedures. In 25 of 26 cases we reviewed from the other functions where taxpayers had written to IRS and sent payments, IRS' response did not acknowledge receipt of the payment. We also found several other instances of what we believe to be unclear responses to taxpayers that did not involve payments.

One reason IRS did not respond appropriately was that IRS staff who prepare the letters did not choose appropriate language when composing the letters on IRS' computerized letter writing system. We do not know why this continues to occur, but we will study the problem in more depth as part of a broader review of IRS correspondence issues we are doing for the Subcommittee.

IRS FORMS, PUBLICATIONS, AND NOTICES

At the Subcommittee's request, we assessed the accuracy of commonly used IRS forms, publications, and notices. We examined forms and publications for conformity with current legal requirements as stated in the Internal Revenue Code and Treasury Regulations. To judge understandability, we compared notices with purpose statements contained in IRS' Taxpayer Service Handbook and the Catalog of Federal Tax Forms, Form Letters and Notices. We expect to issue a report on the results of our work by April 30.

While we did not identify any instances where the documents were not in conformity with current legal requirements or IRS guidance, we did identify 59 changes that could be made to improve the understandability and usefulness of these documents to taxpayers. Generally, we suggested changes directed toward the use of more specific language and consistent terminology and the inclusion of appropriate references to IRS forms and publications. For example, we suggested that the 1991 instructions accompanying Form 2119, Sale of Your Home, should more clearly define the term "sold" as it relates to the date of sale. The 1991 instructions did not clearly define this term, leaving it to be interpreted as either the date a seller accepted a contract from a prospective buyer or the date title was transferred from seller to buyer. We also suggested IRS consider a new format to display taxpayer account information which is an important part of many IRS notices to taxpayers. Our suggested format more clearly compares data reported on the taxpayers's return with IRS' proposed adjustment to the taxpayer's account.

IRS officials said that our suggestions would be incorporated as the forms and publications involved are revised. With respect to notices, they agreed to consider the issues we raised as each of the notices are revised and to the extent IRS' present and planned system of computers, printers, and related equipment permit.

EXCHANGE OF DATA BETWEEN IRS AND CUSTOMS

We recently submitted to the Subcommittee on Oversight correspondence relating to the collection and exchange of data by IRS and Customs.[12] In general, the sharing of desired information is one way--from Customs to IRS--due to the disclosure restrictions of Section 6103 of the Internal Revenue Code. Specifically,

--Customs officials said that IRS has access to all information on importers, manufacturers, third parties, and fraud investigations and that IRS can use Customs data to find undisclosed related parties.

--Section 6103 of the Internal Revenue Code prohibits the disclosure of taxpayer information for unauthorized uses. Customs' transfer pricing issues are not considered authorized use.

--IRS said that it has given Customs access to requested tax return information when it is relevant to a case going before a Federal grand jury and that Customs has routine access to the Currency and Banking Retrieval System and has

[12] IRS-Customs Data Systems Exchange (GAO/GGD-93-33R, Apr. 6, 1993).

access to publicly available statistical information and industry trend data.

We found that each agency is developing its own database on comparable prices. In addition to the Section 6103 barrier, we identified barriers to sharing of data between the two agencies. For instance, we noted that:

--The timing of IRS' audits prevents it from providing Customs with information that is useful and current.

--IRS does not have most of the information desired by Customs (such as examination reports) on an automated database and has no plans to automate it.

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