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Report to Designated Congressional Committees

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TAX POLICY AND ADMINISTRATION

1994 Annual Report on GAO's Tax-Related Work

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February 16, 1995

The Honorable Bob Packwood
Chairman, Committee on
Finance
United States Senate

The Honorable William V. Roth, Jr.
Chairman, Committee on
Governmental Affairs
United States Senate

The Honorable Bill Archer
Chairman, Committee on
Ways and Means
House of Representatives

The Honorable William F. Clinger, Jr.
Chairman, Committee on
Government Reform and Oversight
House of Representatives

This report is submitted in compliance with 31 U.S.C. 719(d) and summarizes our work on tax policy and administration during fiscal year 1994. It contains appendixes that highlight (1) agency actions taken on our recommendations as of December 31, 1994; (2) recommendations we made to Congress before and during fiscal year 1994 that have not been acted upon; and (3) assignments for which we were authorized access to tax information under 26 U.S.C. 6103(i)(7)(A).

Key Recommendations for Tax Policy and Administration

In recommendations to Congress and the administration, we suggested actions that could be taken to improve compliance with the tax laws, increase accounts receivable collections, modernize the Internal Revenue Service (IRS), enhance the effectiveness of tax incentives, assist taxpayers, and improve financial management.

Improve Compliance With Tax Laws

To reduce the gap between what individual and business taxpayers owe and what they voluntarily pay—estimated by IRS at over $127 billion in 1992—IRS must improve voluntary compliance. In the past fiscal year, we recommended a number of ways to help IRS achieve that end.

- **Sole Proprietorships.** Sole proprietorships, which accounted for about 13 percent of individual taxpayers, were responsible for about $39 billion, or 40 percent, of the taxable income earned by individuals but not reported for tax purposes according to the 1988 Tax Compliance Measurement Program—IRS' most recent. Yet, IRS' enforcement strategy does not provide a detailed operating plan for dealing with such noncompliance. Moreover, IRS does not expect to develop the information systems needed to identify causes of the noncompliance and better target resources until the turn of the century. In the interim, we have recommended ways for IRS to better use existing data to improve sole proprietor compliance (GAO/GGD-94-175, Aug. 2, 1994). (See p. 40.)
- **Large Corporations.** Annually, about two-thirds of all additional tax assessments recommended as a result of IRS audits are attributable to the nation's 1,700 largest corporations. Although audits of these large corporations consume about 20 percent of IRS' examination resources, IRS neither measures actual collections from these audits nor the compliance rates of these corporations. We found that IRS revenue agents and appeals officers face conflicting incentives, which contribute to the large gap between taxes recommended and taxes collected after appeals. We also noted opportunities for improvement through changes in the way IRS allocates resources, trains revenue agents, and controls the coordination among IRS functions to prevent recurring tax disputes. We recommended a number of steps to help IRS meet its mission of collecting the proper amount of tax at the least cost. IRS should (1) centralize control over resources devoted to large corporate audits; (2) increase revenue agents' knowledge of the specific industries they audit; (3) begin measuring and tracking collection rates as a common measure across the agency; (4) analyze recurring tax disputes and propose legislative changes for minimizing such recurrence; and (5) test ways to measure compliance (GAO/GGD-94-70, Sept. 1, 1994). (See p. 44.)
- **Independent contractors.** Independent contractors are commonly viewed as self-employed workers who provide services, such as legal or accounting advice. They are responsible for their own taxes, benefits, and income and job security. IRS has found that self-employed workers such as independent contractors have consistently underreported income. Information reporting, tax withholding, and worker classification rules need reform. Because of IRS' and other groups' concerns about independent contractor compliance, many of their reform proposals have included two provisions that we have generally supported in the past. First, the $50 penalty for not filing an information return reporting payments to independent contractors would increase significantly. Second, the $50 penalty would apply (instead of this new larger penalty) if

the payer (employer) reported at least 97 percent, as required, of all aggregated payments to independent contractors for that year. We still favor these provisions and encourage Congress to consider other options we have suggested for improving information reporting (GAO/T-GGD-94-194, Aug. 4, 1994). (See p. 42.)

- **Tax Gap.** We analyzed the composition of the gross income tax gap as well as what has been done, is being done, and could be done to reduce the tax gap. We also updated information related to our past recommendations for reducing the tax gap. IRS estimates showed that of the $127 billion gross income tax gap in 1992, $94 billion was attributable to individuals and $33 billion to corporations. The largest part arose from unreported individual income—$63 billion. Overall, IRS estimated that taxpayers voluntarily paid 82 percent of their income tax liabilities. IRS' goal is to reach 90 percent by 2000. One way Congress could help is to give IRS more compliance tools. Simplifying the definition of independent contractor and requiring withholding on payments made to independent contractors could help IRS improve compliance. Congress also could require information reporting on payments made to corporations, especially those operating as independent contractors. Congress could allow IRS to reinvest productivity gains from Tax Systems Modernization (TSM) projects but may want assurance before doing so that IRS will use the funds for compliance (GAO/GGD-94-123, May 11, 1994). (See p. 37.)

Increase Accounts Receivable Collections

In recent years, IRS has placed increasing emphasis on collecting delinquent taxes, but the results have not been encouraging. The dollar amount of currently not collectible (CNC) accounts increased faster than the collection of delinquent taxes between 1987 and 1992. Several factors, such as inadequate records, an antiquated and ineffective collection process, and ineffective staff allocation processes, have hindered IRS' collection efforts.

- **Collection of Overdue Taxes.** IRS is undermining its ability to collect hundreds of millions of dollars in overdue taxes because of shortcomings in its processes for determining which accounts are collectible and which are not. We recommended that IRS (1) establish guidelines for determining taxpayers' ability to pay to include, for example, requiring minimum payments for taxpayers with income exceeding specified levels; (2) strengthen oversight of the ability-to-pay determination process; and (3) modify criteria for reactivating cases previously classified as not collectible (GAO/GGD-94-2, Oct. 8, 1993). (See p. 20.)

- **Settlement of Tax Debts.** The Offer In Compromise Program affords some taxpayers the opportunity to settle tax debts for less than the amount owed. While IRS was pleased with the results of the program, we found that IRS had not demonstrated that the program's objectives of increased collections and improved compliance had been met. We recommended that IRS develop the indicators necessary to evaluate the Offer In Compromise Program as a collection and compliance tool (GAO/GGD-94-47, Dec. 23, 1993). (See p. 23.)

Modernize IRS

IRS is burdened with manual processes and inaccessible information. Modernization should allow IRS to use resources more productively, speed up tax processing, and reduce costs. We recommended several ways to modernize IRS' operations.

- **Tax Systems Modernization**. In 1993, the Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations, concluded that TSM was at risk and that its successful completion required immediate action to make key decisions and establish an essential technical management infrastructure. Thus, IRS' fiscal year 1994 appropriation included a requirement that IRS report on three key issues—a business plan, a program management approach, and a systems architect's office. IRS supplied the required reports in September 1993. We concluded that IRS did not establish the essential infrastructure the Subcommittee sought. We recommended that IRS complete action on two fronts by (1) defining its business requirements in detail and (2) filling gaps in its technical and management standards (GAO/T-AIMD/GGD-94-104, Mar. 2, 1994). (See p. 53.)
- **Human Resource Implications of Change.** IRS is planning major organizational and operational changes to take advantage of new technology to be provided through TSM. Because those changes will have a major effect on IRS' workforce, we recommended that IRS (1) assess existing workforce knowledge, skills, and abilities; (2) identify specific staffing requirements for modernization projects that will have a significant effect on human resources; and (3) develop detailed retraining and redeployment plans to deal with gaps between staffing requirements and existing workforce knowledge, skills, and abilities (GAO/GGD-94-159, July 8, 1994). (See p. 54.)
- **Electronic Filing Fraud**. Electronic filing fraud is a problem whose true dimensions are unknown. Although the number of fraudulent electronic returns is relatively small, the rate of growth is high, and it is uncertain how much fraud might be going undetected. We made recommendations

to improve IRS' controls over electronic filing fraud in several reports over the years. These recommendations included (1) changes to the electronic filing system that would help keep fraudulent returns from being filed, (2) better detection of fraudulent returns that have been filed, and (3) improved screening and monitoring of persons and firms authorized to transmit returns electronically to IRS (GAO/T-GGD-94-89, Feb. 10, 1994, and GAO/T-AIMD-GGD-94-183, July 19, 1994). (See p. 52.)

Enhance Effectiveness of Tax Incentives

Congress continues to seek equitable ways to reform the current tax system. At the same time, it often adopts tax incentives and preferences to promote certain social policy goals. Hundreds of billions of dollars in revenue are forgone because of incentives and preferences. Forgone revenues from these tax expenditures are expected to increase faster than the economy will grow.

- **Tax Expenditures.** Tax expenditures, or revenues forgone through preferential provisions in the tax code—for example, deductions, exemptions, and credits—can be a useful part of federal policy, but these expenditures should be scrutinized more closely and more often to ensure that, when used, they are the most effective means to an end. We assessed the growth of federal revenues forgone through income tax expenditures and presented three options for reviewing and controlling their growth: (1) strengthening and extending tax expenditure controls used by congressional tax-writing committees, (2) integrating tax expenditures further into the budget process, and (3) reviewing tax expenditures jointly with related federal outlay programs (GAO/GGD/AIMD-94-122, June 3, 1994). (See p. 66.)
- **Research Tax Credit.** In 1981, Congress enacted the research and experimentation tax credit to encourage businesses to do research. Congress believed that increased research was necessary to enhance the competitiveness of the U.S. economy. We did three reports on the tax credit that were used in congressional deliberations about modifying the original act. In our 1994 report we estimated that the pharmaceutical industry earned $1.24 billion of research and experimentation tax credits between 1981 and 1990. The industry's credits, as a share of the credits earned by all industries, increased from 4 percent in 1981 to 12 percent in 1990. The pharmaceutical industry credits were earned primarily by large companies. The biotechnology sector of the industry, consisting primarily of smaller companies, benefited very little from the credit. The research and experimentation tax credit was difficult for IRS to administer. IRS examiners reported that they had difficulty distinguishing research for

product innovation, which qualified for the credit, from research for product development, which did not qualify. Examiners who audited four large pharmaceutical companies said that the technical nature of the issues made the audits difficult. (GAO/GGD-94-139, May 13, 1994). (See p. 68.)

Assist Taxpayers

IRS handles about 75 million inquiries from taxpayers on matters ranging from routine queries on tax account balances to complex requests about corporate tax issues. Telephone calls account for about 63 percent of all inquiries; correspondence, about 28 percent; and personal visits, about 9 percent. To ease taxpayer frustration and increase the likelihood of voluntary compliance with the tax laws, IRS must be able to provide timely and accurate assistance to taxpayers.

- **IRS Correspondence.** Over the past few years, we, IRS, and others have cited delayed, inaccurate, incomplete, and confusing responses to taxpayer letters as chronic IRS problems. Although IRS has made progress in correcting its correspondence problems by adopting quality and timeliness standards and by expanding quality reviews of outgoing mail, some problems persist. We recommended that IRS take several actions, including (1) clarifying notices, letters, and publications to better inform taxpayers of those situations that can be handled by a telephone call; (2) clarifying procedures for responding to taxpayer requests to ensure that taxpayers' questions do not go unanswered; (3) using correspondence mail-out dates instead of the date a response was initiated as a timeliness indicator and adopting goals for providing taxpayers with final responses; and (4) reassessing the purpose of interim letters and then providing the service centers with clear guidelines for accomplishing those purposes (GAO/GGD-94-118, June 1, 1994). (See p. 61.)
- **One-Stop Service.** We reviewed IRS' efforts to implement one-stop service to respond to taxpayer questions and complaints. IRS defines one-stop service as the resolution of issues during the taxpayer's initial contact with IRS or as a result of that contact. Both taxpayers and IRS will benefit if IRS is able to reach its one-stop service goals. We found that IRS has problems measuring the instances counted as one-stop service. To improve this measurement problem, we recommended that IRS develop better measures of one-stop service that do not include instances where taxpayers will likely need to contact IRS again about the same matter. The measures developed should be designed in such a way that they enable IRS to (1) gauge its progress toward providing one-stop service by 1998, (2) identify and correct problems that might impede IRS' progress, and (3) compare delivery of one-stop service among various IRS taxpayer

services—such as forms distribution, walk-in sites, and telephone inquiries (GAO/GGD-94-131, Aug. 29, 1994). (See p. 63.)

Improve Financial Management

Not only must IRS administer the tax code and collect taxes in a fair and equitable manner, it must also efficiently and effectively manage its own finances. Although IRS has implemented many improvements since our 1993 audit of its 1992 financial statements, it continues to face major challenges in developing meaningful and reliable financial management information and adequate internal controls.

- **1994 Financial Audit.** We examined IRS' financial statements for fiscal year 1993. Our audit revealed that the agency is hampered by serious, pervasive financial management problems, including the inability of antiquated systems to generate reliable financial information needed to manage IRS operations. We found, for example, over $90 billion of unrecorded taxpayer transactions that had not been posted to taxpayer accounts and at least $149 million written off because of unexplained differences between IRS' and the Treasury's records for IRS' cash accounts. We were unable to express an opinion on the reliability of IRS's fiscal year 1993 Principal Financial Statements. We made recommendations to help IRS continue its efforts to resolve these long-standing and difficult problems and strengthen its financial management (GAO/AIMD-94-120, June 15, 1994). (See p. 30.)
- **1995 Budget Request.** We analyzed IRS' fiscal year 1995 budget request and raised several concerns based on our past and current work at IRS. We posed several questions for consideration in congressional deliberations on the IRS budget request. Our concerns related to such things as (1) the possibility that a funding shortfall might adversely affect IRS' ability to deliver proposed compliance initiatives, (2) the appropriateness of proposed user fees, (3) the impact of incomplete business requirements and technical standards on TSM projects in the budget request, and (4) the appropriateness of the funding and staffing levels being requested for returns processing and taxpayer service activities (GAO/GGD-94-129, Apr. 20, 1994). (See p. 29.)

We did our work on tax policy and administration matters pursuant to 31 U.S.C. 713, which authorizes the Comptroller General to audit IRS and the Bureau of Alcohol, Tobacco, and Firearms. GAO Order 0135.1, as amended, prescribes the procedures and requirements that must be followed in protecting the confidentiality of tax returns and return information made

available to us when doing tax-related work. This order is available upon request.

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

Major contributors to this report are listed in appendix VIII. If you or your colleagues would like to discuss any of the matters in the report, please call me on (202) 512-5407.

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Contents

Abbreviations

AUR	Automated Underreporter
BSA	Bank Secrecy Act
CEP	Coordinated Examination Program
CFO	Chief Financial Officer
CNC	currently not collectible
CTR	Currency Transaction Report
ERISA	Employment Retirement Income Security Act
ETEP	Employment Tax Examination Program
FBI	Federal Bureau of Investigation
FDIC	Federal Deposit Insurance Corporation
FinCEN	Financial Crimes Enforcement Network
FMFIA	Federal Managers' Financial Integrity Act
FmHA	Farmers Home Administration
GATT	General Agreement on Tariffs and Trade
GSE	government sponsored enterprise
HUD	Housing and Urban Development
IRS	Internal Revenue Service
OMB	Office of Management and Budget
RAL	Refund Anticipation Loan
RTC	Resolution Trust Corporation
SSA	Social Security Administration
TCMP	Taxpayer Compliance Measurement Program
TSM	Tax Systems Modernization
PWBA	Pension and Welfare Benefits Administration

Summaries of Tax-Related Products Issued in Fiscal Year 1994 by Subject Matter

Accounts Receivable and Collection Activities

Budget and Finance

Compliance

Accounts Receivable and Collection Activities

IRS Can Do More to Collect Taxes Labeled "Currently Not Collectible"

GAO/GGD-94-2, 10/08/93

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we presented the results of our evaluation of IRS' procedures for classifying certain accounts as currently not collectible (CNC) and IRS' efforts to monitor these accounts for future collection potential. IRS can classify an account as CNC if the taxpayer cannot be located or contacted, payment would cause significant financial hardship on the taxpayer, the taxpayer is bankrupt, a business taxpayer no longer exists, or an individual taxpayer is deceased.

We reported that IRS was undermining its ability to collect hundreds of millions of dollars because of inadequate and questionable CNC determinations, CNC monitoring limitations, and inefficient collection practices. We also noted that IRS did not provide its employees with specific guidance to make CNC determinations. And, IRS' supervisory reviews and post reviews were not identifying and correcting problems with CNC determinations. Some of these determinations allowed taxpayers who reported incomes of more than $70,000 to pay nothing towards their tax debts when installment payments may have been more appropriate.

We found accounts that may not have been collectible at the time they were classified as CNC but, at the time of our review, had collection potential that was not being realized because collection action remained suspended. Some accounts had not been reactivated because of IRS' policy of not reevaluating collection potential during the first 65 weeks after an account is classified as CNC—referred to as the reactivation hold period.

Other accounts had not been reactivated because IRS tracks only one taxpayer when monitoring a joint CNC account and had therefore not been aware of the potential of collecting from the other taxpayer. In addition, some of these accounts were ignored because IRS' reactivation criteria did not consider all indicators of collection potential. We noted that even when CNC accounts were reactivated, IRS still did not realize potential collections because of its inefficient collection practices for reactivated accounts.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should establish specific guidelines for determining taxpayers' ability to pay delinquent tax debts, including selecting income levels at which CNC accounts will be reactivated. IRS needs criteria for allowable expenses in total or by category that would require, except in extraordinary situations, at least minimum payments from delinquent taxpayers with incomes above a specific level.

We also recommended that the Commissioner ensure that oversight mechanisms—supervisory and post reviews—are thorough enough to identify inappropriate CNC determinations and that reporting standards are developed to provide meaningful information that can be used to identify problems needing IRS-wide corrective action.

We further recommended that IRS eliminate the 65-week reactivation hold period, track both taxpayers when they file separately but have joint CNC delinquencies, use all available indicators of collection potential as reactivation criteria, and expedite the collection process for reactivated accounts.

Action(s) Taken and/or Pending

IRS agreed that the CNC area could be improved and concurred at least in principle with most of our recommendations. For example, IRS has (1) written draft procedures to address the issue of allowable expenses, (2) issued guidance to field collection staff on the income level to which CNC cases are to be reactivated, and (3) plans to revise the Internal Revenue Manual to include guidance on minimum payment requirements from delinquent taxpayers with incomes above a specified level.

IRS is planning to implement the remaining recommendations with the exception of eliminating the 65-week reactivation hold. The Commissioner did not agree with eliminating the 65-week reactivation hold because it ensured that cases were not reactivated unnecessarily when the taxpayers' income was already considered during the investigation. However, as we pointed out, the hold also precluded the timely reactivation of the accounts.

Collecting Delinquent Taxes and Communicating With Taxpayers

GAO/T-GGD-94-50, 11/09/93

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, we presented information on how IRS collects tax debts, processes tax returns, and communicates with taxpayers. The information was taken from recently completed reviews for the Subcommittee. We identified opportunities to increase revenues, treat taxpayers more evenly, reduce taxpayer frustration, and cut down the need for repetitive contacts to resolve tax questions. If IRS implements our recommendations, major improvements should result in the collection of back taxes and in taxpayer relations.

We reported that for the third consecutive year, IRS' collection of delinquent taxes declined in 1993. We believe that increased collections may be achieved from delinquent tax accounts that IRS has deemed "currently not collectible." Questionable work and faulty monitoring systems have resulted in some taxpayers, who earned more than $70,000, paying nothing toward their tax debts. IRS' uneven staffing and antiquated collection process also have a negative impact. With staffing imbalances, the extent of collection action may vary depending on where a taxpayer lives. Thus, the amount of revenues collected per staff year varies considerably among IRS districts. More fundamental changes are needed in the collection process, with more emphasis on earlier telephone contact, tailoring actions to the taxpayer's situation, and evaluating collection staff performance.

We found that the 1993 tax filing season, while generally successful, was clouded by a few problems. About 2 million fewer returns were filed in 1993 than 1992. The main reason fewer returns were filed appeared to be because of revised 1992 withholding tables, which resulted in more taxpayers owing taxes at the end of the year. Also, electronic filing fraud grew in 1993. In the first 8 months of 1993, IRS identified 100 percent more fraudulent electronically-filed tax returns than in 1992. One reason may be IRS' improved detection; however, no one knows how much fraud is going undetected. Also, taxpayers continued to have problems telephoning IRS. In 1993, taxpayers had a one in four chance of getting through to an IRS assistor—even worse than the one in three chance the year before.

IRS' written communication in the form of inaccurate, incomplete, confusing, and late responses to taxpayers continues to be a problem. Forms, notices, and publications are also of concern and we suggested 59 changes to 19 of those commonly used. IRS has made many of the

suggested changes in forms and publications but will not be able to clarify the notices before 1995 because of computer constraints.

Related GAO Product(s)

GAO/GGD-93-7R, 11/18/92; GAO/GGD-93-22, 11/24/92; GAO/T-AFMD-93-1, 02/03/93; GAO/GGD-93-64, 03/22/93; GAO/GGD-93-33R, 04/06/93; GAO/GGD-93-90BR, 04/08/93; GAO/GGD-93-100FS, 04/27/93; GAO/GGD-93-38R, 04/27/93; GAO/T-GGD-93-23, 04/28/93; GAO/GGD-93-72, 04/30/93; GAO/GGD-93-101, 05/04/93; GAO/GGD-93-97, 05/05/93; GAO/GGD-93-67, 05/11/93; GAO/GGD-93-37R, 05/25/93; GAO/GGD-93-131, 09/23/93; and GAO/GGD-94-2, 10/08/93

Changes Needed to Cope With Growth in Offer in Compromise Program

GAO/GGD-94-47, 12/23/93

At the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we reviewed IRS' Offer in Compromise Program to determine the effect that IRS' new emphasis on the program has had in collecting delinquent taxes and encouraging future compliance.

We reported that IRS was pleased with the initial results of the revised program, but it has yet to demonstrate that the use of offers in compromise will meet the program's overall objectives of increased collections and improved compliance. Although our review of case studies showed that IRS staff followed prescribed procedures in processing taxpayers offers, we identified several things IRS needs to consider as part of its improvement process.

First, IRS needs reliable data on the offer program. IRS uses paper records to track the number of offers received and the amount of tax debt compromised—a process we found subject to error. Once IRS has reliable data, it needs better indicators of the program's effectiveness.

Second, IRS needs to continue to improve the efficiency of the offer program. For example, its recent decision to streamline the processing of offers involving tax debts of less than $10,000 should help reduce administrative costs. At the same time, however, IRS needs to be cautious about over reliance on in-house information sources to substantiate taxpayers' asset claims. In addition, IRS is required by law to obtain a legal opinion on all offers with tax liabilities of $500 or more—a process that increases administrative costs. IRS has proposed raising the review threshold to $50,000. Because the legal complexity of offers is not always directly related to the amount of the tax liability, we believe a better

option would be to give IRS discretionary authority to decide when offers need legal review. IRS also relies on time-consuming, manual methods to monitor accepted offers to ensure that taxpayers comply with the conditions of the offer. Automating the monitoring process could improve its efficiency.

Although we had no data to indicate that IRS' increased compromising of tax debts might adversely affect voluntary compliance, we believe IRS needs to be mindful of the effect that settling for less than the full tax liability might have on taxpayers who pay their taxes in full. Congress recognized the potential fairness and equity issues linked to offers in compromise and, as part of the program, required that the names of taxpayers whose debts are compromised, the amount of the debt compromised, and the amount accepted by the government be made public information. IRS might defuse this potential issue if it can demonstrate the overall benefits of the offer program.

Last, IRS needs to determine the causes for variability in offer acceptance rates among district offices. The wide variability in district offices' acceptance rates could raise the question of whether taxpayers are being treated consistently.

Matter(s) for Congressional Consideration

Congress should consider amending section 7122 of the Internal Revenue Code to remove the requirement that the Treasury General Counsel or his delegate review all offers of $500 or more and widen IRS' discretionary authority to decide which offers require review.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should develop the indicators necessary to evaluate the Offer in Compromise Program as a collection and compliance tool. The indicators should be based on accurate data and include (1) the yield of the program in terms of costs expended and amounts collected, (2) the amount of revenues collected that would not have been collected through other collection means, (3) a measure of noncompliant taxpayers who returned to the tax system, and (4) a measure of participating taxpayers who remained compliant in future years.

We also recommended that the Commissioner determine the causes of variability in district office acceptance rates and, where appropriate, take steps to mitigate any inconsistent treatment of taxpayers.

Action(s) Taken And/or Pending

As of December 31, 1994, Congress had taken no decisive action on the requirement that the Treasury General Counsel review all offers of $500 or more.

IRS generally agreed to implement or consider the recommendations contained in our report. For example, IRS has begun to make changes necessary to gather data to determine program costs and revenue yield. IRS does not agree that data on revenue that would not have been collected or on noncompliant taxpayers who returned to the tax system can be gathered or that it would be meaningful. IRS also plans to use a quality measurement system to collect data on offer acceptance rates to determine if there is inconsistent treatment of taxpayers among district offices.

State Tax Administrators' Views on Delinquent Tax Collection Methods

GAO/GGD-94-59FS, 02/02/94

In a fact sheet to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we summarized the views of state tax administrators on collecting delinquent state taxes. We surveyed state tax administrators as part of a study for the Subcommittee on options available to IRS to enhance its collection of delinquent federal taxes.

We found that states were changing their delinquent tax collection strategies to increase collections and make their collection programs more efficient. Those enhancements included (1) new or improved accounts receivable management information systems, (2) updated written billing procedures, (3) the use of telephone collection techniques, and (4) the use of enforcement programs that restrict taxpayer access to certain state licenses and permits if delinquent taxes remain unpaid.

We also found that many states have collection tools not currently available to IRS. Thirty-two states used private collection companies to collect delinquent tax accounts from taxpayers residing in and out of state. Eleven states accepted credit card tax payments; however, most restricted their use to delinquent taxes.

Related GAO Product(s)

GAO/GGD-93-67, 05/11/93

Budget and Finance

IRS' Self-Assessment of Its Internal Controls and Accounting Systems Is Inadequate

GAO/AIMD-94-2, 10/13/93

In a report to the Commissioner of Internal Revenue, we concluded that because of widespread material weaknesses in IRS' operations, we do not believe that IRS can be reasonably sure that the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 have been achieved. The act requires agencies to disclose the condition of their internal control and accounting systems. Except for the accounting systems reviews conducted at the service centers, IRS did not provide adequate guidance or training to staff during FMFIA reviews.

IRS' process for identifying, disclosing, and correcting material weaknesses must be substantially improved if the agency is to produce reliable information that top management can use to control costs and improve operations. Top management involvement is an essential first step in bolstering IRS operations and accurately reporting IRS internal control and accounting system weaknesses to the Secretary of the Treasury.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should direct the Senior Management Council to coordinate and oversee activities to (1) establish and implement proper written procedures that provide for the identification, documentation, and correction of material weaknesses; (2) provide classroom training and guidance materials to all FMFIA review staff; (3) develop effective corrective action plans that address the fundamental causes of the weaknesses; and (4) verify the effectiveness of corrective actions before removing reported weaknesses from IRS' records.

Action(s) Taken and/or Pending

As of December 1994, as part of IRS' annual self-assessment process, the Senior Management Council had instituted the practice of meeting with IRS executives to review the effectiveness of their corrective action plans. IRS is developing written policies requiring testing of corrective actions to determine if the corrective actions are effective in resolving the weaknesses.

Related GAO Product(s)

GAO/HRD-92-81, 09/01/92; GAO/AFMD-93-42, 05/06/93; GAO/AIMD-93-2, 06/30/93; GAO/AIMD-93-24, 08/05/93; and GAO/AIMD-94-120, 06/15/94

Important IRS Revenue Information Is Unavailable or Unreliable

GAO/AIMD-94-22, 12/21/93

As the nation's primary tax collector, IRS reported about $1.1 trillion in tax revenues for fiscal year 1992. Pursuant to a legislative requirement, we reviewed IRS' financial management systems and internal controls over federal tax revenues. This report discussed deficiencies and internal control weaknesses in the systems that accounted for this money.

We found that (1) although IRS accounts for specific types of taxes assessed, it does not obtain and adequately account for payment information to determine specific taxes collected; (2) IRS cannot precisely determine the amount of subsidies provided to the Social Security trust fund because it does not separately account for the specific amount of Social Security taxes collected; (3) trust fund recipients receive little or no information relating to tax revenues; (4) IRS revenue information is unreliable because IRS systems are not designed to generate needed revenue information; (5) IRS does not adequately analyze its transactions to determine how they should be reported and classified; (6) IRS has omitted or misclassified over $150 billion in transactions and has overstated tax distributions by $113 billion by not reducing collections for refunds; (7) IRS does not calculate interest on certain types of accounts receivable; and (8) IRS does not consistently review certain manual accounting entries to prevent erroneous or unauthorized entries.

Recommendation(s) to IRS

IRS should (1) develop a way to capture information on the specific taxes collected for trust funds so that the difference between amounts assessed and amounts collected is readily determinable and tax receipts can be distributed as required by law, (2) determine the trust fund revenue information needs of other agencies and provide such information, and (3) identify the information needed for revenue reporting and related sources and develop written policies and procedures for compiling this information.

Action(s) Taken and/or Pending

IRS is planning to improve its system to account for and report on tax revenues and intends to provide its Chief Financial Officer a larger role in overseeing revenue-related operations and reporting policies. However,

many of its efforts have not yet been defined or are not expected to be completed until well past the year 2000.

Related GAO Product(s)

GAO/GGD-92-81BR, 04/17/92; GAO/HRD-92-81, 09/01/92; GAO/T-GGD-93-4, 02/03/93; GAO/HRD-93-42, 03/29/93; GAO/T-GGD-93-20, 03/30/93; GAO/GGD-93-100FS, 04/27/93; GAO/AFMD-93-40, 04/28/93; GAO/GGD-93-109, 06/08/93; and GAO/AIMD-94-120, 06/15/94

IRS Does Not Adequately Manage Its Operating Funds

GAO/AIMD-94-33, 02/09/94

In a report to the Commissioner of Internal Revenue, we discussed significant weaknesses in the systems that IRS uses to manage, spend, account for, and report on its operating funds. We were unable to audit about $4.3 billion of the $6.7 billion in operating funds that IRS reported spending in fiscal year 1992 because IRS could not account for all the money. Significant control weaknesses included the following: (1) managers lacked current, reliable information on available budget authority; (2) some types of expenditures were recorded only after lengthy delays; and (3) reports used to monitor compliance with laws governing the use of budget authority contained unauthorized adjustments. In addition, (1) IRS reports included misclassified expenditures; (2) IRS did not periodically review and adjust its records to reflect changes in obligations and remove canceled appropriations or resolve billions of dollars in discrepancies between its records and those of the Treasury; and (3) IRS could not ensure that outlays for goods and services were proper because of fundamental control weaknesses in its payment processes, including a lack of proper review and approval of payments.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should direct the Chief Financial Officer to improve controls over operating funds to ensure that budget authority for operations is not exceeded, improve processes and controls to ensure that payments for goods and services are proper and timely, and improve systems and processes to ensure that reports on operating funds are reliable.

Action(s) Taken and/or Pending

IRS agreed with the concerns noted in our report and has been working to implement the appropriate corrective actions as detailed in its corrective action plan.

Related GAO Product(s)

GAO/AIMD-94-120, 06/15/94

Analysis of IRS' Budget Request for Fiscal Year 1995

GAO/GGD-94-129, 04/20/94 and GAO/GGD-94-141R, 06/16/94

IRS' fiscal year 1995 budget request totaled $7.61 billion, a 3.7 percent increase over IRS' fiscal year 1994 appropriation that was primarily attributable to a growth in Tax Systems Modernization (TSM). At the same time, the budget would reduce IRS' staffing level to 109,656 full-time equivalents—a decrease of 5.2 percent that fell most heavily on IRS' enforcement programs. Separate from IRS' budget request, however, the President proposed giving IRS another $405 million for compliance initiatives that would increase IRS staffing by about 5,000 full-time equivalents and reverse the decline in enforcement staff.

Our analysis of the budget request and the proposed initiatives, done at the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, raised several questions:

- Will funding shortfalls again prevent IRS from fully implementing the proposed compliance initiatives?
- Should one of the proposed initiatives be refocused to emphasize more use of the telephone in collecting delinquent tax accounts?
- How will the proposed compliance initiatives and related revenue estimates be revised in light of the lower funding level in the Senate budget resolution?
- Is a fee for installment agreements appropriate and, if so, is there a more equitable alternative to the flat fee being proposed?
- Would it be better to do away with the direct deposit indicator on electronically filed returns rather than charge for providing the service?
- To what extent do incomplete business requirements and technical standards and guidelines increase the risks for TSM projects in the budget request?
- Are the budget requests for returns processing and taxpayer service appropriate considering filing season data on the number of returns filed and toll-free telephone accessibility?

At the request of the Chairman, Senate Committee on the Budget, we provided an opinion on how the additional budget authority being requested for IRS compliance initiatives might affect budget deficits over the next 5 years.

We opined that the additional budget authority will not increase the budget deficit over the 5-years in question provided (1) the funds are used as intended to increase IRS' enforcement staffing levels and thus generate more revenues through enhanced compliance efforts; (2) funds are provided in the fiscal years after 1995 to maintain the increased staffing levels; and (3) IRS is able to successfully hire, train, and retain the additional staff provided by the budget authority. A deficit increase in the first year is possible because of the lag between the time new staff are hired and the time they become productive. In our opinion, however, on the basis of past reviews of IRS' enforcement programs, an increase in enforcement staffing will help generate significant revenues over the long term, provided the increased staffing levels are maintained.

Related GAO Product(s)

GAO/T-GGD-92-34, 04/30/92; GAO/T-GGD-93-23, 04/28/93; GAO/GGD-93-67, 05/11/93; GAO/T-AIMD-GGD-94-104, 03/02/94; and GAO/GGD-94-123, 05/11/94

Examination of IRS' Fiscal Year 1993 Financial Statements

GAO/AIMD-94-120, 06/15/94

Pursuant to a legislative requirement, we examined IRS' financial statements for fiscal year 1993. Our audit revealed that IRS is hampered by serious, pervasive financial management problems, including the inability of antiquated systems to generate the reliable financial information needed to manage IRS operations. We were unable to express an opinion on the reliability of IRS's fiscal year 1993 Principal Financial Statements. The report discussed the scope and severity of IRS' financial management and control problems, the adverse impact of these problems on IRS' ability to effectively carry out its mission, and IRS' actions to remedy the problems.

We found that (1) critical supporting information for IRS financial statements was not available; (2) the available information was generally unreliable due to ineffective internal controls; (3) IRS internal controls did not effectively safeguard assets, provide a reasonable basis for determining material compliance with laws and regulations, or ensure that there were no material misstatements in the financial statements; and (4) although there were no instances of material noncompliance with laws and regulations during fiscal year 1993, there were instances of noncompliance with certain Internal Revenue Code provisions.

Recommendation(s) to IRS

We made recommendations to help IRS continue its efforts to resolve these long-standing and difficult problems and to strengthen its financial management.

Action(s) Taken and/or Pending

IRS is taking steps to resolve problems cited in our report. Phases of its corrective action plan are being implemented; however, some of its milestones have slipped. Other milestones will take longer to activate. In fiscal year 1995, IRS plans to finish cleaning up cash reconciliations and accounts payable. Its budget process was approved by the Congress and will be activated in fiscal year 1995, also. We will continue to work with IRS officials as they strengthen financial management.

Related GAO Product(s)

GAO/GGD-92-26, 02/19/92; GAO/GGD-93-100FS, 04/27/93; GAO/AIMD-93-40, 04/28/93; GAO/AFMD-93-42, 05/06/93; GAO/AIMD-93-24, 08/05/93; GAO/GGD-93-133, 08/13/93; GAO/AIMD-93-34, 09/22/93; GAO/GGD-93-145, 09/24/93; GAO/AIMD-94-2, 10/13/93; GAO/AIMD-94-22, 12/21/93; GAO/AIMD-94-33, 02/09/94; GAO/GGD-94-123, 05/11/94; GAO/T-AIMD-94-157, 07/13/94; GAO/T-AIMD-94-183, 07/19/94; and GAO/T-AIMD-94-164, 07/28/94

CFO Implementation at IRS and Customs

GAO/T-AIMD-94-164, 07/28/94

In testimony before the Senate Committee on Governmental Affairs, we discussed IRS' and Customs' progress in complying with financial reporting and other requirements of the Chief Financial Officers (CFO) Act of 1990. We discussed the results of our attempt to audit IRS' and Customs' fiscal year 1993 financial statements, the short-term actions needed by IRS and Customs to continue their progress in resolving serious financial management problems, and IRS' and Customs' efforts to establish the financial management organizations and systems required by the act.

We noted that (1) although we were unable to provide an opinion on IRS' and Customs' fiscal year 1993 financial statements because of continuing financial management problems, IRS and Customs have made significant improvements to their financial management operations; (2) CFO audits have helped IRS and Customs develop effective financial management systems and internal controls; (3) improvements to IRS' and Customs' financial management systems and internal controls should enhance these agencies' ability to fulfill their mission requirements more effectively and efficiently; (4) IRS and Customs have developed and implemented

methodologies that more accurately report their collectible accounts receivable, reviewed their physical inventory and internal controls over seized assets, conducted physical inventories of their fixed assets, and implemented integrated accounting and budgeting systems; and (5) IRS and Customs need to improve their guidance and oversight, develop additional reconciliation and approval procedures, and improve financial management information reporting so that they can effectively carry out their missions and reliably report on their operations.

Related GAO Product(s)

GAO/AIMD-93-34, 09/22/93; GAO/T-AIMD/GGD-94-97, 02/23/94; GAO/AIMD-94-120, 06/15/94; GAO/AIMD-94-119, 06/15/94; GAO/T-AIMD-94-149, 06/21/94; and GAO/T-AIMD/GGD-94-183, 07/19/94

Some Reforms to Budget Process Offer Promise

GAO/T-AIMD-94-86, 03/02/94

In testimony before the Subcommittee on the Legislative Process, House Committee on Rules, we discussed proposed changes to the budget process focusing on (1) biennial budgeting, (2) increasing controls over tax expenditures and direct spending, and (3) requiring gross national product budget analysis and fiscal policy reports in the President's budget proposals.

We noted that (1) the House members of the Joint Committee on the Organization of Congress have proposed to (a) shift the budget cycle from annual to biennial, (b) broaden congressional control over fiscal policy by including information on tax expenditures in the budget resolution and by a new process to better control direct spending, and (c) broaden the context in which budgets are presented and debated; (2) although shifting appropriations to a biennial cycle could save time for agencies, it could also result in a shift in congressional control and oversight; (3) multiyear fiscal policy agreements and multiyear authorizations make sense and do not require changing the appropriations process from annual to biennial; (4) incorporating tax expenditures into the budget resolution is the first step toward putting tax expenditures on a more equal footing with budget outlays; (5) periodic assessments of actual direct spending against anticipated levels and decisions on whether to take action based on such assessments would be valuable; and (6) requiring the President to submit a gross domestic product analysis and a separate fiscal and budget policy report would allow for longer range economic planning and further link fiscal policy with the broader goals for the U.S. economy.

Regarding tax expenditures, we pointed out that exemptions and exclusions from taxation, deductions, credits, deferrals, and preferential tax rates result in forgone revenues of about $400 billion a year. Because tax expenditures, unlike appropriated programs, are not considered as part of the annual budget process, they are largely beyond the reach of budgetary controls. We proposed that Congress begin to increase scrutiny over tax expenditures by incorporating information on tax expenditures in budget resolutions.

Related GAO Product(s)

GAO/AIMD-94-41, 04/27/94 and GAO/T-AIMD-94-112, 04/28/94

Budgetary Implications of Selected GAO Work

GAO/OCG-94-3, 03/11/94

In a report to the Congress, the Comptroller General stated that we have consistently stressed the urgent and ultimately unavoidable need to reduce the deficit. Further, he stated that the persistently high deficit levels of the 1980s and 1990s and the mounting debt burden—now more than $4 trillion—are hobbling the government's ability to meet pressing national needs and are absorbing savings that could otherwise be used to finance investment. The report presented options for spending reductions and revenue increases that stemmed from key findings and issues developed in our audits and evaluations.

Our deficit reduction framework consists of three broad strategies: (1) considering whether to end or revise government services, (2) redefining for whom these services are or should be provided, and (3) exploring how the services can be delivered more efficiently. The 57 options in this report covered a host of federal policies and programs ranging from the dairy price support system, to burden sharing in Korea, to the collection of gasoline excise taxes.

We discussed each spending option with the Congressional Budget Office and each revenue option with the Joint Committee on Taxation to determine budgetary effects. Where possible, 5-year estimates of savings were provided for each option by these offices. Specific tax options dealt with the deductibility of home equity loan interest, the tax treatment of interest earned on life insurance policies and deferred annuities, the targeted jobs tax credit, and the tax treatment of health insurance premiums.

Related GAO Product(s)

GAO/OCG-92-2, 06/05/92; GAO/OCG-93-1TR, 12/92; and GAO/AIMD-94-155, 07/18/94

Compliance

Tax Impacts of Forgiven Debts at the Farmers Home Administration (FmHA)

GAO/GGD-94-25R, 11/10/93

In a letter to Representative Robert L. Livingston, we provided information on the tax impacts of debt being forgiven by FmHA. This work followed our February 1993 report on information reporting on forgiven debt (GAO/GGD-93-42, Feb. 17, 1993).

We reported that taxpayers should report forgiven debt as income except when the debtor (1) is bankrupt, (2) is insolvent to an extent that exceeds the amount of the forgiven debt, (3) has been forgiven a qualified farm debt held by an unrelated lender, or (4) has been forgiven a debt for a qualified real property business. Otherwise, taxpayers should reduce tax attributes such as net operating loss deductions by the amount of the forgiven debt.

Data did not exist to allow us to identify how much FmHA forgiven debt met any of the four exceptions. We did report that FmHA had forgiven $3.1 billion in direct loan obligations from fiscal year 1989 through the first three-quarters of 1992 and had written off another $4.5 billion to settle direct loans with borrowers who had ceased farming.

We also provided information about the high noncompliance in reporting forgiven debt as income and the importance of information reporting in boosting compliance. Using the February 1993 report, we found that taxpayers had reported income from just 1 percent of the debts forgiven by the Federal Deposit Insurance Corporation (FDIC) when the taxpayers had not received information returns, compared to 48 percent when they had received them. When the FDIC did not file information returns for 1989, an estimated $78 million in federal income taxes was lost. Furthermore, we found that taxpayers who did not report forgiven debts as taxable income appeared financially able to pay additional taxes.

Related GAO Product(s)

GAO/GGD-93-42, 02/17/93

IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A

GAO/GGD-94-61, 02/04/94

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we provided information on IRS' enforcement of section 1059A of the Internal Revenue Code. We also presented proposals to reconcile the different IRS and U.S. Customs Service valuation rules that affected the use of section 1059A.

Congress enacted section 1059A in 1986 to improve IRS' enforcement of transfer pricing regulations.[1] Section 1059A was designed to prevent the federal government from being whipsawed by an importer, on property acquired from a related party, who claimed a low valuation for customs purposes and a higher valuation for tax purposes.

Two general options were available to reconcile the differences in the valuation definitions that affected the use of section 1059A—multilateral renegotiation of the Customs Valuation Code of the General Agreement on Tariffs and Trade (GATT), and unilateral congressional amendment either of section 1059A or of section 402 of the customs legislation (19 U.S.C. section 1401a).

Commenting on the legislative option, IRS said that the issue addressed in the technical advice memorandum was not a tax problem. Rather, the problem was with Customs valuation, resulting from a loophole in Customs legislation. Thus, IRS concluded the issue should be resolved by amending Customs law.

Customs concluded that the legislative option would violate GATT. According to Customs, the amendatory language would place the U.S. valuation legislation in conflict with the Customs Valuation Code, which was negotiated between the United States and its major trading partners.

The agencies have not agreed on a common approach to resolving the problem of the differences in valuation definitions.

[1]Transfer prices are prices companies charge related companies for goods and services transferred on an intercompany basis.

Many Actions Taken on Tax Gap, but a Cohesive Compliance Strategy Needed

GAO/GGD-94-123, 05/11/94

In a report to Representative John W. Olver, we analyzed the composition of the gross income tax gap as well as what had been done, was being done, and could be done to reduce the gap. We developed this report by tracking actions on past recommendations for reducing the tax gap. We also updated information related to those recommendations.

The U.S. income tax system relies on taxpayers to voluntarily comply. However, many do not, creating the tax gap and shifting the burden of funding government services to compliant taxpayers. IRS estimates showed that the gross income tax gap is large and growing—$76 billion in 1981 to $127 billion in 1992. IRS estimated that $94 billion of the gap was caused by individuals and $33 billion by corporations. The largest part arose from unreported individual income—$63 billion. Overall, IRS estimated that taxpayers voluntarily paid 82 percent of their income tax liabilities. IRS' goal is to reach 90 percent by 2000.

Since the early 1980s, Congress has given IRS tools to help reduce the tax gap. Tax laws have subjected more income and deductions to information reporting and increased penalties for noncompliance. Congress also closed the door on various ways to shelter income from taxation and on some individual tax deductions, which reduced the opportunity for noncompliance. Congress has also given IRS additional funds for specific compliance initiatives. However, time lags in hiring, training, and assigning new staff prevented IRS from achieving projected revenue gains. Also, because of budget shortfalls, IRS redirected compliance initiative funds to nonenforcement areas.

Despite these tools and additional funds, IRS has not been able to increase its enforcement. Audits of corporations have decreased from over 5 percent in fiscal year 1981 to less than 3 percent in fiscal year 1992. During the same period, audits of individuals decreased from 1.8 percent to less than 1 percent. Computer matching has been reduced to absorb budget shortfalls. As a result, a matching program for finding unreported income generated about the same amount of tax assessments in fiscal year 1992 as in fiscal year 1986—$1.8 billion.

Ongoing changes at IRS offer new ways to reduce the gap. These changes include a new compliance strategy called Compliance 2000, modernization of computer systems, and organizational restructuring. In Compliance 2000, IRS wants to maintain existing compliance while also helping

noncompliant taxpayers become compliant and pursue those who do not intend to comply. The transition to this new strategy has been uneven. IRS has not fully developed a system that can determine whether the strategy is on track or needs correction. If these changes do not work, IRS' goal to increase voluntary compliance to 90 percent by 2000 will be difficult to meet.

In developing its compliance strategy, IRS needs data to objectively identify noncompliance and the reasons for it. IRS is developing these data, which will not be available for several years. In the interim, IRS could use existing statistical compliance data from its Taxpayer Compliance Measurement Program (TCMP) to focus more of its enforcement resources on such highly noncompliant taxpayers as small corporations and sole proprietors (which make up 29 percent of the tax gap). We also stated that IRS should not further reduce its enforcement and that IRS could attack more noncompliance through computer matching. For any computer match to be effective, IRS needs to receive all required information returns in a timely fashion.

One way Congress could help is to give IRS even more compliance tools. Simplifying the definition of independent contractor and requiring withholding on payments made to them could help improve compliance. Congress also could require information reporting on payments made to independent contractors operating as corporations. Congress could allow IRS to reinvest productivity gains from modernization projects. Before doing so, Congress may want assurance that IRS will use the funds for compliance.

Related GAO Product(s)

GAO/GGD-91-12, 01/07/91; GAO/GGD-91-11, 03/13/91; GAO/GGD-91-36, 03/13/91; GAO/GGD-91-49, 03/13/91; GAO/GGD-91-38, 03/29/91; GAO/T-GGD-91-17, 03/20/91; GAO/GGD-91-45, 04/16/91; GAO/T-GGD-91-21, 04/17/91; GAO/GGD-91-64, 05/14/91; GAO/IMTEC-91-39, 06/18/91; GAO/T-GGD-91-20, 06/25/91; GAO/GGD-91-91, 07/03/91; GAO/GGD-91-94, 08/26/91; GAO/GGD-91-118, 09/27/91; GAO/GGD-91-89, 09/30/91; GAO/GGD-92-26, 02/19/92; GAO/T-GGD-92-23, 03/17/92; GAO/T-GGD-92-48, 06/03/92; GAO/T-GGD-92-56, 06/23/92; GAO/GGD-92-108, 07/23/92; GAO/T-GGD-92-63, 07/23/92; GAO/GGD-92-130, 09/22/92; GAO/GGD-93-27, 12/30/92; GAO/GGD-93-40, 01/22/93; GAO/GGD-93-42, 02/17/93; GAO/GGD-93-60, 03/19/93; GAO/GGD-93-52, 04/05/93; GAO/GGD-93-97, 05/05/93; GAO/GGD-93-104, 05/10/93; GAO/GGD-93-67, 05/11/93; GAO/GGD-93-93, 05/18/93; GAO/GGD-93-102FS, 05/26/93; GAO/GGD-93-131, 09/23/93; and GAO/GGD-93-145, 09/24/93

Feasibility of Using a Meter to Capture Unreported Business Income

GAO/GGD-94-158R, 06/07/94

At the request of Senators Paul Simon and David L. Boren, we analyzed the potential revenue, costs, and feasibility of a tax compliance proposal submitted by a concerned citizen. The proposal was intended to help prevent businesses from underreporting sales income and thus underpaying taxes. IRS estimated that unreported business income created a $38 billion income tax shortfall for 1992.

The proposal would require businesses to enter sales figures into portable meters at each point of sale. Businesses would be allowed a federal tax credit to reduce the cost of the meter. When businesses prepare their tax returns, they would attach a small slip of paper from the meter showing cumulative sales. Meters also would issue special receipts that customers could redeem for free tickets to enter a nationwide lottery. To receive the tickets, customers would redeem their receipts at self-service lottery terminals. Centrally located computers would help to manage the lottery system and validate receipts before issuing any lottery ticket.

We reported that the feasibility of this proposal rested on the premise that tax revenues will far exceed costs. This premise could not be confirmed due to a number of relatively optimistic, untested assumptions. We also found that the proposal could cost billions of dollars to implement and manage. For example, (1) the federal cost for a tax credit to buy meters could be substantial, (2) technical safeguards to protect the computerized lottery network would be costly, (3) a new government entity would be needed to manage and administer the lottery, and (4) government resources for meter enforcement and administration could be large.

Information on IRS' International Tax Compliance Activities

GAO/GGD-94-96FS, 06/27/94

In a fact sheet to the Chairman, Senate Committee on Finance, we provided information on (1) how IRS had used additional resources allocated to international compliance activities and (2) how it measured the effectiveness of its international tax compliance activities.

From fiscal year 1990 to 1993, IRS devoted more resources to international tax compliance activities—12 percent more in authorized positions and 25 percent more in time actually spent by international examiners and economists. IRS used these resources mainly to increase examinations of foreign-controlled corporations by 353 percent and to initiate and expand

its Advance Pricing Agreement Program, which sought to obtain agreement up front on transfer pricing issues to avoid later disputes during the examination process. In the same period, IRS' international examinations of the tax returns of taxpayers that were not foreign-controlled corporations decreased 31 percent.

IRS used several indicators to measure the effectiveness of its international tax compliance activities. For example, in examinations, IRS compared the additional tax recommended by international examiners with the number of staff hours used to do the examination. And in the appeals process, IRS used as indicators the amounts sustained by IRS' Appeals function compared to the proposed unagreed adjustments from examination.

IRS Can Better Pursue Noncompliant Sole Proprietors

GAO/GGD-94-175, 08/02/94

In a report to the Joint Committee on Taxation, we analyzed the tax compliance of sole proprietors (i.e., self-employed individuals) and IRS' efforts to improve their compliance.

Although they accounted for an estimated 13 percent of individual taxpayers, sole proprietors accounted for an estimated 40 percent of underreported total income by individuals in IRS' most recent TCMP. They also accounted for an estimated 36 percent of the $94 billion individual tax gap for 1992. Further, TCMP data showed that sole proprietors reported only 75 percent of their net business income while individuals reported almost 98 percent of nonbusiness total income. Since 1979, sole proprietor compliance has fluctuated with little evidence that IRS' current compliance efforts will prompt significant improvements. Even with such noncompliance, we did not find a comprehensive linkage between IRS' compliance strategy and compliance efforts for sole proprietors.

Each of IRS' compliance efforts has limitations. Requiring many resources, audits reached relatively few sole proprietors. In 1992, IRS audited only 2.3 percent of the 6.6 million individuals whose primary income was from the sole proprietorship. Computer matching was limited because information returns were not required for sole proprietor income earned from selling goods or from providing services to individuals. IRS' compliance projects were often judgmentally selected on the basis of local officials' experience rather than objective data, such as from TCMP. As a result, IRS has little assurance that these projects addressed the most significant compliance

problems. Even if projects succeeded locally, IRS' system to communicate the results was limited.

IRS was developing new information systems to better identify the causes of noncompliance and target enforcement resources, but the systems were not expected to be fully implemented for years. Whether they will produce data needed to systematically improve sole proprietor compliance was unknown. IRS also was improving TCMP to identify local compliance problems and causes. However, such data will not be available until at least 1998.

Meanwhile, IRS could better use existing TCMP data to identify the root causes of some sole proprietor noncompliance. Such data indicated that truckers were among the less compliant sole proprietors. The primary reason, as found in TCMP workpapers, was inadequate books and records. IRS could work with the trucking industry to fix this problem. TCMP workpapers also indicated that unincorporated automobile body shops did not report all income from work done for businesses such as insurance companies. Although businesses are required to send information returns, the shops seldom received them. This suggests that IRS may need to work with businesses on sending information returns.

Recommendation(s) to IRS

IRS should

- develop a system for managing and monitoring all sole proprietor compliance projects, linking them to IRS-wide plans, and disseminating their results throughout IRS;
- use existing TCMP information, including workpapers, to help identify projects that would address the most noncompliant sole proprietor market segments on a nationwide basis and analyze the underlying causes of noncompliance;
- work with trucking industry groups to improve record keeping and with other sectors where TCMP indicates that record keeping may be a problem; and
- clarify information return filing instructions for insurance companies and work with these companies to improve compliance with information reporting requirements.

Action(s) Taken and/or Pending

As of December 1994, IRS was taking actions that address our recommendation on developing a system for managing and monitoring

sole proprietor compliance projects. IRS cited various activities already underway, such as its strategic planning process. On using existing TCMP data and workpapers to identify projects that address the most noncompliant sole proprietors, IRS pointed to plans to use TCMP data and other data to profile market segments that represent cash and privately owned businesses and to develop strategies to improve their compliance.

IRS pointed out that it uses nonenforcement approaches to improve compliance within specific industries, such as the trucking industry, on problems with books and records. IRS developed guidance for trucking companies containing information on accounting requirements and record keeping. IRS is also clarifying information reporting requirements for insurance companies making payments to automobile body shops, as we recommended.

Improving Independent Contractor Compliance With Tax Laws

GAO/T-GGD-94-194, 08/04/94

In testimony before the House Committee on Small Business, we presented our views on the tax compliance issues arising from proposed health care reform provisions that would have affected the use of independent contractors.

Independent contractors are commonly viewed as self-employed workers who provide services. Employees also may provide services but usually for one employer over a longer time. In classifying a worker as an independent contractor or employee, an employer should follow the 20 common-law rules. These rules focus on the degree of control an employer has over the worker. Workers who must follow instructions on when, where, and how to do the work are more likely to be viewed as employees.

An employer may switch classification from employee to independent contractor to reduce labor and some other business costs. Being reclassified allows the independent contractor to deduct business expenses and reduce taxable income. Such classification rules have been controversial for some time and still need clarifying.

Some reform provisions touched on rules for classifying workers as employees or independent contractors and reporting payments made to independent contractors on information returns. Tax law does not require information returns from independent contractors who (1) are

incorporated, (2) provide services to households, or (3) earn less than $600 annually.

Some employers could have been mandated to pay most health insurance premiums for their employees. Within this context, our major points were

- independent contractors tend to have lower tax compliance than employees;
- an employer mandate could induce employers to use more independent contractors, some of which will be misclassified because of unclear classification rules; and
- to the extent that health reform can address these issues through improved information reporting and other actions, tax administration would benefit.

Because of concerns about independent contractor compliance, many reform proposals included two provisions that we have supported. First, the $50 penalty for not filing an information return would increase significantly. Second, the $50 penalty would apply (instead of this new larger penalty) if the employer reported at least 97 percent of all aggregated payments to independent contractors for that year. We still favor these provisions and encourage Congress to consider these and other options we have provided for improving information reporting.

Related GAO Product(s)

GAO/GGD-91-49, 03/13/91; GAO/GGD-92-108, 07/23/92; GAO/T-GGD-92-63, 07/23/92; GAO/GGD-92-130, 09/22/92; GAO/GGD-94-123, 05/11/94; and GAO/GGD-94-175, 08/02/94

Dependent Exemption for Noncustodial Parents

GAO/GGD-94-200R, 08/31/94

When parents are divorced or separated, only one can claim the dependent exemption. Representative William J. Coyne asked us for suggestions on how the law could be changed to allow all noncustodial parents who provide over half of their children's support to claim the exemption.

We reported that Congress specifically amended the law in 1984 to allow the custodial parent to receive the exemption unless he or she transfers the right to the exemption to the noncustodial parent. The law was changed to relieve IRS' administrative burden in settling disputes when both parents claimed the exemption and to provide more certainty as to who could claim the exemption. We concluded that changing the law

would reintroduce the uncertainty that existed prior to the law change and make it difficult to administer.

Compliance Measures and Audits of Large Corporations Need Improvement

GAO/GGD-94-70, 09/01/94

In a report to the Chairman, Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, we analyzed the taxes paid by the largest, most complex corporations and IRS' audits of them under its Coordinated Examination Program (CEP). Excluding refunds, these corporations pay income taxes of about $155 billion each year. IRS considers CEP to be its most important audit program.

Specifically, we computed the collection rate—the portion of additional taxes recommended by CEP auditors that IRS eventually collected after CEP corporation appeals and litigation. The collection rate does not measure corporate compliance or the tax gap; these estimates are done by IRS. We also identified factors that reduced the amounts collected as well as the status of IRS' changes to the program to address those factors.

Tax law complexity makes measuring tax compliance and the collection rate very difficult. Complex laws provide opportunities for different interpretations, which may lead to different calculations of corporate liability. IRS auditors annually recommend that CEP corporations pay billions in additional tax—about two-thirds of that recommended from all IRS audits. Yet the 1,700 audit staff years devoted to CEP are modest compared to the task of auditing the 1,700 CEP corporations. Recognizing this challenge, IRS does CEP audits, unlike other audits, under a team approach using specialists such as engineers, economists, and international specialists.

We computer-matched IRS databases to calculate the percentage of taxes recommended by CEP teams between fiscal years 1983 and 1991 that was eventually collected after any appeals or litigation through fiscal year 1992. Our computer match showed a 22-percent collection rate. Had IRS' databases accounted for factors such as claims for net operating losses, the collection rate computation could be even more accurate. We expressed the belief that collecting 22 cents per dollar left room for improvement in the audit process, appeals process, or both.

CEP teams and corporations may disagree on the information needed for an audit. Some IRS requests for information were overly broad or hard to

satisfy. However, CEP teams need certain information to determine whether income and deductions are properly reported. Without the necessary support, CEP recommendations for additional taxes are unlikely to survive an appeal. We found that two methods for obtaining information—information document requests and summonses—did not work well.

Conflicting incentives within IRS contributed to the low collection rate. IRS encouraged CEP teams to recommend more taxes in the shortest time possible, making full audits hard to do. Appeals focused on settling cases, which encouraged concessions of taxes that CEP teams recommended to avoid losing all such taxes in court. With this knowledge, corporations could negotiate from a stronger position in Appeals, particularly when IRS litigated very few CEP cases. Rather than providing CEP teams with needed data during the audit, about half of the corporations we surveyed said they introduced new data in Appeals.

We also noted opportunities for improvement in how IRS manages CEP resources and trains CEP auditors. The authority to control budget resources resided with IRS' district offices. We found that this lack of central authority allowed districts to redirect resources from CEP, leaving CEP teams ill-equipped to comprehensively audit enormous corporations. Funds for travel, training, and private sector experts were insufficient.

IRS did not encourage CEP auditors to specialize in auditing certain industries. Instead, IRS rotated them to different corporations that often involved different industries, accounting standards, and issues. We said that rotating auditors to corporations in different industries hindered their ability to recommend taxes that could be sustained in Appeals.

Appeals' controls to ensure coordination with other IRS functions did not always work or exist. Insufficient coordination gave an edge to CEP corporations and led to inconsistent settlements. Specifically, corporations had an advantage during negotiations whenever Appeals (1) used new evidence submitted by corporations after audit without letting CEP officials evaluate it and (2) settled issues contrary to IRS legal positions without obtaining the views of the Office of Chief Counsel.

IRS has been concerned about the effectiveness of CEP since the 1970s. IRS announced 10 changes to CEP in 1990 that were intended to relieve taxpayer burden through tax simplification and better systems and procedures, resolve many factual issues at the audit level, provide

appropriate training and resources, improve the effectiveness and efficiency of audits, and improve the currency of audits. We concurred that these changes were needed in addition to those we recommended.

Recommendation(s) to IRS

We recommended that IRS

- use the 22 percent collection rate to estimate the taxes that CEP audits will yield, until more reliable information becomes available;
- correct its databases to allow for a more accurate computation of the collection rate;
- test ways to measure CEP corporate tax compliance and the related tax gap;
- provide the CEP Director with authority over CEP resources in the districts;
- include a common measure, such as the collection rate, in CEP and Appeals;
- increase revenue agents' knowledge of specific industries in which they do CEP audits;
- improve IRS' tools for collecting information from CEP corporations during the audit;
- allow CEP auditors to rotate among corporations in the same industries;
- improve controls to ensure that Appeals seeks CEP teams' evaluation of new information from corporations and coordinates with Counsel officials before conceding taxes in opposition to IRS legal positions; and
- propose legislative changes that will permanently resolve recurring tax disputes.

Actions Taken(s) and/or Pending

IRS disagreed with most of our recommendations about the collection rate. IRS did not agree to use the collection rate in any capacity or to correct its databases to allow for a more accurate computation of the rate. Nor did IRS agree to test ways to measure corporate compliance. However, as of December 1994, IRS was taking actions related to these areas. It was creating a database, accounting for some of the errors in its existing databases, that could be used eventually to compute the collection rate. IRS also has been attempting to develop a baseline measure of voluntary compliance and to study whether CEP audits could identify more noncompliance.

IRS is taking actions to increase revenue agents' knowledge of industries in which they do audits, thereby improving IRS' tools to collect data from corporations and allowing agents to rotate to corporations within the

same industry—to the extent possible. IRS did not agree to give the CEP Director more authority over CEP resources. IRS agreed to improve its various controls over Appeals' settlements of CEP audit disputes. IRS also agreed to propose legislative changes more strongly.

Information on Transfer Pricing

GAO/GGD-94-206R, 09/15/94

In a letter to Senator Byron L. Dorgan, we provided updated statistical information on IRS' administration of section 482 of the Internal Revenue Code, which deals with transfer pricing issues. Following up a 1993 GAO testimony, the information summarized IRS' recent experience with section 482 in examinations, appeals, and litigation. It was developed from IRS international examination and appeals data covering the late 1980s through 1993 and from 1993 and 1994 U.S. Tax Court rulings.

Related GAO Product(s)

GAO/T-GGD-93-16, 03/25/93

Data on the Tax Compliance of Sweatshops

GAO/GGD-94-210FS, 09/23/94

In a report to the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, we provided data on the federal and state tax compliance of sweatshops in the garment and restaurant industries. Federal law and regulations did not define a sweatshop. Building on past research, we defined a sweatshop as a business that violated more than one federal or state law governing wages and hours, child labor, health or safety, workers' compensation, or industry registration. We did our work at IRS and the Department of Labor and two states—California and New York—where sweatshops were common.

Although no data existed on their overall tax compliance, many sweatshops that we reviewed failed to comply with one or more elements of federal or state tax laws. For example, of the 94 garment and restaurant sweatshops we studied, 84 (89 percent) were assessed at least one penalty for filing returns or paying taxes late in 1 or more years between 1990 and 1993. As of mid-1994, 30 sweatshops still owed tax liabilities of $492,000—$16,400 on average. Lacking comparable tax data for other types of businesses, we could not determine whether the 94 sweatshops complied better or worse in filing tax returns and paying taxes.

IRS identified most of these tax liabilities through audits—the most comprehensive way to identify noncompliance. IRS audited 15 of the 94 sweatshops at least once during the 4 years. Of the overall $848,800 in additional taxes assessed against the 94 sweatshops during those 4 years, the 15 audits accounted for about 70 percent ($589,000).

Lacking tax data on sweatshops, IRS and the two states could not focus on pursuing unpaid income taxes of sweatshops. Tax officials at IRS and these states said they applied their limited resources to industries with more unpaid taxes. IRS officials said these industries are an enforcement priority and may include sweatshops. For example, IRS and the two states directed enforcement efforts at the garment and restaurant industries but not the tax compliance of sweatshops. The state efforts tended to focus on violations of labor laws. IRS' efforts included a nationwide audit program for the garment industry. For this industry, IRS had a group in Los Angeles to address compliance and was planning similar groups in other states.

Officials at the Department of Labor and the two states generally favored working with IRS on joint compliance projects, such as for garment sweatshops. Such joint efforts could improve compliance with all laws, including tax laws. The federal tax code, however, restricts IRS' ability to share tax data in joint efforts.

IRS' Handling of Undelivered Income Tax Refund Checks

GAO/T-GGD-94-186, 09/26/94

In a statement for the record submitted for hearings by the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, we provided the results of our work on how IRS handles undelivered income tax refund checks. For the 1992 filing season, IRS sent over 89.3 million refunds, totaling about $113 billion, to taxpayers. In light of this large volume of refunds and the mobility of Americans, it is not surprising that some of these refunds were not delivered to taxpayers but were returned to IRS. About 279,000 of the 89.3 million refunds, or about one-third of 1 percent, were initially returned by the U.S. Postal Service as undeliverable.

According to IRS, undeliverable refunds are caused by (1) taxpayers moving and leaving no forwarding address with the Postal Service or IRS, (2) the Postal Service not delivering or forwarding refund checks, and (3) IRS incorrectly recording taxpayers' addresses.

IRS follows certain procedures for handling undeliverable tax refunds. These procedures include attempts to locate better addresses for the taxpayers and publicity efforts to notify taxpayers of undelivered refunds.

As a result of these procedures, IRS was able to resolve over 251,000 of the 279,000 undeliverable 1992 refunds. Thus, only about 28,000 undelivered refunds, totaling $12.4 million and representing less than 1/35th of 1 percent of the total number of refunds issued during the 1992 filing season were not resolved.

Although about 28,000 refunds could not be delivered, IRS credits taxpayers' accounts for the refund amount. This ensures that the refunds are available to the taxpayers in the future. We believe that IRS is acting responsively in its handling of undelivered income tax refunds and that the burden of further responsibility for obtaining refunds due should shift to the taxpayers.

IRS Use of Customs Data

GAO/GGD-94-217R, 09/30/94

Trade data have been provided by the U.S. Customs Service to IRS under a working arrangement signed in 1992 that sought to enhance both agencies' enforcement efforts. The arrangement was signed following hearings by the Subcommittee on Oversight, House Committee on Ways and Means, in which the two agencies were encouraged to share such information. In a letter to the Chairman of the Subcommittee, we provided information on the use of the data in developing tax audits of transfer prices. As of September 30, 1994, IRS had made 17 requests for Customs data. Of these requests, 14 were specifically requested for use in transfer pricing audits under section 482. We discussed these 14 cases with the IRS field staff who requested the Customs data. We analyzed the reasonableness of the information we received by discussing it with IRS National Office representatives responsible for coordinating the use of the data.

Our discussions indicated that a substantial tax adjustment was obtained in one case and savings in audit time were obtained in six cases, as a result of the use of Customs data. IRS field staff also said they would like to receive data in a more timely and more accessible form. Since IRS has begun to step up its efforts to raise field agents' awareness of the Customs data, it will be increasingly important for the data to be accessible as the number of requests will probably increase.

Related GAO Product(s)

GAO/GGD-93-33R, 04/06/93

IRS Modernization

IRS' New Business Vision

GAO/T-GGD-94-58, 11/17/93

IRS has been encouraged on several occasions to use the opportunity afforded by Tax Systems Modernization to identify alternative business practices that would provide better service to taxpayers. In 1992, IRS began to do just that. IRS has now developed its new business vision, at least conceptually. That vision was the subject of this testimony before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations.

IRS' new vision calls for (1) shifting from a paper-based to an electronic tax-processing system, (2) consolidating fragmented telephone assistance into fewer centrally managed locations that can handle almost all taxpayer calls, and (3) developing a database that will contain all pertinent account information readily available to employees who need it. We support these business concepts. They hold promise for improved taxpayer service and more efficient and effective government.

IRS got a late start in developing its new vision and faces many challenges before the vision becomes a reality. One challenge is to increase significantly the number of tax returns that are filed electronically. IRS' goal is to increase the number to 80 million by 2001. To reach this goal, IRS said it needs legislation that would enable it to require electronic filing under certain conditions. Considering the time needed to pass legislation and issue regulations, we believe that the legal issues associated with electronic filing need to be resolved and legislative proposals submitted to Congress soon if IRS is to meet its goal.

Besides legislation, IRS needs to make electronic filing more accessible to a broader range of taxpayers. We have recommended that IRS (1) encourage employers and financial institutions to offer electronic filing to employees and customers and (2) consider letting taxpayers file through their personal computers. IRS has developed a strategy that includes these initiatives and many others.

IRS' new business vision also poses a significant human resource challenge because it will dramatically change the work done by many IRS employees. IRS has pledged that all career and career-conditional employees in jobs

affected by new technology will be given the opportunity for retraining and continued employment at the same grade level. IRS will use several strategies in trying to meet the human resource challenge, including retraining and redirecting some affected employees into tax compliance and customer service positions.

Related GAO Product(s)

GAO/T-GGD-91-54, 07/09/91; GAO/GGD-93-40, 01/22/93; and GAO/GGD-94-159, 07/08/94

GAO/T-GGD-94-89, 02/10/94 and GAO/T-AIMD/GGD-94-183, 07/19/94

Electronic Filing Fraud

As we noted in separate testimonies before the Subcommittee on Oversight, House Committee on Ways and Means, and the Senate Committee on Governmental Affairs, electronic filing fraud is a problem whose true dimensions are unknown. In 1993, IRS received about 115 million individual income tax returns. Of those returns, about 12 million were filed electronically—13 percent more than in 1992. By comparison, IRS identified 25,633 fraudulent electronic returns during the first 10 months of 1993 compared to 12,488 for the same period in 1992—a 105 percent increase. Although the number of identified fraudulent electronic returns is relatively small, the rate of growth is high, and it is uncertain how much fraud might be going undetected.

In the past, IRS has appeared more interested in expanding electronic filing than in ensuring that it fully understood and adequately addressed the associated risks. As a result, IRS has been in a reactive posture—adding controls every year in the hope of effectively dealing with a problem that it did not fully understand. With IRS planning to expand to 80 million electronic returns by 2001, IRS must thoroughly assess its controls and determine what is needed to adequately protect the government's revenues.

We reiterated several recommendations made in earlier reports directed at improving IRS' controls over electronic filing fraud. The recommendations involved (1) changes to the electronic filing system that would help prevent fraudulent returns from being filed, (2) better detection of fraudulent returns that have been filed, and (3) improved screening and monitoring of persons and firms authorized to transmit returns electronically to IRS. Some of those recommendations have not yet been implemented.

In the longer term, IRS must ensure that fraud control needs, like various up-front matching capabilities, are fully identified and considered in planning its systems modernization program. It is also important that IRS learn from its electronic filing experience by building adequate controls into the design of future systems, like TeleFile (the system that allows certain taxpayers to file their returns over the telephone), and ensuring that those controls are adequate before nationwide implementation.

Related GAO Product(s)

GAO/GGD-93-37, 12/30/92 and GAO/GGD-94-65, 12/22/93

Status of Tax Systems Modernization Planning and Technical Foundation

GAO/T-AIMD-GGD-94-104, 03/02/94

In 1993, the Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations, concluded that the Tax Systems Modernization (TSM) effort was at risk and that its successful completion required immediate action to make key decisions and establish an essential technical management infrastructure. Thus, IRS' fiscal year 1994 appropriation included a requirement that IRS report on three key issues—a business plan, a program management approach, and a systems architect's office. IRS supplied the required reports in September 1993.

In testimony before the Subcommittee, we concluded that although IRS' reports contained as much information as IRS was able to provide, they did not establish the essential infrastructure the Subcommittee sought. To establish this infrastructure, IRS must complete action on two fronts.

IRS must first define its business requirements in detail. Without approved business requirements, which precisely define the operational capabilities needed from TSM, IRS is not in a position to develop the technical specifications that shape specific information systems development projects. The absence of complete and detailed TSM requirements puts ongoing systems development projects at risk because the resulting systems may not fit properly into the whole.

Second, IRS must fill gaps in its technical and management standards. Technical standards form a foundation that guides the system development and allows the many systems and subsystems of TSM to connect and work cooperatively. Without a common data format for storing and transmitting information, for example, TSM systems will not be able to readily exchange information—a primary TSM goal. Management standards form a foundation for the overall management of TSM and the

complex physical deployment of TSM systems for use by IRS employees nationwide. Short-term and long-term investments are at risk because the technical and management standards are not in place. To reduce its risks, IRS should set aggressive schedules and clear accountability for completing these efforts.

Related GAO Product(s)

GAO/T-GGD-93-24, 04/27/93; GAO/T-IMTEC-93-6, 04/27/93; and GAO/GGD-94-129, 04/20/94

Automated Underreporter Project Shows Need for Human Resource Planning

GAO/GGD-94-159, 07/08/94

Over the next several years, IRS plans to implement its $23 billion TSM program. Among other things, TSM will replace outdated computer and telecommunications equipment with new systems designed to provide instant access to information and move IRS toward a paperless electronic environment. In conjunction with the modernization, IRS is overhauling its organization and operations to take better advantage of the new technology and is reshaping its workforce to meet the job requirements of the new work environment.

This report, addressed to the Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, discusses IRS' (1) human resource planning for TSM, (2) strategy for meeting the human resource needs of the new environment, and (3) experience in implementing the Automated Underreporter (AUR) project—the first TSM project with a significant human resource impact.

With modernization, IRS estimated that over 24,000 workers will no longer be needed for the jobs they are now doing, but it has pledged that no career or career-conditional employees will lose their jobs because of TSM. At the time of our review, IRS had not yet (1) determined workforce requirements for the new work environment; (2) assessed the knowledge, skills, and abilities of its current workforce in relation to the new requirements; and (3) developed detailed retraining and redeployment plans.

IRS' experience in implementing the AUR project reveals some of the problems that can occur without comprehensive human resource planning. IRS was not adequately prepared to redeploy the almost 1,900

employees displaced at four service centers that lost the underreporter function. Despite a large number of vacant positions that had accumulated during a 2-year freeze on hiring permanent employees, the centers did not have enough vacant positions to reassign all of the displaced employees. As of November 1993—about 18 months after the redeployment began—about 16 percent of the employees were still awaiting reassignment. Additionally, IRS began reassigning staff before it had negotiated redeployment guidelines with the National Treasury Employees Union, which represents many of the affected employees.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should take the following steps before fielding other modernization projects that have a significant human resource impact:

- assess existing workforce knowledge, skills, and abilities and update this assessment periodically for later comparison with project requirements;
- identify specific staffing requirements (numbers, skills, grades, and training) for all TSM projects that will have a significant effect on human resources; and
- compare project staffing requirements with the inventories of existing workforce knowledge, skills, and abilities and develop detailed retraining and redeployment plans to meet the requirements for TSM projects that will have a significant effect on human resources.

Action(s) Taken and/or Pending

IRS has efforts underway that are intended to help it manage the human resource implications of its modernization effort. These efforts lay an organizational framework within which IRS could plan for, and its employees could cope with, the human resource impacts of TSM. However, IRS has not specifically addressed our recommendations. We are continuing to monitor those efforts.

Controlling Improper Access to Taxpayer Data

GAO/T-AIMD/GGD-94-183, 07/19/94

In testimony before the Senate Committee on Governmental Affairs, we discussed IRS' efforts to (1) safeguard taxpayer automated files from unauthorized access and manipulation by IRS employees and (2) remove unnecessary risk from its computer systems environment. A portion of this testimony also dealt with electronic filing fraud. Because that part of our

statement generally mirrored information in other testimony that is summarized on page 52, it is not included in this summary.

We identified the following primary weaknesses with IRS' computer systems security: (1) inadequate control over access to computer systems, which leaves taxpayer data at risk of illegal disclosure or alteration; (2) limited monitoring of changes to taxpayer accounts; (3) poor contingency preparation for recovery after a disaster, which could leave IRS unable to provide basic tax processing and support services; and (4) improper management of software changes, which could leave IRS open to sabotage.

IRS has taken some steps and plans to take others to reduce these risks. Adequately reducing the risk in these areas will depend on the prompt and effective implementation of significant computer systems security improvements.

Related GAO Product(s)

GAO/T-AIMD-93-3, 08/04/93

Changes Needed in the Role of IRS' Regional Offices

GAO/GGD-94-160, 07/26/94

In a time of expanding telecommunications and persistent budget pressures, some large federal organizations are reducing their field structures. IRS has a three-tiered organizational structure that includes a National Office, 7 regional offices, and 73 field offices (63 district offices and 10 service centers). Questions have been raised about the value of the seven regional offices and whether they could operate more efficiently. This report, prepared in response to a request from the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, addresses those questions.

Past studies of IRS' organization have concluded that IRS needs regional offices. In our study, we reached the same conclusion after surveying the internal customers of regional offices—executives in IRS' National Office and field offices—and after reviewing regional office involvement in IRS' initiative aimed at bringing nonfilers back into the tax system.

At the time of our review, IRS had about 96,000 field office employees spread over about 700 work locations. Evidence indicates that regional offices are needed for effective management of such a large and widespread organization. The need for regional offices could change,

however, if IRS were to significantly reduce the number of district offices or if future changes to IRS' business processes and the technology supporting those processes enabled IRS to broaden its span of control (ratio of supervisors to employees).

Even though regional offices are needed, it was clear from our analysis and from executives' responses to our survey that those offices were not operating in a way that provided the most value to internal customers. Many customers, while acknowledging the need for regional offices, often responded negatively to questions about how helpful regional offices have been.

With these concerns in mind and in conjunction with upcoming changes that will reduce the number and size of regional offices, IRS needs to rethink the role of those offices. For example, regional staff should not spend valuable time funneling information between National and field offices or doing unproductive reviews of field office activities. It is also unproductive, in our opinion, for regional offices to be involved in managing activities, such as returns processing, where the number of sites involved is small enough for the National Office to manage directly.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should ensure that regional office roles and responsibilities are defined in a way that clearly support field office needs and contribute to accomplishing IRS' mission. In defining those roles and responsibilities, IRS should (1) allow field offices to exchange information directly with the National Office, when appropriate, rather than having to funnel everything through a regional office; (2) ensure that reviews done by regional offices do not duplicate those done by other offices and that the reviews focus on helping to solve problems; and (3) remove regional offices from the chain of command in those situations where span of control is not an issue.

Action(s) Taken and/or Pending

The Commissioner of Internal Revenue said that (1) as IRS continues to redesign its processes, consolidate and realign operational components, and implement new technology, it expects that more exchanges of information will be handled directly from the National Office to field offices; (2) as the number of regional offices is reduced, the roles of the regions will shift to more proactive analysis and improvement of compliance operations in the districts; and (3) chain of command is considered when operations are consolidated as part of IRS' reinvention

effort and that field operations are being realigned under the National Office, when appropriate. With respect to the third point, IRS has decided to have service centers report directly to the Chief of Taxpayer Services.

Taxpayer Assistance

Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season

GAO/GGD-94-65, 12/22/93

At the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we assessed various aspects of IRS' performance during the 1993 tax filing season. Specifically, we looked into tax return processing—including the growth in fraudulent electronic returns—the accuracy and accessibility of toll-free telephone assistance, and the availability of tax materials to taxpayers.

As of April 30, 1993, about 2 million fewer individual income tax returns had been filed than during the comparable period in 1992. IRS believed that a major reason for the decrease was the change in withholding tables for tax year 1992, which caused fewer taxpayers to receive refunds and more to owe taxes—many of those owing taxes apparently choosing not to file early returns.

Although the number of income tax returns filed decreased, IRS, as of August 31, 1993, had identified about 54,000 returns involving fraudulent refund claims, about twice as many as were identified in 1992. The fraudulent refund claims involved returns filed on paper as well as those filed electronically.

Electronic filing fraud is a particular problem for IRS because the speed with which refunds on electronic returns are processed leaves little time for IRS to stop fraudulent refunds before they are issued. IRS identified more fraudulent electronic refunds in 1993 than in 1992, continuing the trend of annual increases in fraudulent refund claims since electronic filing became available nationwide in 1990. IRS took several steps in an attempt to better combat electronic fraud in 1993. For example, IRS implemented an up-front computer check to verify that taxpayer names and Social Security numbers on returns matched information in IRS' records. For 1994, IRS plans to offer tax return preparers who provide electronic filing with an indicator on whether IRS will honor a taxpayer's request for direct deposit of a refund. That indicator will be needed to receive Refund Anticipation Loans (RAL) from banks while tax refunds are being processed. However, first-time electronic filers will not receive RALs because of the number of fraudulent returns filed thus far.

We believe that IRS can do other things to improve its ability to identify and stop fraudulent electronic refunds. Toward that end, we made several recommendations in December 1992 and made two additional recommendations in this report. See GAO/GGD-93-27, Dec. 30, 1992.

Except for the continuing problem with fraud, IRS indicators show that it did a good job processing returns during the 1993 filing season. According to IRS data, for example, most refunds were issued quickly and accurately. IRS also implemented procedures that (1) allowed it to make more accurate eligibility determinations on returns where taxpayers claimed the Earned Income Credit and (2) made it easier for taxpayers to obtain installment agreements. If IRS decides to continue the latter effort, it should make the procedure more available to taxpayers by allowing them to file the installment agreement request form electronically.

IRS' data showed that assistors handling toll-free telephone calls did a good job answering tax law questions, and distribution centers did a good job responding to taxpayers' requests for forms, instructions, and publications. However, taxpayers continued having difficulty getting through to telephone assistors. Using IRS data, we determined that IRS answered only about one out of four calls. IRS is taking steps to compile better data on the extent of this accessibility problem.

Recommendation(s) to IRS

To improve its ability to identify and stop fraudulent electronic refunds, IRS should (1) analyze the fraud cases identified from information provided by banks that give RALs to see if those cases involve unique features that should be included in the criteria used by IRS computers to screen electronic returns for potential fraud and (2) determine which RAL banks were used for fraudulent refunds to see if special attention should be given to banks that do not use the Fraud Service Bureau—an entity established by the four main RAL banks to review RAL applications and identify those involving potential fraud.

To make the new installment agreement procedures more available to taxpayers, IRS should allow taxpayers to file the installment agreement request form electronically.

Action(s) Taken and/or Pending

According to IRS, it analyzes information received from the RAL banks to determine whether there are unique characteristics that should be included in IRS' scoring criteria. IRS said that only some of its 10 service

centers maintain the kind of data needed to determine whether the bank involved did or did not use the Fraud Service Bureau. IRS planned to ask those centers to review their information to see if use or nonuse of the Fraud Service Bureau is a characteristic that should be considered in assessing a return's fraud potential. IRS prepared a request for programming changes that would allow the electronic filing of installment agreement request forms beginning in January 1995.

Related GAO Product(s)

GAO/GGD-91-23, 12/27/90; GAO/GGD-91-98, 06/28/91; GAO/GGD-92-132, 09/15/92; and GAO/GGD-93-27, 12/30/92

More Improvements Needed in IRS Correspondence

GAO/GGD-94-118, 06/01/94

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we discussed IRS' efforts to improve its correspondence with taxpayers and recommended additional improvements. During the past 6 years, GAO, IRS, and others have cited delayed, inaccurate, incomplete, and confusing responses to taxpayer letters as chronic IRS problems. Although IRS has made progress in correcting its correspondence problems by adopting quality and timeliness standards and by expanding quality reviews of outgoing mail, some problems persist.

Our review of nearly 1,900 closed correspondence cases in IRS' Atlanta and Cincinnati Service Centers found that 15 percent of the cases were incorrect, unclear, incomplete, or nonresponsive. Also, 11 percent of the cases resulted from taxpayers repeatedly trying to contact IRS to resolve a matter. Problems such as these increase IRS' costs, frustrate taxpayers, and ultimately discourage taxpayer compliance with the tax laws. We outlined several opportunities for IRS to improve its responsiveness to taxpayers, including resolving more taxpayer issues by telephone, clarifying the situations that warrant an IRS response to taxpayer correspondence, making timeliness indicators more useful, and improving interim letters. Interim letters are sent to taxpayers when the issue in question cannot be resolved within 30 days; however, IRS' measures of timeliness do not focus solely on providing a final response to taxpayers, which may underestimate the time required. We also found interim letters in our sample to be unclear and potentially confusing to taxpayers.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should direct IRS' staff to take the following actions:

- clarify the wording in IRS' notices, letters, and publications to better inform taxpayers of those situations that can be handled by a telephone call. Before implementing this recommendation, however, IRS first needs to ensure that its telephone system can meet the additional demand;
- clarify IRS' existing procedures for responding to taxpayer requests to ensure that taxpayers' questions do not go unanswered;
- use correspondence mail-out dates instead of the date a response was initiated as a timeliness indicator and adopt goals for providing taxpayers with final responses;
- reassess the purposes of interim letters and then provide the service centers with clear guidelines for accomplishing those purposes;
- review samples of interim letters to ensure that improvement in quality results from the revised guidelines; and
- implement Correspondence Task Force recommendations to (1) incorporate correspondence improvements at district offices, (2) meet user requirements for a letter writing system and an automated inventory control system, and (3) measure taxpayer satisfaction.

Action(s) Taken and/or Pending

IRS agreed with five of the six recommendations. IRS provided an alternative solution to GAO's recommendation that it use correspondence mail-out dates as a timeliness indicator and adopt goals for providing taxpayers with final responses. IRS' alternative solution was to mandate the use of spot-checks of interim letters in all functional areas. We agreed that IRS' alternative was reasonable but recommended that the results of the spot-checks be incorporated into timeliness measures. In May 1994, IRS issued a memorandum entitled "Action 61 Interim Letter Guidelines." A training package on interim letters was also provided to all employees who correspond with taxpayers. IRS' May 1994 guidelines on interim letters directed the service centers to conduct reviews of the interim letter process and set improvement objectives. IRS' National Office is to examine the results of these procedures during annual program reviews.

Related GAO Product(s)

GAO/GGD-91-66, 03/20/91; and GAO/GGD-93-38R, 04/27/93

Better Measures Needed to Assess Progress of IRS' One-Stop Service

GAO/GGD-94-131, 08/29/94

In a report to the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, we reported on IRS' efforts to implement one-stop service to respond to taxpayers' questions and complaints. IRS defined one-stop service as the resolution of issues during the taxpayer's initial contact with IRS or as a result of that contact. Taxpayers and IRS will benefit if IRS is able to reach its one-stop service goals. Taxpayers will have the opportunity to resolve issues in one contact with IRS, thus avoiding the time-consuming frustration of dealing with multiple IRS contacts. Reducing multiple contacts will save money for IRS, and lowering taxpayer frustration should benefit IRS through increasing taxpayer compliance.

Between 1992 and 1993, IRS improved its ability to deliver one-stop service to taxpayers who telephoned with account inquiries. Although progress has been made, several barriers limit IRS' ability to deliver one-stop service over the telephone. IRS hopes to remove some of the barriers through its consolidation of various telephone and correspondence handling services into 23 Customer Service Centers. IRS expects these centers to be operational by 2001. In the meantime, current measures overstate delivery of one-stop service. In many instances counted as one-stop service, a taxpayer will likely need to contact IRS again about the same matter. Moreover, measures of one-stop service in service center correspondence activities and at forms distribution and walk-in sites are limited or nonexistent.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should develop better measures of one-stop service that do not include instances where taxpayers will likely need to contact IRS again about the same matter. The measures developed should apply to all taxpayer telephone inquiries—including account-related, tax law, and procedural inquiries as well as calls to automated collection sites and forms distribution sites—service center correspondence activities, and walk-in sites. Moreover, the measures should be designed in such a way that they enable IRS to (1) gauge its progress toward meeting its 1998 one-stop service goal, (2) identify and correct problems that might impede IRS' progress toward that goal, and (3) compare delivery of one-stop service among various taxpayer services available at IRS.

Action(s) Taken and/or Pending

IRS has begun to revise its one-stop measurement system for telephone account calls. Also, in the longer term, automated case files are planned that would enable IRS to determine if a taxpayer made multiple contacts on a given problem.

Related GAO Product(s)

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

Tax Policy

Effects on Environmental Infrastructure of Limits on Certain Tax-Exempt Bonds

GAO/RCED-94-2, 10/28/93

Although state and local governments rely heavily on tax-exempt bonds to finance environmental infrastructure, such as solid waste, wastewater treatment, and drinking water facilities and to comply with federal environmental mandates, Congress capped the volume of tax-exempt bonds that can be issued each year for this purpose. At the request of Representatives Nita M. Lowey and Christopher Shays, we reviewed the impact of the volume cap on state and local investment in environmental infrastructure, focusing on (1) national investment in drinking water, wastewater treatment, and solid waste facilities and (2) the cap's effect on private companies' investments in those facilities.

We found that capital spending and the volume of tax-exempt bonds issued for environmental projects have changed little since the law was revised, suggesting that the volume cap has not curbed overall investment nationwide. Nevertheless, further examination of spending trends show that capital spending on the environment as a percentage of the gross domestic product has fallen. Moreover, it has not kept pace with the rising tide of federal environmental mandates, which will require considerably higher levels in the future.

Private companies claim that the volume cap and other provisions of the act have discouraged private investment. They noted that the volume cap has discouraged some companies from investing because states' allocation processes give low priority to environmental projects. Also, several states allocate private activity bond authority on a first-come, first-served basis, increasing the risk that investors will be unable to secure all the necessary financing. Private companies said that other provisions of the 1986 Tax Reform Act, which eliminated the investment tax credit and lengthened depreciation schedules, have influenced investment decisions to an even greater degree than the volume cap.

Related GAO Product(s)

GAO/HRD-90-34, 03/22/90; GAO/HRD-92-87FS, 03/31/92; and GAO/RCED-92-35, 01/27/92

Health Insurance Tax Credit Participation Rate Was Low

GAO/GGD-94-99, 05/02/94

In response to a request from the Ranking Minority Member of the Subcommittee on Health, House Committee on Ways and Means, we described the administration of the health insurance tax credit and studied the effect of the credit on the purchase of health insurance. We discussed the estimated participation rate, in part to determine whether the potentially eligible population was aware of the health insurance credit, and the health insurance tax credit's influence on low-wage workers' purchase of health insurance.

We estimated that about one-quarter of those who potentially were eligible actually claimed the health insurance credit in 1991. A lack of awareness may have prevented more eligible taxpayers from taking the credit.

We found that the credit may not have been sufficient to encourage eligible taxpayers to purchase insurance coverage. The health insurance credit reimbursed only a small percentage of taxpayers' reported costs of health coverage. The maximum health insurance credit available in 1991 was $428. The analysis of tax year 1991 tax returns showed that the health insurance credit paid, on average, $233, or 23 percent of the average reported health insurance premium of $1,029 for credit recipients. This $1,029 average annual premium for recipients represented only a fraction of the total cost of employer-provided health insurance, because employers generally pay a significant part of the cost.

We made no recommendations because during our work on this request the health insurance tax credit was repealed by the Omnibus Budget Reconciliation Act of 1993. The requester's staff asked us to complete the work because much of the information would be helpful in discussions on health care reform.

Related GAO Product(s)

GAO/GGD-91-110FS, 09/12/91

Tax Expenditures Deserve More Scrutiny

GAO/GGD/AIMD-94-122, 06/03/94

At a time when the federal government faces hard choices to reduce the deficit and use available resources wisely, all federal expenditures and subsidies should be carefully reviewed. Tax expenditures, or revenues forgone through preferential provisions in the tax code—for example, deductions, exemptions, and credits—can be a useful part of federal

policy, but they should be scrutinized. Congressional and executive branch processes do not subject existing tax expenditures to the same controls that apply to programs receiving appropriated funds. This report assessed the growth of federal revenues forgone through income tax expenditures and presented three options for reviewing and controlling their growth: (1) strengthening and extending expenditure control methods now used by congressional tax-writing committees, (2) integrating tax expenditures further into the budget process, and (3) reviewing tax expenditures jointly with related federal outlay programs.

At the request of Representative William J. Coyne, we reviewed tax expenditure growth, focusing on (1) the size of increases in tax expenditures, (2) whether tax expenditures need increased scrutiny, and (3) options that could be used to control the growth of tax expenditures and the advantages and disadvantages of each alternative.

We found that (1) substantial revenues are forgone through tax expenditures, but they do not overtly compete in the annual budget process and most are not subject to reauthorization, (2) policymakers have few opportunities to make explicit comparisons or trade-offs between tax expenditures and federal spending programs, (3) the revenues forgone through tax expenditures reduce the resources available to fund other programs or reduce the deficit and force tax rates to be higher to obtain a given amount of revenue, (4) greater scrutiny of tax expenditures could be achieved by strengthening techniques currently used to control tax expenditures, (5) Congress could further integrate tax expenditures into the budget process by deciding whether savings in tax expenditures are desirable and setting specific savings targets in annual budget resolutions, and (6) reviews of tax expenditures could be integrated with functionally related outlay programs, which could make the government's overall funding effort more efficient.

Recommendation(s) to Congress

The tax-writing committees should explore, within the existing framework, opportunities to exercise more scrutiny over indirect "spending" through tax expenditures.

If Congress wishes to consider tax expenditure efforts in a broader context of the allocation of federal resources, it could consider further integrating tax expenditures into current budget processes. Providing for congressional consideration of a savings target as part of the annual

budget process could ensure that Congress addresses tax expenditures periodically.

Alternatively, options that integrate consideration of related outlay and tax expenditure efforts could promote a more thorough review by the legislative and executive branches of possible trade-offs.

Recommendation(s) to the Office of Management and Budget

Once tax expenditure performance data are developed, the Office of Management and Budget (OMB) should consult with the Treasury in considering how to portray tax expenditure performance information in the budget. The tax expenditure performance information should be combined with related outlay information to demonstrate the relative efficiency, effectiveness, and equity of federal outlay and tax expenditure efforts within a functional area. Such a presentation could be used to show the relative effectiveness of federal spending programs funded through outlays and tax expenditures.

Action(s) Taken and/or Pending

As a result of our work, examinations of tax expenditures were made part of agency performance plans. Such plans are required by the Government Performance and Results Act. Furthermore, tax expenditures were made part of the congressional budget process when they were incorporated into the 1995 Congressional Budget Resolution as a nonbinding agreement.

Related GAO Product(s)

GAO/HRD-91-33, 02/20/91; GAO/GGD-91-85, 07/10/91; GAO/GGD-93-63, 03/25/93; and GAO/RCED-93-31, 07/16/93

Pharmaceutical Industry's Use of the Research Tax Credit

GAO/GGD-94-139, 05/13/94

In 1981, Congress enacted the research and experimentation tax credit to encourage businesses to do research. Congress believed that increased research was necessary to enhance the competitiveness of the U.S. economy. In our report to the Chairman, Senate Special Committee on Aging, we estimated the amount of research and experimentation tax credit claimed by the pharmaceutical industry. We found that the pharmaceutical industry earned $1.24 billion of research and experimentation tax credits between 1981 and 1990. The industry's credits, as a share of the credits earned by all industries, increased from 4 percent in 1981 to 12 percent in 1990.

The pharmaceutical industry credits were earned primarily by large companies. Between 1981 and 1990, companies with assets of $250 million or more earned, on average, about 90 percent of the industry's credits. The biotechnology sector of the industry, which consisted largely of smaller companies, benefitted very little from the credit. Although their research spending had been increasing, the biotechnology companies typically could not claim the credit because they had low or no tax liabilities.

The research and experimentation tax credit was difficult for IRS to administer. IRS examiners reported that they had difficulty distinguishing research for product innovation, which qualified for the credit, from research for product development, which did not qualify. Examiners who audited four large pharmaceutical companies said that the technical nature of the issues made the audits difficult.

Related GAO Product(s)

GAO/GGD-89-114, 09/05/89; GAO/GGD-92-72BR, 05/04/92; and GAO/GGD-93-109, 06/08/93

Implications of Removing State and Local Tax Exemption for Government Sponsored Enterprises

GAO/T-GGD-94-182, 07/14/94

In testimony before the House Committee on the District of Columbia, we discussed the (1) basis for exempting government-sponsored enterprises (GSE) from state and local taxation and (2) the implications of removing the exemption.

Except for real property taxes, GSEs are exempt from state and local taxes. This is one of a set of advantages that GSEs receive in exchange for performing certain services. These services are meant to compensate for perceived market failure. For example, mortgages and student loans were (1) small, (2) not standardized, (3) difficult to evaluate, and (4) illiquid. GSEs, by providing primary and secondary markets for these loans, increased liquidity, efficiency, and reduced risk in the national market. In addition to the tax exemption, these GSEs have lines of credit to the federal Treasury that reduce their perceived riskiness to potential investors. As a result, GSEs pay interest rates only slightly higher than the federal government.

If the exemption is removed for D.C. alone, the main effect would be on the Federal National Mortgage Associate (Fannie Mae). Because of its competition with the Federal Home Loan Mortgage Corporation, Fannie

Mae will have an incentive to reduce its tax bill by shifting activity out of D.C. The tax bill it pays will come from two primary sources: customers and shareholders. To the extent that it can, Fannie Mae will try to pass the tax on to financial institutions and the final borrowers. If Fannie Mae cannot pass on these higher costs to borrowers, it may be forced to cut dividends to shareholders and Fannie Mae stock prices may fall.

Other

Paperwork Reduction: Reported Burden Hour Increases Reflect New Estimates, Not Actual Changes

GAO/PEMD-94-3, 12/06/93

The U.S. government is the world's largest creator, collector, distributor, and user of information. From filing income tax returns to applying for food stamps, the American citizen is faced with a government form. Thousands of businesses, nonprofit groups, and state and local governments also fill out applications to receive federal benefits or to remain eligible as government contractors.

Each year OMB completes an information collection budget that measures federal information collection requirements imposed on everyone outside the federal government. To determine the burden associated with a particular information collection effort, agencies usually develop an estimate of the time required to comply with a particular collection, the number of respondents complying, and the number of times respondents comply. Then the total burden, measured in hours, is calculated by multiplying the average response time per respondent by the expected number of respondents.

At the request of Representative William F. Clinger, Jr., we examined apparent increases in the paperwork reduction burden. We found an increase in reported burden hours of 261 percent (from over 1.8 billion hours to nearly 6.6 billion) between 1987 and 1992. Most of this change (3.4 billion of the 4.8 billion hour increase) is accounted for by Department of the Treasury reestimates of the time spent processing paperwork, especially tax-related reporting and filing requirements at IRS rather than by the imposition of actual new burdens. A net increase of about 1.5 billion hours can be accounted for by changes in ongoing collections, primarily stemming from changes in population size and revisions to collection instruments. In addition to the Treasury reestimates, some increases in paperwork burden were due to new statutory requirements for other agencies. There were also some decreases. For example, in 1991, revisions in forms related to estimated income taxes and business partnerships led to a decrease of 38.6 million hours reported by the Treasury.

The major reason for collecting information continues to be the existence of what the OMB calls "regulatory or compliance requirements." Although these requirements appear to have increased, this change may be more

attributable to the Treasury's reestimates of time needed to deal with the compliance burden.

Related GAO Product(s)

GAO/PEMD-89-19FS, 06/14/89; GAO/PEMD-93-5, 02/03/93; and GAO/T-AIMD/NSIAD-94-126, 05/19/94

Actions Needed to Sustain and Enhance Management Reforms

GAO/T-OCG-94-1, 01/27/94

Over the years, we have testified repeatedly on the breadth and the seriousness of the problems undermining the effectiveness and efficiency of federal programs. In testimony before the Senate Committee on Governmental Affairs, the Comptroller General urged Congress to (1) expand the requirement for auditing financial statements to more federal programs and agencies, (2) strengthen the framework for managing information technology to ensure that agencies come up with systems that effectively support federal programs, (3) focus on high-risk programs especially vulnerable to waste and mismanagement, (4) implement the new performance results measurement legislation, and (5) develop strategies for implementing National Performance Review recommendations.

With respect to IRS, one of several agencies that were cited as examples, the Comptroller General said that

- IRS's books showed that the government was owed $110 billion in delinquent taxes and that it would collect about $30 billion of this amount. Our audit showed that only about $65 billion was owed and, of that amount, IRS could expect to collect only about $19 billion;
- because of its accounting weaknesses, IRS is considered one of several high-risk agencies, meaning that it is especially vulnerable to waste and mismanagement. IRS cannot determine the amount of tax revenues that should be accrued to the excise tax trust funds. Consequently, general fund tax dollars subsidize these funds and give decisionmakers the impression that excise taxes are generating more revenue than they actually do; and
- IRS' $23 billion TSM program is intended to deliver systems that support the agency's business vision of fast, accurate, virtually paperless, and less-costly tax processing. The program needs continuing attention to ensure that sufficient technical leadership, skills, and experience are

available to manage and implement this highly complex systems integration effort.

Related GAO Product(s)

GAO/T-AIMD-94-98, 03/24/94; GAO/T-AIMD/NSIAD-94-126, 05/10/94; GAO/GGD-94-203R, 09/02/94; and GAO/AIMD-94-141, 08/12/94

Opportunity to Strengthen Government's Management of Information and Technology

GAO/T-AIMD/GGD-94-126, 05/19/94

The Paperwork Reduction Act is a vital part of a legislative framework, including the Chief Financial Officers Act and the Government Performance and Results Act, designed to resolve basic management problems undermining the effectiveness of many government programs. The legislation is intended to reduce the information collection burden imposed on citizens by the federal government and to increase the efficiency and effectiveness of federal programs through information technology. This testimony before the Senate Committee on Governmental Affairs (1) focused on implementation of the act, particularly as it affects information resources management and (2) the proposed reauthorization compromise.

IRS was cited as an agency having difficulty harnessing information technology. IRS' $23 billion TSM program, designed to support faster, more accurate, and less-costly tax administration, is being undertaken without adequately defined business requirements and technical or management standards, thereby greatly increasing the risk of failure.

We noted that (1) federal agencies, including IRS, have difficulties in managing and using information technology; (2) the federal government can learn from successful private organizations and state governments how to manage information technology as an integral part of its business strategy; (3) fundamental practices critical to a modern information management system include directing resources toward high-value uses and supporting improvements with the right skills, roles, and responsibilities; (4) reauthorization of the act should clarify the responsibilities of line managers for effectively managing information, require agencies to ensure that information technology investments effectively support agency missions, and encourage agencies to redesign their business practices and supporting systems before upgrading or replacing existing systems; (5) the act should also require agencies to establish performance measures, integrate information management and

technology into organizationwide decisionmaking, and establish a chief information officer; and (6) we have made numerous recommendations to improve agencies' compliance with legislative, data collection, regulatory review, and reporting requirements.

Related GAO Product(s)

GAO/IMTEC-91-7, 12/12/90; GAO/PEMD-92-33, 07/02/92; GAO/OCG-93-5TR, 12/92; GAO/PEMD-93-5, 02/03/93; GAO/PEMD-94-3, 12/06/93; GAO/GGD-94-28, 12/13/93; GAO/T-OCG-94-1, 01/27/94; GAO/T-AIMD/GGD-94-104, 03/02/94; GAO/AIMD/NSIAD-94-101, 04/12/94; and GAO/GGD-94-105, 04/27/94

Information on IRS Executive Relocations and Travel Matters

GAO/GGD-94-140, 06/01/94

In response to a request from the Chairman, Subcommittee on Federal Services, Post Office and Civil Service, Senate Committee on Governmental Affairs, we developed information on executive relocations and other aspects of IRS' travel and transportation activities.

In the 3 years ending September 1992, there were 122 IRS executive relocations at a cost estimated by the IRS Chief Financial Officer of about $60,000 each. IRS executive assignments, including relocations, are made by the Commissioner upon advice by IRS' Executive Resources Board. Relocations are made to meet immediate management needs and to develop a qualified corps of executives to meet future needs.

IRS procedures require consideration of lower cost alternatives for long-term travel associated with temporary duty assignments exceeding 2 months. IRS does not centrally maintain long-term travel data because authority to approve such assignments is dispersed among many IRS units throughout the organization. We reviewed long-term travel assignments made at four IRS offices during fiscal year 1992. In these cases, officials who authorized the travel said that less-costly alternatives were considered.

Our review of a judgmental sample of 67 meetings and conferences held at nongovernmental facilities during fiscal year 1992 showed that the site selections, for the most part, generally met federal requirements that were in effect at that time. In 1993, IRS revised its procedures for selecting meeting and conference sites to restrict the use of nongovernmental facilities. The revisions responded, in part, to recommendations from the Department of the Treasury's Inspector General that were based on a

conclusion that IRS was not adequately managing the selection of nongovernmental facilities for such activities.

IRS has encouraged the use of modern technology to reduce travel costs and estimated that it saved nearly $3 million in travel expenses from January through July 1993 by using videoconferencing. IRS officials said that IRS continues to assess its strategies to take advantage of emerging telecommunications technology.

Progress Report on Treasury's Financial Crimes Enforcement Network

GAO/GGD-94-30, 11/08/93

In a report to the President of the Senate and the Speaker of the House of Representatives, we reported on the Financial Crimes Enforcement Network (FinCEN), as required by Public Law 102-550. FinCEN, part of the Department of the Treasury, distributes a variety of financial data to help federal, state, and local law enforcement agencies combat money laundering. The primary source of most of the financial intelligence information accessed and disseminated by FinCEN are reports required by the Bank Secrecy Act (BSA). The act requires individuals as well as banks and other institutions, such as check cashing businesses, currency exchanges, and money transmitters, to report large foreign and domestic financial transactions to the Treasury. Over 95 percent of the more than 52 million BSA reports filed as of September 1993 were Currency Transaction Reports (CTR). Financial institutions and certain types of businesses must file a CTR with IRS for each deposit, withdrawal, exchange, or other payment or transfer, by, through, or to such financial institutions or businesses that involve more than $10,000 in currency. BSA databases are stored on computers at IRS' Detroit Computing Center and the Treasury Enforcement Communications System in Newington, VA.

Since its inception less than 4 years ago, FinCEN has been receiving a steadily increasing volume of requests for intelligence data. Similarly, the number of individual agencies requesting these data has continued to rise each year. The network also provides strategic intelligence analyses that identify emerging trends, patterns, and issues relating to money laundering. Law enforcement groups use these reports for everything from instructional seminars to threat assessments of specific geographic areas.

Related GAO Product(s)

GAO/GGD-91-53, 03/18/91

Characteristics of Currency Transaction Reports Filed in Calendar Year 1992

GAO/GGD-94-45FS, 11/10/93

In a fact sheet prepared for the Chairman, House Committee on Banking, Finance and Urban Affairs, we provided information on CTRs filed pursuant to the BSA with IRS' Computing Center in Detroit.

We provided statistical data on the 100 businesses for which the most CTRs were filed in 1992, and information on the procedures that can be used to exempt certain businesses from CTR reporting requirements. We found that banks accounted for virtually all of the nine million CTRs filed in 1992. The reports described about $418 billion in cash transactions by companies and individuals.

Businesses accounted for about 92 percent of all CTRs filed and for about 99 percent of the total dollar amount of the transactions reported. Most of the transactions were deposits, and over half of the CTRs were for transactions of $20,000 or less.

Treasury regulations allow banks to exempt certain types of businesses from reporting transactions. Data on the number of businesses exempted are not collected. But, 1.2 million of the 9.2 million records from 1992 resulted from transactions that exceeded the dollar limit on exemptions. In addition, IRS officials estimated that between 30 and 40 percent of all reports filed could qualify for exemptions.

Related GAO Product(s)

GAO/T-GGD-93-31, 05/26/93

Money Laundering: Project Gateway

GAO/GGD-94-91R, 02/15/94

In a letter to the Chairman of the House Committee on Banking, Finance and Urban Affairs, we provided information on a Department of the Treasury initiative to facilitate access by the states to BSA data. In July 1993, Treasury officials announced a test program known as "Project Gateway," that allows Texas law enforcement authorities direct access to BSA data maintained on computer at IRS' Detroit Computing Center.

Project Gateway, which began operating September 1, 1993, allows authorized state personnel in Texas direct access to the IRS database through a computer located in Austin. Analysts may only search for information about a specific individual or business. Consequently, analysts are precluded from performing any analyses of the reports based on, for

example, types of institutions filing the reports, reports filed within certain geographical areas, or reports filed by type of business. Federal agencies have found these types of analyses useful for identifying emerging trends and geographic patterns in money laundering.

Six states currently have agreements with the Treasury that allow them to maintain their own computerized databases of currency transaction reports. The Treasury periodically supplies each state with report data on tape copied from the IRS database. Because the states can construct and maintain their own databases, there are no limits on what reports can be accessed and what type of intelligence analyses can be produced. However, the states are limited in that they receive only the reports from those institutions located within their geographic boundaries.

In November 1993, FinCEN proposed a new initiative for sharing BSA data with the states. This proposal would permit those states presently authorized to receive BSA data on tape direct access to the IRS database in Detroit without any limitation as to what records would be accessed. The proposal is currently being evaluated by Department of the Treasury officials.

Related GAO Product(s)

GAO/GGD-93-1, 10/15/92

GAO/T-GGD-94-113, 03/15/94

The Volume of Currency Transaction Reports Filed Can and Should Be Reduced

In testimony before the Senate Committee on Banking, Housing and Urban Affairs, we discussed proposed legislation to reduce the volume of CTRs filed that have no law enforcement value. Under the BSA, banks and other financial institutions are required to file a currency transaction report for each transaction involving more than $10,000 in cash. The number of reports filed has been steadily increasing—as of April 1993 nearly 50 million reports had been filed and this figure could double in the next 3 years. Although these reports are extremely useful in detecting and prosecuting money laundering, we concluded that the volume of filings could be substantially reduced without jeopardizing law enforcement. In fact, the large volume of reports has made analysis difficult, expensive, and time consuming. Many of the reports being filed are of routine business transactions that could have been exempted from being reported. We supported the legislative provisions that would have encouraged greater use of exemptions for routine transactions that do not have law enforcement value.

1993 Annual Report on GAO's Tax-Related Work

GAO/GGD-94-82, 03/31/94

This summary, prepared in compliance with a legislative requirement, contains information on GAO's tax policy and administration-related work during fiscal year 1993. It includes (1) summaries of tax-related products issued in fiscal year 1993; (2) summaries of tax-related products issued before fiscal year 1993 with open recommendations to Congress; (3) descriptions of legislative actions taken in fiscal year 1993 in response to GAO recommendations; (4) a listing of recommendations to Congress that were open as of December 31, 1993; (5) a listing of recommendations we made in fiscal year 1993 to the Commissioner of Internal Revenue; and (6) brief descriptions of assignments for which we were authorized access to tax data in fiscal year 1993 under 26 U.S.C. 6103(i)(7)(A).

White House Travel Office Operations

GAO/GGD-94-132, 05/02/94

In a report prepared in response to Public Law 103-50, we provided information on the White House Travel Office. Specifically, we reviewed (1) past operations and oversight of the Travel Office, (2) the current operations of the Travel Office and the extent to which past problems have been corrected, (3) the actions taken in 1993 that led to a White House official's decision to investigate the operations of the Travel Office and remove employees, (4) the actions of other federal agencies during this period including IRS and the Federal Bureau of Investigation (FBI), and (5) certain other matters related to events that occurred in the Travel Office.

We concluded that although the White House had the authority to fire several employees in its press travel office in 1993, the White House should have tried to insulate its management decisions from influence of persons with personal interest in travel office operations. We questioned the practice of granting nongovernment employees uncontrolled access to White House officials without having policies to govern their activities because the appearance of influence and authority that access conveys could lead to inappropriate actions or abuses.

Media reports that IRS agents issued a taxpayer a summons to obtain records in response to the Travel Office controversy and that a White House official suggested to FBI officials that IRS might be called, raised concerns that the White House may have attempted to influence IRS action, either directly or through the FBI. On the basis of our review of

investigations by IRS' Inspection Service, the Department of the Treasury's Office of Inspector General, and in our own review, we concluded that IRS officials acted within the scope of their procedures and regulations. We found no evidence that White House officials contacted IRS about the Travel Office matter or that the FBI made any inappropriate contacts with IRS.

The White House Counsel issued guidelines to White House staff in February 1993 that contain the White House procedures for obtaining and providing information to IRS. Expanded in July 1993, these guidelines require all information concerning potential tax violations to be sent to the White House Counsel, who in turn refers the information to either the Attorney General or the Deputy Secretary of the Treasury.

We made several recommendations as a result of our review, none of which related to IRS or to tax-related matters.

Related GAO Product(s)

GAO/GGD-93-143, 09/30/93 and GAO/GGD-93-148, 09/09/93

Stronger Labor ERISA Enforcement Should Better Protect Plan Participants

GAO/HEHS-94-157, 08/08/94

The Department of Labor's Pension and Welfare Benefits Administration (PWBA) is responsible for enforcing provisions of the Employee Retirement Income Security Act of 1974 (ERISA)—the federal program to protect an estimated 200 million participants and beneficiaries of private pension and welfare plans—as well as the $2.5 trillion in assets held by those plans. We reviewed the Department of Labor's enforcement of ERISA, focusing on Labor's (1) enforcement strategy, (2) methodology for targeting pension and welfare plans for investigation, and (3) use of penalties to increase compliance.

A review of Labor's enforcement program showed improvements since 1986 but also showed the need to strengthen enforcement by taking steps to ensure maximum use of investigative resources. PWBA has never evaluated its current enforcement strategy. Such an evaluation is needed to determine whether PWBA is focusing on the right issues and whether the strategy produces the greatest results. In addition, PWBA has done little to assess the effectiveness of computer-targeting programs developed to systematically select pension and welfare plans for investigation of potential fiduciary violations. The enforcement program also can be

strengthened by increasing the use of penalties authorized by ERISA to deter plans from violating the law.

In this report to the Secretary of Labor, we reported that PWBA lacks the staff and resources necessary and does not routinely follow up on IRS referrals so that it can take appropriate legal action and impose penalties against those firms that do not comply with ERISA fiduciary requirements. Further, PWBA needs to determine whether additional administrative guidance and legal changes are needed to enhance PWBA penalty enforcement.

Recommendation(s) to Labor

We recommended that the Secretary of Labor direct the Assistant Secretary for Pension and Welfare Benefits Administration to increase the use of penalties authorized by ERISA. This can be done by establishing procedures to routinely review referrals of potential reporting violators from IRS service centers and by using decentralized legal staff to help assess prohibited transaction penalties when warranted. PWBA should also determine whether additional administrative guidance, changes to the law, or both are needed to remedy confusion associated with the penalty and enhance PWBA penalty enforcement.

Action(s) Taken and/or Pending

Labor agreed that its ERISA enforcement program should maximize the use of resources but generally disagreed with many of the recommendations. Labor said that its current strategy and computer-targeting leverage enforcement resources are extremely limited in view of the large universe of participants and plans covered by ERISA. Labor also said that recent and anticipated initiatives should improve the program. We commend Labor for its enforcement efforts, but we continue to believe that our recommendations, if implemented, would strengthen the program.

Related GAO Product(s)

GAO/HRD-93-34R, 09/30/93

GAO/HEHS-94-48, 09/02/94

Social Security Trust Funds Can Be More Accurately Funded

Each year, the social security trust funds are credited with revenues derived from income taxes paid on social security benefits. But are these funds credited with the right amount? At the request of the Subcommittee on Oversight, House Committee on Ways and Means, we reviewed the effect of unreported tax-exempt income on the taxation of social security

benefits, focusing on (1) additional compliance measures that would improve IRS' ability to assess and collect social security benefit taxes and (2) how the Department of the Treasury and IRS determine the amount of revenue owed to social security trust funds.

We reported that the social security trust funds' revenues could be increased by recognizing additional taxes identified through IRS' efforts to locate underreported taxable income and through better detection of underreported tax-exempt interest. Recognizing additional taxes identified by IRS, could have boosted the trust funds by more than $200 million in tax revenue and investment income for tax years 1984 to 1989. Further, data from the Federal Reserve and the Investment Company Institute indicated that taxpayers may have underreported an estimated $7.2 billion in tax-exempt income on their 1989 tax returns.

Recommendation(s) to IRS

We recommended that the Secretary of the Treasury direct IRS to identify the amount of additional taxes that have been assessed on social security benefits through its underreporter program. Given the uncertainty of the tax revenue losses from underreporting of tax-exempt income and the financial industry's potential processing burden, we recommended that IRS conduct a detailed study of tax returns to better identify the benefits of having taxpayers report tax-exempt income. In addition, IRS should obtain data on the costs of reporting and processing such information. The study could involve IRS' TCMP or a pilot study that solicits the cooperation of several payers so that the benefits and costs of reporting tax-exempt income can be estimated. If a favorable cost-benefit ratio is identified, IRS should take appropriate steps to make it possible to routinely acquire this information.

Action(s) Taken and/or Pending

The Commissioner of Internal Revenue stated that the TCMP survey of tax year 1994 returns filed in 1995 would examine 153,000 returns of which 92,000 will be Form 1040 based—33,000 nonbusiness and 59,000 business. All income, deduction, and exemption items on the returns are to be examined, which should enable IRS to analyze the levels of compliance related to underreporting of tax-exempt interest.

Related GAO Product(s)

GAO/HRD-92-81, 09/01/92 and GAO/HRD-93-42, 03/29/93

Summaries of Tax-Related Products Issued Before Fiscal Year 1994 With Open Recommendations to Congress as of December 31, 1994

Open Recommendations

Open Recommendation

Congress may wish to consider revising current tax law to allow IRS to use collection performance in determining compensation and rewards for its collection staff as long as other criteria, such as fair and courteous treatment of taxpayers, are also considered (GAO/GGD-93-67, 05/11/93)

Summary

In response to a request by the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we reported on the options available to IRS to enhance its collection of delinquent federal taxes. Specifically, we examined whether IRS could strengthen its tax collection programs by adopting private sector or state collection techniques.

We found that IRS' ability to collect delinquent taxes has been hampered by self-imposed and external constraints. For example, IRS has generally followed a lengthy and rigid three-stage collection process that (1) because of convention, begins with a series of written notices, or bills, sent to delinquent taxpayers over a period of about 6 months followed by telephone calls and ends with visits to delinquent taxpayers; (2) because of legal restrictions, IRS handles all aspects of delinquent tax collection itself and does not evaluate or reward its collection staff on the basis of collection performance; and (3) because of inadequate information systems, IRS pursues delinquent accounts without knowing whether the amounts recorded in the accounts are valid receivables and with only limited knowledge about the characteristics of the delinquent taxpayers.

We noted that (1) although IRS and state tax departments currently cooperate in many tax administration projects, only about 10 percent of these projects are directly related to tax collection; (2) IRS may have opportunities for expanding cooperative projects with states that are directly related to collecting delinquent federal taxes; and (3) concluding from our survey of states, more than half of the states with an opinion about participating in joint tax collection projects with IRS would consider engaging in such projects if they were compensated.

We concluded that since IRS competes with private collection companies and state governments for payments from debtors, IRS should adopt collection strategies that are more effective than its current approaches, including (1) early telephone contact with delinquent taxpayers, (2) customized handling of delinquency cases, (3) expanded use of cooperative efforts with state governments, and (4) use of private collection companies.

We also concluded that, for IRS to enhance its collection of delinquent federal taxes, certain external and internal changes would have to occur.

Matter(s) for Congressional Consideration

Congress may wish to consider revising current tax law to allow IRS to use collection performance in determining compensation and rewards for its collection staff as long as other criteria, such as fair and courteous treatment of taxpayers, are also considered.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should (1) restructure IRS' collection organization to support earlier telephone contact with delinquent taxpayers and determine how to use current collection staff in earlier, more productive phases of the collection cycle; (2) develop detailed information on delinquent taxpayers and use it to customize collection procedures; (3) identify and implement ways to increase cooperation with state governments in collecting delinquent taxes. We also recommended that the Commissioner allow the Assistant Commissioner (Collection) to use private collection companies, on a test basis, to support IRS' collection efforts as permitted by current law.

Action(s) Taken and/or Pending

In 1995, IRS plans to change its collection procedures by (1) reducing the number of notices it sends taxpayers and (2) initiating earlier telephone contact. IRS has future plans, such as analyzing information from various databases to identify the characteristics of tax debtors, which should help in customizing collections. Cooperative agreements between IRS and individual states have increased and efforts are continuing to expand the level of cooperation that currently exists. No further IRS action was taken on our other recommendations, nor was any legislative action taken as of December 1994.

Related GAO Product(s)

GAO/T-GGD-90-19, 02/20/90; GAO/GGD-92-23, 12/10/91; and GAO/IMTEC-92-63, 09/21/92

Open Recommendation

Congress may wish to consider several options to enhance tax-exempt bond voluntary compliance, by (1) adopting other penalties for specific kinds of noncompliance and (2) permitting the disclosure of some tax-exempt, bond-related tax information, with appropriate safeguards (GAO/GGD-93-104, 05/10/93)

Summary

In a report to the Chairman of the Subcommittee on Human Resources and Intergovernmental Relations, House Committee on Government Operations, we assessed IRS' efforts to oversee compliance with tax-exempt bond requirements.

We found that IRS' principal tax-exempt bond enforcement effort, the Expanded Bond Audit Program, had concentrated almost exclusively on possible noncompliance cases that were identified by others and that were a part of an alleged surge in abusive bonds issued in anticipation of the stricter requirements in the Tax Reform Act of 1986. IRS recognized that its tax-exempt bond oversight efforts needed to be improved and had, therefore, begun some initiatives during the period studied and will take more initiatives on the basis of our report. We also concluded that Congress could take actions to enhance IRS' ability to deter abusive uses of tax-exempt bonds.

We found that several areas merited particular attention to improve IRS' tax-exempt bond oversight. IRS' near-total concentration on bond abuses predating the 1986 Tax Reform Act hampered its understanding of current compliance problems and IRS had not used tax-exempt bond return information to monitor issuers' compliance. In addition, IRS' plan for improving its tax-exempt bond oversight, while a positive step, did not provide a clear direction for integrating tax-exempt bond efforts throughout IRS.

We also found that the basic sanction for tax-exempt bond noncompliance available to IRS—collecting taxes on interest earned by bondholders—is inadequate to deter noncompliant behavior by those who are most responsible for abusive transactions. That is, this sanction applies to the innocent purchasers of the bond but not to the bond's issuer and the specialists who the issuer relies on to provide legal, financial, and other services. This aspect of the sanction is contrary to the commonly accepted theory that to provide the best deterrence, a penalty should be targeted to those responsible for the noncompliance. Legislation would be needed to develop better targeted penalties.

IRS' ability to deter abusive use of tax-exempt bonds could be further enhanced by bringing market forces to bear against abusers. To do so, we suggested that Congress may wish to explore options for modifying the present tax information disclosure prohibitions. If IRS could, in some way, disclose limited information about the results of its tax-exempt bond enforcement activities, market participants would be in a better position

to make judgments about the potential consequences of doing business with specific parties.

Matter(s) for Congressional Consideration

Congress may want to consider options to enhance tax-exempt bond voluntary compliance: (1) adoption of other penalties for specific kinds of noncompliance and (2) whether permitting the disclosure of some tax-exempt, bond-related tax information, with appropriate safeguards, would improve overall compliance incentives in the industry.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue (1) partially redirect existing Expanded Bond Audit Program efforts to include active testing of current market compliance, (2) identify and make better use of information to detect noncompliance and direct enforcement efforts, (3) provide final guidance for tax-exempt bond enforcement, and (4) reassess program staffing levels and locations and training needs in light of the program's future.

We also recommended that the Commissioner develop and implement a plan to guide efforts throughout IRS to make more effective use of resources to promote voluntary compliance in the tax-exempt bond industry and test the use of the penalty for promoting abusive tax shelters in tax-exempt bond enforcement.

Action(s) Taken and/or Pending

As of December 1994, Congress had not considered alternative penalties or revised disclosure provisions for tax-exempt bonds.

IRS generally agreed to implement most of the recommendations contained in our report. For example, IRS (1) transferred responsibility for tax-exempt bond enforcement activities to the Employee Plans and Exempt Organizations Division, (2) is identifying targeted areas of potential noncompliance by using information available on Forms 8038 and 8038G, (3) developed an action plan to promote voluntary compliance and guide tax exempt bond oversight efforts, (4) developed specialized training for examiners, and (5) is emphasizing public education and information dissemination.

Open Recommendation

Congress should consider enacting legislation that would substitute a residency test for the dependent support test if the

dependent lives with the taxpayer. If enacted, Congress also should consider eliminating the household maintenance test for filing as head of household status (GAO/GGD-93-60, 03/19/93)

Summary

In a report to the Chairman, Senate Committee on Finance, we reported on individual compliance in claiming dependent exemptions and filing status. We analyzed IRS' most recent compliance audits of individuals for 1988 to determine the extent and causes of noncompliance and to identify ways to improve compliance. According to IRS' audits, taxpayers erroneously claimed exemptions for an estimated 9 million dependents for 1988, improperly lowering their taxable income by an estimated $17 billion. Also, an estimated 3 million taxpayers claimed the wrong filing status.

According to our estimates, the primary source (73 percent) of erroneous dependent claims for 1988 was the taxpayer's failure to meet the dependent support test. Of those not meeting this test, taxpayers either did not (1) provide the necessary financial support or (2) have adequate records to show whether they provided the support. We found that the support test was complex because it required detailed records and difficult financial analyses. After analyzing four options, we found only one that eliminated the complexity of the support test by replacing it with a residency test. Under this test, taxpayers can claim dependents who lived with them for at least 6 months, if they meet other dependency tests.

If the support test were replaced, complexity would not be reduced for taxpayers claiming head of household filing status. These taxpayers would still have to meet a maintenance test, which is nearly as complex as the support test. IRS data showed that the head of household accounted for an estimated 82 percent of all filing status errors in 1988.

Even if Congress simplified these tests, IRS could do more to detect any remaining erroneous dependent claims. For 1988, IRS matched about 3 percent of dependents' social security numbers to identify dependents who were claimed on more than one tax return or did not meet income and age requirements. If IRS had a 100-percent matching program for 1988, IRS could have generated an estimated $751 million in tax revenues at a cost that ranges between $45 million to $60 million. A 100-percent matching program coupled with the simpler rules would address an estimated 4.3 million (71 percent) of the 6.1 million erroneous dependent claims.

Matter(s) for Congressional Consideration

Congress should consider enacting legislation that would substitute a residency test for the dependent support test if the dependent lives with the taxpayer. If this legislation is enacted, Congress also should consider eliminating the household maintenance test for filing as head of household status.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should correct the operational problems in IRS' limited matching program and implement a 100-percent computer matching program to identify erroneous dependent claims.

Action(s) Taken and/or Pending

Congress considered this legislation in 1993 but not in 1994. The recommendation to IRS had not been implemented as of December 1994, but IRS is planning to implement it as more computer capability becomes available.

Open Recommendation

Congress may want to consider legislation that would require states to send IRS and taxpayers an annual information return on any cash rebates for real estate tax payments (GAO/GGD-93-43, 01/19/93 and GAO/T-GGD-93-46, 09/21/93)

Summary

In a report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the IRS, Senate Committee on Finance, and in subsequent testimony before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, we discussed the issue of overstated real estate tax deductions among individual taxpayers. We reviewed IRS' random compliance audits of individuals and contacted 171 local governments that collected $100 million or more in real estate taxes.

We found that IRS audits showed individuals overstated their 1988 real estate tax deduction by an estimated $1.5 billion nationwide. This level of noncompliance resulted in an estimated $300 million federal income tax loss for 1988 and about $400 million for 1992. However, we found that the level of noncompliance and resulting tax loss were much greater. IRS audits detected only an estimated $37 million (29 percent) of $127 million in overstated deductions in three locations.

The overstated deductions arose from taxpayers deducting Montgomery County, Maryland, user fees and not reporting New Jersey and Minnesota

real estate tax rebates. The reasons for such noncompliance included (1) inadequate IRS instructions on what to deduct or report and (2) confusing real estate tax bills that did not clearly distinguish taxes from user fees.

Matter(s) for Congressional Consideration

Congress may want to consider legislation that would require states to send IRS and taxpayers an annual information return on any cash rebates for real estate tax payments.

Recommendation(s) to IRS

The Commissioner of Internal Revenue should (1) include rules on the tax deductibility of user fees and rebates in tax return instructions and consider ways, such as an optional worksheet, to help taxpayers calculate the real estate tax deduction; (2) work cooperatively with local governments to revise their real estate tax bills to identify user fees, label these charges as not tax deductible, and notify taxpayers that the local government may report the deductible tax to IRS; (3) notify examiners to check local records on user fees and state records on rebates to verify real estate tax deductions; and (4) negotiate agreements with local governments on sharing data on real estate tax payments made by individuals and use the data in IRS' enforcement programs.

Action(s) Taken and/or Pending

IRS has improved its instructions on deducting real estate taxes and drafted changes to the tax return to clarify that taxpayers should not deduct user fees. IRS also has notified its examiners to better check support for the deduction and has been working with local governments on revisions to their bills. Congress is awaiting the outcome of IRS' work with the local governments before considering the need for any legislation.

Open Recommendation

Congress should amend the disclosure provisions of the Internal Revenue Code to (1) give the Secretary of the Treasury permanent authority to disclose to federal agencies information reported on IRS Form 8300 and (2) allow states access to the data on the same basis as federal law enforcement agencies (GAO/GGD-93-1, 10/15/92)

Summary

In response to a request from the Chairman of the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, we identified (1) actions taken by states to combat money

laundering and (2) actions taken by the federal government to assist the states.

Federal efforts over the past 20 years to curtail money laundering operations and identify and locate income derived from criminal activity have developed into an approach using legislation and requiring reporting of large currency transactions. In 1970, the Bank Secrecy Act (BSA) was enacted which required individuals, banks, and other financial institutions to report large foreign and domestic financial transactions to the Department of the Treasury. In 1984, section 60501 was added to the Internal Revenue Code and required certain persons engaged in a trade or business who receive more than $10,000 in cash payments in certain transactions to file a report on an IRS Form 8300 with IRS.

Although a growing number of states have recognized the importance of attacking money laundering as a means of reducing the profitability of crime, their efforts vary considerably. Only a few states use both legislation and financial transaction reports as federal law enforcement agencies do. Most states make only limited use of the BSA data available from the Treasury.

Although IRS Form 8300 provides the same basic information as BSA reports, the Internal Revenue Code does not allow disclosure of the data to entities other than federal agencies for law enforcement purposes.

Recommendation(s) to Congress

Congress should amend the disclosure provisions of the Internal Revenue Code to give the Secretary of the Treasury permanent authority to disclose to federal agencies information reported on IRS Form 8300 and to allow states access to the data on the same basis as federal law enforcement agencies.

Recommendation(s) to the Department of the Treasury

If IRS Form 8300 information is made available to the states, the Treasury should make it available to states on magnetic media ready for computer processing, as are BSA data.

Action(s) Taken and/or Pending

The Commissioner of Internal Revenue generally agreed with our recommendations to Congress and said that if the disclosure provisions were amended, IRS would work closely with the Treasury to provide

access to the states. Although several bills have been introduced, none had been enacted as of December 1994.

Open Recommendation

Congress needs to (1) clarify the rules for classifying workers along the lines that we recommended in our 1977 report, by amending the law to exclude from the common law definition of "employee" certain classes of workers and (2) consider legislation to improve independent contractor compliance through withholding and/or improved information reporting (GAO/GGD-92-108, 07/23/92 and GAO/T-GGD-92-63, 07/23/92)

Summary

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

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

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

Because of the continual noncompliance of independent contractors, IRS began the nationwide ETEP in 1988. IRS planned to reduce this noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. We reported that 6,900 ETEP audits through December 1991 proposed assessments of

$468 million and reclassified 338,000 workers as employees. Since fiscal year 1989, IRS data have shown that 90 percent of ETEP audits have found misclassified workers.

We found that while the classification rules still need clarifying, IRS could use approaches in addition to ETEP to help improve independent contractor compliance. For example, IRS could require businesses to (1) withhold taxes from payments to independent contractors and (2) improve compliance in filing information returns on payments to independent contractors. We concluded that either approach should help collect more of the taxes owed through means other than retroactive tax assessments under ETEP. While we acknowledged that both approaches would increase the burden on independent contractors and businesses that use them, we believed that both approaches had merit.

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

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

Recommendation(s) to Congress

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

Action(s) Taken and/or Pending

As of December 1994, Congress had considered but had not enacted either of our recommendations.

Related GAO Product(s)

GAO/GGD-89-107, 09/25/89; GAO/GGD-91-94, 08/28/91; and GAO/GGD-77-88, 11/21/77

Open Recommendation

Congress should amend the Internal Revenue Code to allow HUD temporary access to federal tax data to validate its cost-benefit analysis of using tax data to identify subsidized households' misreporting of income (GAO/HRD-92-60, 07/17/92)

Summary

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

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

Recommendation(s) to HUD

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

Recommendation(s) to Congress

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

Action(s) Taken and/or Pending

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) grants HUD temporary access to federal tax data for income verification under certain housing assistance programs in section 13404 until September 1998. Proposed rules outlining a matching program with IRS and the Social Security Administration (SSA) are awaiting HUD clearance, and revised consent forms to permit IRS and SSA matching were issued in June and September 1994. A pilot income verification program with appropriate data safeguards is expected in 1995. The Congressional Budget Office estimated that over $1 billion would be saved between 1994 and 1998 because of this recommendation.

Open Recommendation

Congress may wish to consider clarifying the Internal Revenue Code to (1) specifically provide IRS authority to withdraw a notice of a lien when it is in the best interests of the taxpayer and the government and (2) eliminate the uncertainty over whether taxpayers should be given 21 days to correct an erroneous levy under section 6332(c) (GAO/GGD-92-23, 12/10/91 and GAO/T-GGD-92-09, 12/10/91)

Summary

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

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

Matter(s) for Congressional Consideration

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

Recommendation(s) to IRS

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

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

Action(s) Taken and/or Pending

In October 1992, Congress passed the Revenue Act of 1992, which, among other things, contained a provision giving IRS authority to withdraw a notice of a lien when it is in the best interests of the taxpayer and the government. On November 3, 1992, however, the act was vetoed by the President. As of December 1994, no further action had been taken.

Open Recommendation

Congress should consider modifying the Targeted Jobs Tax Credit Program by imposing new eligibility requirements if it wishes to encourage employers using the program to take special actions that benefit members of the targeted group (GAO/HRD-91-33, 02/20/91)

Summary

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

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

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

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

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

Matter(s) for Congressional Consideration

If Congress wishes a higher proportion of employers using the Targeted Jobs Tax Credit Program to take special actions that benefit members of the targeted groups, it could modify the program by imposing new requirements. For example, program requirements might involve employer outreach efforts to eligible populations, prescreening to determine eligibility before the hiring decision, or providing additional training or supervision to eligible workers to increase the likelihood of retention.

Action(s) Taken and/or Pending

No legislative action had been taken on this matter as of December 31, 1994, when this program expired. When this happened in the past, the program was reauthorized, sometimes retroactively.

Legislative Actions Taken in 1994 on GAO Recommendations

Closed Recommendations

Recommendation

Congress should require the Federal Deposit Insurance Corporation and the Resolution Trust Corporation to issue information returns on forgiven debts that exceed $600. If this is proven to be cost effective, Congress also may wish to explore whether extending similar information reporting to other institutions is warranted (GAO/GGD-93-42, 02/17/93)

Summary

In a report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the IRS, Senate Committee on Finance, we measured the impact of information returns on individual taxpayers who reported income from forgiven debts. We tested a random sample of debts forgiven by the Federal Deposit Insurance Corporation (FDIC). The test covered 1986—when FDIC filed information returns on its forgiven debts and 1989—the most recent year for which FDIC did not file these returns when we did our test.

We found 1 percent voluntary compliance in reporting income from FDIC-forgiven debts when the taxpayers had no information returns compared to 48 percent when they had information returns. Moreover, by computer matching the information returns and pursuing potential noncompliance, IRS determined that 20 percent failed to report their forgiven debt income and owed taxes for 1986, while 12 percent did not owe taxes. The match found another 20 percent who may have underreported forgiven-debt income, but IRS did not pursue these potential underreporters, largely because of limited resources. For those 1986 cases that were pursued, IRS generated an estimated $37 in recommended taxes for every $1 that IRS spent. For those cases in which IRS had complete records, 83 percent of the taxpayers had paid these recommended taxes.

When FDIC did not file information returns for 1989, an estimated $78 million in federal income taxes was lost. FDIC's forgiven debts totaled $2.2 billion in 1989 and increased to over $8.4 billion by 1991. This 1991 total would rise to $10.9 billion if the Resolution Trust Corporation's (RTC), whose forgiven debts approximated FDIC's, were included.

If Congress extends information reporting to debts forgiven by FDIC and RTC, taxpayers with debts forgiven by FDIC or RTC will be subject to more IRS scrutiny than those whose debts are forgiven by private lending institutions (e.g., banks and savings and loans). The amount of debt forgiven by these institutions has doubled to $40 billion from 1985 to 1990. Because loans in the FDIC samples came from banks and were selected

randomly, taxpayers' compliance in reporting this $40 billion would likely be similar to the 1-percent compliance we found for FDIC's debts that were forgiven but not covered by information returns.

Recommendation(s) to Congress

To improve taxpayer compliance in reporting forgiven debt, Congress should require FDIC and RTC to issue information returns on forgiven debts that exceed $600.

Matter(s) for Congressional Consideration

If FDIC and RTC information reporting on forgiven debts proves to be cost effective, Congress also may wish to explore whether extending similar information reporting to other institutions is warranted.

Recommendation(s) to IRS

If Congress extends information reporting, IRS should use the information returns on forgiven debts in its enforcement programs.

Action(s) Taken and/or Pending

In August 1993, Congress enacted legislation that extended information reporting to debts forgiven by FDIC, RTC, and certain private financial institutions. The Joint Committee on Taxation estimated that this provision would generate $484 million in revenue over 5 years. In September 1993, Congress considered a legislative proposal to extend such reporting to all financial institutions. No action was taken.

As of December 1994, IRS had issued proposed regulations for filing the information returns and convened a public hearing. On the basis of comments made at the hearing, IRS plans to issue revised regulations that clarify various reporting issues. IRS also developed a system for processing and matching the information returns. This information return filing requirement is slated to start for tax year 1994.

Recommendation

Congress should explore the level of motor fuel excise tax evasion with the responsible federal agencies and affected industries. If evasion is sufficiently high, Congress should consider moving the collection of excise taxes to the point at which gasoline first leaves the refinery or is first imported (GAO/GGD-92-67, 05/12/92)

Summary

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

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

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

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

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

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

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

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

Matter(s) for Congressional Consideration

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

Action(s) Taken and/or Pending

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) moved the motor fuel tax collection point up in the distribution system and incorporated a fuel dying requirement. As a result, collections should increase by $1 billion from 1994 through 1998.

Listing of Open Recommendations to Congress Before and During Fiscal Year 1994

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The tax-writing committees should explore, within the existing framework, opportunities to exercise more scrutiny over "indirect" spending through tax expenditures as a part of the annual budget process	60
Congress may wish to consider revising current tax law to allow IRS to use collection performance in determining compensation and rewards for its collection staff as long as other criteria, such as fair and courteous treatment of taxpayers, are also considered	84
Congress may wish to consider several options to enhance tax-exempt bond voluntary compliance, by (1) adopting other penalties for specific kinds of noncompliance and (2) permitting the disclosure of some tax-exempt, bond-related tax information, with appropriate safeguards	85
Congress should consider enacting legislation that would substitute a residency test for the dependent support test when the dependent lives with the taxpayer. If enacted, Congress also should consider eliminating the household maintenance test for filing as head of household status	87
Congress may want to consider legislation that would require states to send IRS and taxpayers an annual information return on any cash rebates for real estate tax payments	89
Congress should amend the disclosure provisions of the Internal Revenue Code to (1) give the Secretary of the Treasury permanent authority to disclose to federal agencies information reported on IRS Form	90

8300 and (2) allow states access to the data on the same basis as federal law enforcement agencies	
Congress needs to (1) clarify the rules for classifying workers along the lines that we recommended in our 1977 report, by amending the law to exclude from the common-law definition of "employee" certain classes of workers and (2) consider legislation to improve independent contractor compliance through withholding and/or improved information reporting	92
Congress should amend the Internal Revenue Code to allow HUD temporary access to federal tax data to validate its cost-benefit analysis of using tax data to identify subsidized households' misreporting of income	94
Congress may wish to consider clarifying the Internal Revenue Code to (1) specifically provide IRS authority to withdraw a notice of a lien when it is in the best interests of the taxpayer and the government and (2) eliminate the uncertainty over whether taxpayers should be given 21 days to correct an erroneous levy under section 6332(c)	95
Congress should consider modifying the Targeted Jobs Tax Credit Program by imposing new eligibility requirements if it wishes to encourage employers using the program to take special actions that benefit members of the targeted group	96

Listing of Recommendations Made in Fiscal Year 1994 to the Commissioner of Internal Revenue and to Other Agency Heads

Accounts Receivable and Collection Activities

Establish guidelines for determining taxpayers' ability to pay delinquent tax debts; select income levels at which Currently Not Collectible (CNC) accounts will be reactivated; develop criteria to require minimum payments from delinquent taxpayers with incomes above a specified level; ensure oversight mechanisms adequate to identify inappropriate CNC determinations; develop reporting standards that allow identification of problems needing IRS-wide corrective action; expedite collection process for reactivated accounts; and eliminate 65-week reactivation hold period	21
Develop the indicators necessary to evaluate the Offer in Compromise Program as a compliance and collection tool and determine causes of variability in district office acceptance rates	24

Budget/Finance

Coordinate and oversee internal control and accounting activities to (1) establish and implement proper written procedures that provide for the identification, documentation, and correction of all material weaknesses; (2) provide classroom training and guidance materials to all FMFIA review staff; (3) develop effective corrective action plans that address the fundamental causes of the weaknesses; and (4) verify the effectiveness of corrective actions before removing reported weaknesses from IRS' records	26
Develop a way to capture information on the specific taxes collected for trust funds; determine the trust fund revenue information needs of other agencies and provide such information, as appropriate; and identify the information needed for revenue reporting and related sources and develop written policies and procedures for compiling this information	27
Improve controls over operating funds to ensure that budget authority for operations is not exceeded, improve processes and controls to ensure payments for goods and services are proper and timely, and improve systems and processes to ensure reliable reports on operating funds	28

	Implement recommendations from our examination of IRS' fiscal year 1993 financial statements	31
Compliance	Develop system for managing and monitoring all sole proprietor compliance projects; identify projects that would address the most noncompliant sole proprietor market segments and analyze underlying causes of noncompliance; work with trucking groups and other market sectors to improve record keeping; and clarify information return filing instructions for insurance companies and work with them to improve compliance	41
	Improve the Coordinated Examination Program (CEP) by providing the CEP director with authority over CEP resources in the districts; improving IRS' tools for collecting information from CEP corporations during the audit; expanding measures in CEP and appeals to a common measure; increasing revenue agents' knowledge of specific industries in which they do CEP audits and use staff rotation to help; ensuringappropriate evaluation and coordination before conceding taxes in opposition to IRS legal positions; proposing legislative changes that will permanently resolve recurring tax disputes; correcting IRS databases to allow for a more accurate computation of the collection rate but meanwhile use the 22 percent collection rate; and testing ways to measure CEP corporate compliance and the related tax gap	46
IRS Modernization	Assess knowledge, skills, and abilities of existing workforce; identify specific staffing requirements for all TSM projects; and compare staffing requirements to workforce's current skill inventory and develop retraining and redeployment plans to meet TSM project requirements	55
	Define regional office roles and responsibilities to clearly support field office needs and contribute to accomplishing IRS' mission. In doing so, allow field offices to exchange information directly with the National Office without going through the region; ensure that regional office reviews are not duplicative and focus	57

	on solving problems; and remove regional offices from chain of command where span of control is not an issue	
Taxpayer Assistance	Analyze the fraud cases identified from information provided by RAL banks; determine which RAL banks were used for fraudulent refunds to help decide whether certain banks warrant special attention; and allow taxpayers to submit the installment agreement request form electronically	60
	Better inform taxpayers of situations that can be handled by telephone; clarify procedures for responding to taxpayer requests; improve timeliness indicators and adopt timeliness goals; provide service centers with clear guidelines; determine if revised guidelines improve quality of responses; and implement Correspondence Task Force recommendations	62
	Develop better measures of one-stop service that allow IRS to gauge progress in meeting its one-stop service goal; identify and correct problems that might impede progress; and compare delivery of one-stop service among various taxpayer services available at IRS	63
Tax Policy	OMB in consultation with the Treasury should decide how to portray tax expenditure information in the budget so that tax expenditures and related outlay information can show the relative effectiveness of federal spending within functional areas	68
Other	The Department of Labor should increase the use of penalties authorized by ERISA by establishing procedures to routinely review IRS referrals of potential violators and using decentralized legal staff to help assess prohibited transaction penalties; and determine if additional administrative guidance and/or legislative changes are needed to remedy confusion and enhance penalty enforcement	80
	Identify the amount of additional taxes that have been assessed on social security benefits through IRS'	81

underreporter program; conduct a detailed study of tax returns to better identify the benefits of having taxpayers report tax-exempt income; and obtain data on the costs of reporting and processing such information

Chronological Listing of GAO Products on Tax Matters Issued in Fiscal Year 1994

Tax Administration: IRS Can Do More to Collect Taxes Labeled "Currently Not Collectible" (GAO/GGD-94-2)	10/08/93
Financial Management: IRS' Self-Assessment of Its Internal Control and Accounting Systems Is Inadequate (GAO/AIMD-94-2)	10/13/93
Environmental Infrastructure: Effects of Limits on Certain Tax-Exempt Bonds (GAO/RCED-94-2)	10/28/93
Money Laundering: Progress Report on Treasury's Financial Crimes Enforcement Network (GAO/GGD-94-30)	11/08/93
Tax Administration: Collecting Delinquent Taxes and Communicating with Taxpayers (GAO/T-GGD-94-50)	11/09/93
Farmers Home Administration (FmHA) Forgiven Debts (GAO/GGD-94-25R)	11/10/93
Money Laundering: Characteristics of Currency Transaction Reports Filed in Calendar Year 1992 (GAO/GGD-94-45FS)	11/10/93
Tax Administration: IRS' New Business Vision (GAO/T-GGD-94-58)	11/17/93
Paperwork Reduction: Reported Burden Hour Increases Reflect New Estimates, Not Actual Changes (GAO/PEMD-94-3)	12/06/93
Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22)	12/21/93
Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65)	12/22/93
Tax Administration: Changes Needed to Cope with Growth in Offer in Compromise Program (GAO/GGD-94-47)	12/23/93
Improving Government: Actions Needed to Sustain and Enhance Management Reforms (GAO/T-OCG-94-1)	01/27/94
Tax Administration: State Tax Administrators' Views on Delinquent Tax Collection Methods (GAO/GGD-94-59FS)	02/02/94
International Taxation: IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A (GAO/GGD-94-61)	02/04/94
Financial Management: IRS Does not Adequately Manage Its Operating Funds (GAO/AIMD-94-33)	02/09/94
Tax Administration: Electronic Filing Fraud (GAO/T-GGD-94-89)	02/10/94
Money Laundering: Project Gateway (GAO/GGD-94-91R)	02/15/94
Tax Systems Modernization: Status of Planning and Technical Foundation (GAO/T-AIMD-GGD-94-104)	03/02/94
Budget Process: Some Reforms Offer Promise (GAO/T-AIMD-94-86)	03/02/94
Addressing the Deficit: Budgetary Implications of Selected GAO Work (GAO/OCG-94-3)	03/11/94
Money Laundering: The Volume of Currency Transaction Reports Filed Can and Should Be Reduced (GAO/T-GGD-94-113)	03/15/94
Tax Policy and Administration: 1993 Annual Report on GAO's Tax-Related Work (GAO/GGD-94-82)	03/31/94
Tax Administration: Analysis of IRS' Budget Request for Fiscal Year 1995 (GAO/GGD-94-129)	04/20/94
Tax Policy: Health Insurance Tax Credit Participation Rate Was Low (GAO/GGD-94-99)	05/02/94
White House: Travel Office Operations (GAO/GGD-94-132)	05/02/94
Tax Gap: Many Actions Taken but A Cohesive Compliance Strategy Needed (GAO/GGD-94-123)	05/11/94
Tax Policy: Pharmaceutical Industry's Use of the Research Tax Credit (GAO/GGD-94-139)	05/13/94
Paperwork Reduction Act: Opportunity to Strengthen Government's Management of Information and Technology (GAO/T-AIMD/GGD-94-126)	05/19/94
Tax Administration: Information on IRS Executive Relocations and Travel Matters (GAO/GGD-94-140)	06/01/94
Tax Administration: More Improvement Needed in IRS Correspondence (GAO/GGD-94-118)	06/01/94
Tax Policy: Tax Expenditures Deserve More Scrutiny (GAO/GGD/AIMD-94-122)	06/03/94
Feasibility of a Meter to Capture Business Income (GAO/GGD-94-158R)	06/07/94
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120)	06/15/94
Effect of Proposed IRS Compliance Initiatives on Budget Deficits (GAO/GGD-94-141R)	06/16/94
Tax Administration: Information on IRS' International Tax Compliance Activities (GAO/GGD-94-96FS)	06/27/94

(continued)

Tax Systems Modernization: Automated Underreporter Project Shows Need for Human Resource Planning (GAO/GGD-94-159)	07/08/94
GSEs: Implications of Removing State and Local Tax Exemption (GAO/T-GGD-94-182)	07/14/94
IRS Automation: Controlling Electronic Filing Fraud and Improper Access to Taxpayer Data (GAO/T-AIMD/GGD-94-183)	07/19/94
Internal Revenue Service: Changes Needed in the Role of Regional Offices (GAO/GGD-94-160)	07/26/94
Financial Audits: CFO Implementation at IRS and Customs (GAO/T-AIMD-94-164)	07/28/94
Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175)	08/02/94
Tax Administration: Improving Independent Contractor Compliance With Tax Laws (GAO/T-GGD-94-194)	08/04/94
Pension Plans: Stronger Labor ERISA Enforcement Should Better Protect Plan Participants (GAO/HEHS-94-157)	08/08/94
Tax Administration: Better Measures Needed to Assess Progress of IRS' One-Stop Service (GAO/GGD-94-131)	08/29/94
Correspondence on the Dependent Exemption for Noncustodial Parents (GAO/GGD-94-200R)	08/31/94
Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement (GAO/GGD-94-70)	09/01/94
Social Security: Trust Funds Can Be More Accurately Funded (GAO/HEHS-94-48)	09/02/94
Information on Transfer Pricing (GAO/GGD-94-206R)	09/15/94
Tax Administration: Data on the Tax Compliance of Sweatshops (GAO/GGD-94-210FS)	09/23/94
Undelivered Tax Refunds: IRS' Handling of Undelivered Income Tax Refund Checks (GAO/T-GGD-94-186)	09/26/94
IRS Use of Customs Data (GAO/GGD-94-217R)	09/30/94

Listing of Assignments for Which GAO Was Authorized Access to Tax Data in Fiscal Year 1994 Under 26 U.S.C. 6103(i)(7)(A)

Subject matter	Objectives
Administration of original issue discount instruments	To determine (1) how IRS uses information reported by issuers of publicly issued original issue bonds to assure compliance, (2) whether Original Issue Discount information reporting can be expanded or modified to increase taxpayer compliance, and (3) whether lessons from IRS' regulatory experience with the Original Issue Discount provisions can be applied to the taxation of other new financial products.
Business taxpayer compliance burden	To (1) understand the process by which business taxpayers identify and comply with their tax requirements and the ways in which the compliance process is considered burdensome and (2) determine the feasibility of obtaining reliable information from businesses on their tax compliance costs.
Audits of large corporations	To (1) compute the rate at which taxes recommended in these audits are assessed over time, (2) analyze factors that affect this rate, and (3) identify the status of ongoing and planned changes to improve these audits.
Tax compliance of sweatshops	To identify (1) the extent of tax compliance by sweatshops and (2) IRS' and states' efforts to improve that compliance.
Form 5500	To determine whether (1) Form 5500 information can be provided in a more timely and cost effective manner; (2) the accuracy, processing, enforcement, targeting, and management of this information can be improved; and (3) the information presently requested on the form is adequate to meet agency needs. Form 5500, with its attendant schedules, is the principal financial reporting mechanism used by the Department of Labor, IRS, and the Pension Benefit Guaranty Corporation to oversee compliance with the Employee Retirement Income Security Act of 1974 and obtain relevant statistical and research data.
IRS' consolidated statement of financial position on September 30, 1994	To (1) determine the extent of financial management and internal control problems needing correction, (2) identify needed audit procedures to opine on fiscal year 1994 financial statements, (3) assist IRS in preparing appropriate financial statements, and (4) analyze available data maintained on IRS operations to attest to the adequacy of such data.
IRS' Taxpayer Compliance Measurement Program (TCMP)	To (1) monitor IRS' TCMP design efforts, (2) identify issues that IRS may be excluding from TCMP, and (3) review IRS audits to assess the quality of the TCMP work.
Long-term effects of training under the Job Training Partnership Act	To determine (1) the earnings and employment outcomes of persons who have participated in training programs sponsored under the Job Training Partnership Act, and (2) how these outcomes compare to those that might have occurred in the absence of training.
Invalid segment of the Individual Master File (IMF)	To determine (1) why the number of accounts on the invalid segment of the IMF are increasing, (2) how the invalid segment of the IMF affects taxpayers and IRS' processing and enforcement operations, and (3) what can be done to reduce or minimize the growth of accounts on the invalid segment.

Major Contributors to This Report

General Government Division, Washington, D.C.

David J. Attianese, Assistant Director, Tax Policy and Administration Issues
Rodney F. Hobbs, Evaluator-in-Charge
Bryon S. Gordon, Evaluator
Gillian M. Martin, Evaluator
Judy A. Lanham, Secretary

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