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Status of Tax Systems Modernization, Tax Delinquencies, and the Potential for Return-Free Filing

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Summary

Two of the most critical and long-standing operational issues facing the Internal Revenue Service (IRS) are the management and implementation of its multibillion dollar Tax Systems Modernization (TSM) and the collection of tens of billions of dollars in tax debts. For years GAO has voiced concern over IRS' planning and management of TSM and its efforts to accurately report and collect taxes owed the government. Because of the significance of these issues and the problems associated with them, GAO has included them on its list of high-risk areas and has made numerous recommendations to correct pervasive management and technical weaknesses. IRS is taking steps to address these problems, but their underlying causes remain and continue to hinder IRS' efforts for significant improvement.

Regarding TSM, GAO is concerned with weaknesses in (1) electronic filing strategy, (2) strategic information management; (3) software development; (4) systems architecture, integration, and testing; and (5) accountability and control of systems modernization. Because of these weaknesses, GAO believes that the government's multibillion dollar investment in TSM is at serious risk. Until these weaknesses are corrected, IRS' ability to successfully complete TSM will remain highly questionable.

In addition to more effective use of technology, as IRS pursues its vision of a modern, almost paperless system, more filing options could provide benefits for taxpayers and IRS. For example, if certain impediments can be overcome, return-free filing can offer many taxpayers reduced burden while also reducing the amount of paper IRS must process.

In tax collection, IRS has made little progress in resolving its accounts receivable problems. It continues to contend with (1) inaccurate and unreliable information; (2) antiquated computer systems and a rigid collection process; (3) unintended problems with safeguards against potential taxpayer abuses; (4) a lack of accountability in its organizational structure; and (5) staffing imbalances. As a result, IRS cannot accurately identify how much money the government is owed or how much of the debt is collectible.

Statement

Mr. Chairman and Members of the Subcommittee:

We are pleased to have this opportunity to assist in your review of the Internal Revenue Service's (IRS) operations. As you requested, our statement today will cover three areas (1) IRS' efforts to correct management and technical weaknesses that have impeded its Tax Systems Modernization (TSM) program as well as whether IRS can successfully complete the program within the time frames and cost figures it has established; (2) IRS efforts to collect delinquent tax debts and deal with its accounts receivable problems; and (3) the viability of return-free filing as an option to the current tax filing system.

Our testimony, which is based on past reports and ongoing work, makes the following points:

- IRS' efforts to modernize tax processing are jeopardized by persistent and pervasive management and technical weaknesses. Our July 1995 report made specific recommendations that were intended to correct many of these weaknesses by December 31, 1995.[1] IRS has initiated some activities to address these weaknesses. However, these weaknesses have not been corrected and ongoing efforts provide little assurance that weaknesses will be corrected. IRS has continued with plans to spend billions more on TSM solutions with little confidence of successfully delivering effective systems within established TSM time frames and cost figures.
- Inaccurate data and IRS' antiquated and rigid collection process continue to hinder its efforts to stem the growth of its accounts receivable and improve collection of delinquent debts. Little progress has been made in resolving the underlying causes of these problems since 1988, when IRS' accounts receivable was first identified as a high-risk area. Both the private sector and other government entities could offer IRS valuable lessons in improving its collections performance.
- The size of IRS' total inventory of tax debts—$166 billion at the end of fiscal year 1994—is deceiving because it is an accumulation of debts for a 10-year period and includes debts that are clearly uncollectible—i.e., those of defunct businesses and deceased taxpayers. The inventory also includes accounts that have been established for compliance reasons and that may not be valid receivables. According to IRS estimates, the net result is that only about 20 percent of the inventory, or about $35 billion, is potentially collectible.

[1] Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995).

- According to IRS data, collections of delinquent taxes, while increasing to $25.1 billion in fiscal year 1995, are still below the high of $25.5 billion collected in fiscal year 1990. Because of IRS' decision to absorb fiscal year 1996 budget cuts by reducing collections staffing, IRS projects that collections will decrease about 13 percent in fiscal year 1996—to about $21.9 billion.
- While return-free filing could provide benefits to both the taxpayer and IRS, certain impediments would have to be overcome for successful implementation.

TSM Will Not Succeed Unless Persistent Management and Technical Weaknesses Are Corrected

Modernizing tax processing is key to IRS' vision of a virtually paper-free work environment in which taxpayer information is readily available to IRS employees to update taxpayer accounts and respond to taxpayer inquiries. In July 1995, we reported on the need for IRS to have in place sound management and technical practices to increase the likelihood that TSM's objectives will be cost-effectively and expeditiously met.[2] A 1996 National Research Council report on TSM has a similar message.[3] Its recommendations parallel the more than a dozen recommendations we made involving IRS' (1) business strategy to reduce reliance on paper, (2) strategic information management practices, (3) software development capabilities, (4) technical infrastructures, and (5) organizational controls.

The Treasury, Postal Service and General Government Appropriations Act of 1996 "fences" $100 million in TSM funding until the Secretary of the Treasury reports to the Senate and House Appropriations Committees on the progress IRS has made in responding to our recommendations with a schedule for successfully mitigating deficiencies we reported.[4] The conference report on the act directed that we assess for the Committee the status of IRS' corrective actions.[5] As of March 4, 1996, the Secretary of the Treasury had not reported to the Committees on TSM. This testimony is a progress report to the Committee on actions taken as reported to us by IRS officials.

In our July report, we analyzed IRS' strategic information management practices, drawing heavily from our research on the best practices of

[2]GAO/AIMD-95-156, July 26, 1995.

[3]Continued Review of the Tax Systems Modernization of the Internal Revenue Service—Final Report, Computer Science and Telecommunications Board, National Research Council, 1996.

[4]Public Law 104-52, 11-19-95.

[5]H.R. Report No. 291, 104th Cong., 1st Session (1995).

private and public sector organizations that have been successful in improving their performance through strategic information management and technology. These fundamental best practices are discussed in our report Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology (GAO/AIMD-94-115, May 1994), and our Strategic Information Management (SIM) Self-Assessment Toolkit (GAO/Version 1.0, October 28, 1994, exposure draft).

To evaluate IRS' software development capability, we validated IRS' August 1993 assessment of its software development maturity based on the Capability Maturity Model (CMM) developed in 1984 by Carnegie Mellon University's Software Engineering Institute, a nationally recognized authority in the area. This model establishes standards in key software development processing areas (i.e., requirements management, project planning, project tracking and oversight, configuration management, quality assurance, and subcontractor management) and provides a framework to evaluate a software organization's capability to consistently and predictably produce high-quality products.

When we briefed the IRS Commissioner in April 1995 and issued our report documenting its weaknesses in July 1995, IRS agreed with our recommendations to make corrections expeditiously. At that time, we considered IRS' response to be a commitment to correct its management and technical weaknesses. In September 1995, IRS submitted an action plan to Congress explaining how it planned to address our recommendations. However, this plan, follow-up meetings with senior IRS officials, and other draft and "preliminary draft" documents received through early March 1996 have provided little tangible evidence that actions being taken will correct the pervasive management and technical weaknesses that continue to place TSM, and the huge investment it represents, at risk.

Our ongoing assessment has found that IRS has initiated a number of activities and made some progress in addressing our recommendations to improve management of information systems; enhance its software development capability; and better define, perform, and manage TSM's technical activities. However, none of these steps, either individually or in the aggregate, has fully satisfied any of our recommendations. Consequently, IRS today is not in an appreciably better position than it was a year ago to ensure Congress that it will spend its 1996 and future TSM appropriations judiciously and effectively.

IRS Still Does Not Have a Comprehensive Strategy to Maximize Electronic Filings

We reported that IRS was drowning in paper—a serious problem IRS can mitigate only through electronic tax filings. We noted that IRS would not achieve the full benefits that electronic filing can provide because it did not have a comprehensive business strategy to reach or exceed its electronic filing goal, which was 80 million electronic filings by 2001. IRS' estimates and projections for individual and business returns suggested that, by 2001, as few as 39 million returns may be submitted electronically, less than half of IRS' goal.

We reported that IRS' business strategy would not maximize electronic filings because it primarily targeted taxpayers who use a third party to prepare and/or transmit simple returns, are willing to pay a fee to file their returns electronically, and are expecting refunds. Focusing on this limited taxpaying population overlooked most taxpayers, including those who prepare their own tax returns using personal computers, have more complicated returns, owe tax balances, and/or are not willing to pay a fee to a third party to file a return electronically.

We concluded that, without a strategy that also targets these taxpayers, IRS would not meet its electronic filing goals or realize its paperless tax processing vision. In addition, if, in the future, taxpayers file more paper returns than IRS expects, added stress will be placed on IRS' paper-based systems. Accordingly, we recommended that IRS

refocus its electronic filing business strategy to target, through aggressive marketing and education, those sectors of the taxpaying population that can file electronically most cost-beneficially.

IRS agreed with this recommendation and said that it had convened a working group to develop a detailed, comprehensive strategy to broaden public access to electronic filing, while also providing more incentives for practitioners and the public to file electronically. It said that the strategy would include approaches for taxpayers who are unwilling to pay for tax preparer and transmitter services, who owe IRS for balances due, and/or who file complex tax returns. IRS said further that the strategy would address that segment of the taxpaying population that would prefer to file from home, using personal computers.

Since then, IRS has performed an electronic filing marketing analysis at local levels; developed a marketing plan to promote electronic filing; consolidated 21 electronic filing initiatives into its Electronic Filing Strategies portfolio; and initiated a reengineering project to begin this

month with a goal to reduce paper tax return filings to 20 percent or less of the total volume by 2000. These initiatives could result in future progress toward increasing electronic filings. However, these initiatives have yet to culminate in a comprehensive strategy that identifies how IRS will reach its electronic filings goal, including how it plans to target those sectors of the taxpaying population that can file electronically most cost-beneficially, and what efforts it will make to develop requisite supporting systems.

IRS' Strategic Information Management Practices Remain Ineffective

We reported that IRS did not have strategic information management practices in place. We found, for example, that, despite the billions of dollars at stake, information systems were not managed as investments. To overcome this, and provide Congress with insight needed to assess IRS' priorities and rationalization for TSM projects, we recommended that the IRS Commissioner

take immediate action to implement a complete process for selecting, prioritizing, controlling, and evaluating the progress and performance of all major information systems investments, both new and ongoing, including explicit decision criteria, and using these criteria, to review all planned and ongoing systems investments by June 30, 1995.

In agreeing with these recommendations, IRS said it would take a number of actions to provide the underpinning it needs for strategic information management. IRS said, for example, that it was developing and implementing a process to select, prioritize, control, and evaluate information technology investments to achieve reengineered program missions.

Since then, IRS has taken steps towards putting into place a process for managing its extensive investments in information systems. For example, IRS has created the executive-level Investment Review Board for selecting, controlling, and evaluating all information technology investments; developed initial and revised sets of decision criteria that it used last summer to rank and prioritize TSM projects and used in November 1995 to recommend additional changes to information systems resource allocations, respectively; developed its Investment Evaluation Handbook and Business Case Handbook to strengthen management decision-making on systems investments; and is using the Investment Evaluation Handbook to review operational TSM projects.

Although these steps represent some progress in responding to our concerns, none of them to date—individually or collectively—has fully satisfied our recommendations. IRS has not demonstrated that it is following a well-defined, consistent, and repeatable information technology investment decision-making process for selecting, controlling, and evaluating its information technology initiatives and projects. In particular, working procedures, required decision documents, decision criteria, and reliable cost, benefit and return data needed for an investment process are not complete. IRS has not provided evidence to demonstrate how analyses are being conducted on all systems investments using such data as expected improvement in mission performance, costs to date, technical soundness, or pilot performance. Instead, IRS operates on the assumption that it will receive a specified funding ceiling for systems development and technology, and then determines how much funding can be eliminated from projects in order to lower overall modernization costs to that level.

Over the last few months, we have communicated several concerns to IRS about weaknesses in its current investment process that continue to raise risks and erode confidence in the quality of decisions being made about TSM investments. These include:

- the absence of initial screening criteria to determine if IRS has developed sufficient data about an information technology project—such as benefit-cost analyses, proposed return-on-investment calculations, and an accepted return on investment threshold level used as a decisional cut-off point—in order for the investment review board to reach an informed funding decision;
- the lack of analysis and trade-offs being made among all proposed information technology investments as a single portfolio—such as spending on legacy, infrastructure, and proposed modernization projects—in order to fully justify a ranking and prioritization of modernization efforts;
- the lack of mechanisms to ensure that the results of IRS' investment evaluation reviews, such as that recently completed on the Service Center Recognition/Image Processing System, are being used to modify selection and control decision-making processes or to change funding decisions for projects.

Software Development Activities Are Still Inconsistent and Poorly Controlled

We reported that, unless IRS improves its software development capability, it is unlikely to build TSM in a timely or economical manner, and systems are unlikely to perform as intended. To assess its software capability, in September 1993, IRS rated itself using the Software Engineering Institute's CMM. IRS found that, even though TSM is a world-class undertaking, its software development capability was immature.

IRS placed its software development capability at the lowest level, described as ad hoc and sometimes chaotic and indicating significant weaknesses in its software development capability. Our review also found that IRS' software development capability was immature and weak in key process areas. For instance,

- a disciplined process to manage system requirements was not being applied to TSM systems,
- a software tool for planning and tracking development projects was not consistently used,
- software quality assurance functions were not well defined or consistently implemented,
- systems and acceptance testing were neither well defined nor required, and
- software configuration management[6] was incomplete.

To address IRS' software development weaknesses and upgrade IRS' software development capabilities, we recommended that the IRS Commissioner

immediately require that all future contractors who develop software for the agency have a software development capability rating of at least CMM level 2,[7] and before December 31, 1995,

define, implement, and enforce a consistent set of requirements management procedures for all TSM projects that goes beyond IRS' current request for information services process, and for software quality assurance, software configuration management, and project planning and tracking; and

[6]Configuration management involves selecting project baseline items (e.g., specifications), systematically controlling these items and changes to them, and recording their status and changes.

[7]The Software Engineering Institute at Carnegie Mellon University has developed a model, the Software Capability Maturity Model (CMM), to evaluate an organization's software development capability. CMM level 2 denotes that basic project management processes are established to track cost, schedule, and functionality and that the necessary process discipline is in place to repeat earlier successes on similar projects.

define and implement a set of software development metrics to measure software attributes related to business goals.

IRS agreed with these recommendations and said that it was committed to developing consistent procedures addressing requirements management, software quality assurance, software configuration management, and project planning and tracking. Regarding metrics, IRS said that it was developing a comprehensive measurement plan to link process outputs to external requirements, corporate goals, and recognized industry standards.

Specifically regarding the first recommendation, IRS has (1) developed standard wording for use in new and existing contracts that have a significant software development component requiring that all software development be done by an organization that is at CMM Level 2, (2) developed a plan for achieving CMM Level 2 capability on all of its contracts, and (3) initiated plans for acquiring expertise for conducting CMM-based software capability evaluations of contractors and designated personnel to perform these evaluations. We found, however, no evidence that all contractors developing software for the agency are being required to develop it at CMM Level 2. For example, our review of an IRS electronic filing system being developed by a contractor found that the system was being developed at CMM Level 1.

With respect to the second recommendation, IRS is updating three software development lifecycle methodologies, developed a draft quality audit procedures handbook, updated its requirements management request for information services document, and developed and implemented a requirements management course. IRS also evaluated its current contractor management processes, compared these processes with the CMM goals, and is considering improvement activities.

However, to progress towards CMM Level 2, IRS must define and implement the detailed procedures to be used for completing the goals of CMM's key process areas. Based on our assessment, we have found some activities to address our recommendations, but IRS still has not allocated the resources needed to define and implement these areas. It appears that IRS software development projects will continue to be built using ad hoc and chaotic processes that offer no assurance of successful delivery.

Since our review, IRS has also started a three-phase process to (1) identify data sources for metrics, (2) define metrics to be used, and (3) implement

the metrics. According to IRS, although phase one has been completed, no metrics have been defined, and implementation is currently planned for sometime between June 1996 and January 1997. In this regard, although IRS has begun to act on our recommendations, systems are still being developed without the data and discipline needed to give management assurance that they will perform as intended.

Systems Architectures, Integration, and Testing Continue to Be Inadequate

We reported that IRS' systems architectures,[8] integration planning, and system testing and test planning were incomplete. To address IRS' technical infrastructure weaknesses, we recommended that the IRS Commissioner

before December 31, 1995,

complete an integrated systems architecture, including security, telecommunications, network management, and data management;

institutionalize formal configuration management for all newly approved projects and upgrades and develop a plan to bring ongoing projects under formal configuration management;

develop security concept of operations, disaster recovery, and contingency plans for the modernization vision and ensure that these requirements are addressed when developing information system projects;

develop a testing and evaluation master plan for the modernization;

establish an integration testing and control facility; and

complete the modernization integration plan and ensure that projects are monitored for compliance with modernization architectures.

IRS agreed with these recommendations and said that it was identifying the necessary actions to define and enforce systems development standards and architectures agencywide. IRS' current efforts in this area follow:

- IRS is developing a "descriptive overview" of an integrated systems architecture, which, for example, includes a security architecture chapter.

[8]A system architecture is an evolving description of an approach to achieving a desired mission. It describes (1) all functional activities to be performed to achieve the desired mission, (2) the system elements needed to perform the functions, (3) the designation of performance levels of those system elements, and (4) the technologies, interfaces, and location of functions.

A draft of the descriptive overview is due in April 1996, and an executive summary is due in mid-March.

- IRS has developed and distributed a Configuration Management Plan template, which identifies the elements needed when constructing a configuration management plan, and established a charter for its Configuration Management branch.
- IRS has prepared a security concept of operations and a disaster recovery and contingency plan.
- IRS has developed a test and evaluation master plan for TSM.
- IRS is in the process of establishing an interim integration testing and control facility but has not determined an initial operating date. It is also planning a permanent integration testing and control facility, scheduled to be completed by the end of 1996.
- IRS has completed an informal draft of its TSM Release Definition Document and a draft of its Modernization Integration Plan.

These activities start to address our recommendations. However, they do not fully satisfy any of our recommendations for the following reasons.

First, IRS has not completed an integrated systems architecture (the "blueprints" of TSM), and no evidence has been provided to suggest that it will have one in the foreseeable future. The draft architecture documents received are high-level descriptions that fall far short of the level of detail needed to provide effective guidance in designing and building systems. For example, IRS' concept of a three-tier, distributed architecture does not provide sufficient detail to understand the security requirements and implications. It does not, for instance, specify what security mechanisms are to be implemented between and among the three tiers to ensure that only properly authorized users are allowed to access tax processing application software and taxpayer data.

Second, IRS has not brought its development, acceptance, and production environments under configuration management control. For example, there is no disciplined process for moving software from the test to the production environment.

Third, our review of the security concept of operations found that the document does not identify selected security methods and techniques. For example, it discusses two methods for providing identification and authentication for controlling user access to various systems without specifying which method should be used. The security concept of operations is also sometimes inconsistent with the security mechanisms

currently being implemented on systems now being developed and does not indicate how, when, or if these inconsistencies will be resolved.

Fourth, IRS' disaster recovery and contingency plan is a high-level document for planning that presents basic tenets for information technology disaster recovery but not the detail needed to provide guidance. For example, it does not explain the steps that computing centers need to take to absorb the workload of a center that suffers a disaster.

Fifth, the test and evaluation master plan provides the guidance needed to ensure sufficient developmental and operational testing of TSM. However, it does not describe what security testing should be performed, or how these tests should be conducted. Further, it does not specify the responsibilities and processes for documenting, monitoring, and correcting testing and integration errors.

Sixth, the plans for IRS' integration testing and control facility are inadequate. The purpose of an off-line test site is to provide a safe, controlled environment for testing that realistically simulates the production environment. This permits new hardware and software to be thoroughly tested without putting IRS operations and service to taxpayers at risk. However, current plans for the facility do not provide for the testing of all IRS software prior to nationwide delivery. It is unclear why this position has been taken or how difficult and expensive it will be to make the modifications needed to enable the facility to effectively replicate its operational environment.

Finally, IRS' draft TSM Release Definition Document and Modernization Integration Plan have not been finalized. In addition, they (1) do not reflect TSM rescoping and the information systems reorganization under the Associate Commissioner; (2) do not provide clear and concise links to other key documents (e.g., its integrated systems architecture, business master plan, concept of operations, and budget); and (3) assume that IRS has critical processes in place that are not implemented (e.g., effective quality assurance and disciplined configuration management).

No Single Entity Controls All Information Systems Efforts

We reported that IRS had not established an effective organizational structure to consistently manage and control systems modernization organizationwide. The accountability and responsibility for IRS' systems development were spread among IRS' Modernization Executive, Chief

Information Officer, and research and development division. To help address this concern, in May 1995, the Modernization Executive was named Associate Commissioner. The Associate Commissioner was to manage and control systems development efforts previously conducted by the Modernization Executive and the Chief Information Officer.

In September 1995, the Associate Commissioner for Modernization assumed responsibility for the formulation, allocation, and management of all information systems resources for both TSM and non-TSM expenditures. In February 1996, IRS issued a Memorandum of Understanding providing guidance for initiating and conducting technology research and for transitioning technology research initiatives into system development projects.

It is important that IRS maintain an organizationwide focus to manage and control all new modernization systems and all upgrades and replacements of operational systems throughout IRS. To fully strengthen systems development accountability and responsibility, we recommended that the IRS Commissioner

give the Associate Commissioner management and control responsibility for all systems development activities, including those of IRS' research and development division.

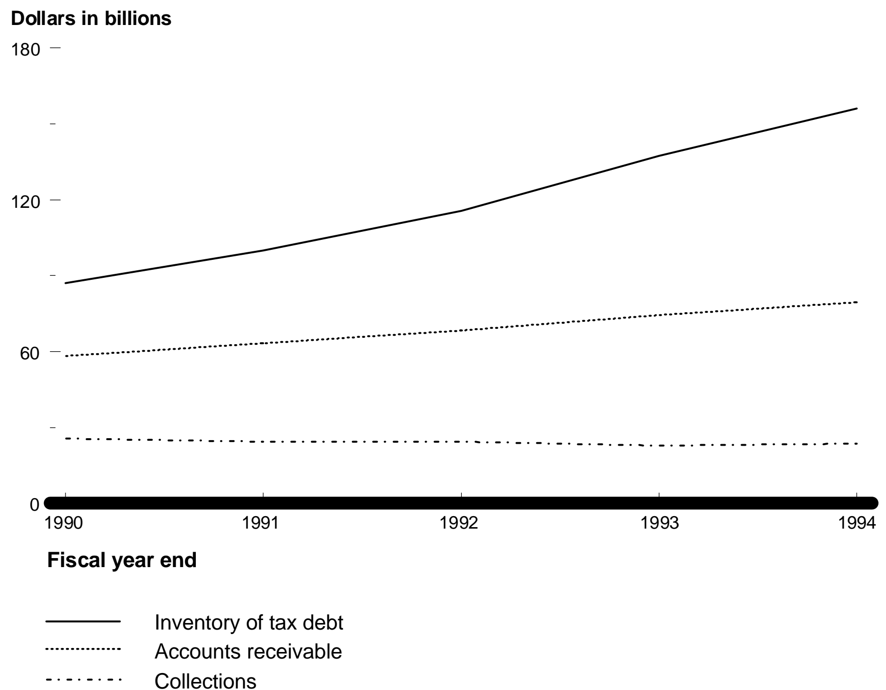
We are concerned that IRS still has not established an organizationwide focus to consistently manage and control information systems. Specifically, we have seen no evidence that systems development, upgrades, and replacements at IRS field locations are being controlled by the Associate Commissioner. Although the Associate Commissioner was given authority for the formulation, allocation, and management of all information systems resources for TSM and non-TSM systems, the research and development division still retains approval authority for initiating technology research projects and for conducting proof-of-concept systems prototypes. It is unclear whether the building processes and budget used for these systems development areas are controlled by the Associate Commissioner.

Again, despite some improvements in consolidating management control over systems development, IRS still does not have a single entity with the responsibility and authority to control all of its information systems projects.

Little Progress Has Been Made in Addressing Accounts Receivable Problems

The growth in IRS' inventory of tax debt, coupled with its inability to collect a significant portion of tax delinquencies, prompted us and OMB to designate IRS' accounts receivable as a high-risk area several years ago. Since that initial designation, IRS has made little progress in resolving the problems at the root of its poor collections performance. As shown in figure 1, its inventory of tax debt grew almost 80 percent, while collections declined about 8 percent from 1990 to 1994.

Figure 1: Inventory of Tax Debt, Accounts Receivable, and Collections, 1990 Through 1994



Note 1: The inventory of tax debt includes outstanding debts owed by taxpayers that are in IRS' detailed accounting records, even though many are invalid. IRS currently cannot differentiate financial (valid) inventory from compliance (invalid) inventory.

Note 2: Effective November 1990, Public Law 101-508 extended the statutory time limit on collections from 6 to 10 years.

Source: IRS.

While collections of delinquent taxes increased in fiscal years 1994 and 1995 to $23.5 billion and $25.1 billion, respectively, IRS projects a 13-percent decrease in collections in fiscal year 1996 to $21.9 billion because of its decision to reduce collections staffing due to cuts in its fiscal year 1996 budget. This amount would represent the lowest level of delinquent collections since fiscal year 1986.

We realize that it is not an easy task for IRS to fix the underlying causes of its accounts receivable problems. IRS has undertaken many efforts in attempting to do so. However, some of these efforts have been curtailed, and others have produced limited improvements. Further, IRS is in the process of rethinking and rescoping many of its modernization and operational initiatives that would affect accounts receivable and collections. But, despite these initiatives, IRS' efforts do not reflect a comprehensive strategy to address the underlying causes of the problems that cut across the agency and across lines of managerial authority and responsibility.

Nature of the Inventory

When discussing the problems affecting IRS' receivables, it is important to understand the nature of the tax debt inventory. In the simplest terms, this inventory represents delinquent taxes recorded in IRS' records as being owed by taxpayers. Delinquent taxes are to remain in the inventory until they are paid or abated, or until the 10-year collection statute of limitations expires.

While much attention has been focused on the size of IRS' tax debt inventory—which as of September 30, 1994, was $166 billion—this figure is deceiving for several reasons. Primary among these is the fact that this figure includes an IRS estimated $97 billion in potential taxes that have been assessed but which may not be valid receivables.

For example, under IRS procedures, when IRS' information return matching process identifies a taxpayer who received a Form W-2 but did not file a tax return, IRS creates a return for the taxpayer. Generally, this is done using the standard deduction and single filing status and often results in the taxpayer's owing taxes. IRS then sends balance due notices to the taxpayer reflecting the amount of taxes owed as calculated by IRS—to encourage the taxpayer to file a return with the correct amount of tax. If the taxpayer does not subsequently file the return, IRS records the amount it calculated as taxes due. However, since the taxpayer has not agreed with the assessment and could later provide information that could result

in the full or partial abatement of the tax debt, the amount recorded is not a valid receivable for financial reporting purposes.

In the past, IRS used a statistical sampling methodology to estimate the compliance and financial portions of the inventory for financial statement purposes. Using this methodology, IRS estimated that, of the $166 billion tax debt inventory, about $69.2 billion represented financial receivables. IRS recently developed a methodology to identify how much of its inventory of tax debts represents these types of assessments. However, we found that the data upon which the analysis was based was flawed.

IRS' inventory of tax debt also includes delinquent debt that may be up to 10 years old. This is because there is a 10-year statutory collection period and IRS generally does not write off uncollectible delinquencies until the 10 years is over. As a result, the receivables inventory includes accounts up to 10 years old that may be impossible to collect because the taxpayers are deceased or the corporations are defunct. Of the $166 billion total receivables inventory, IRS data show that $1.7 billion was owed by deceased taxpayers and $19.1 billion was owed by defunct corporations.

During a review of accounts receivable cases greater than $10 million as of September 30, 1995, we identified several examples that illustrate problems with IRS' accounts receivable inventory. For example, out of a total of 460 accounts receivable cases that we reviewed, IRS identified 258 as currently not collectible: 198 of these represented defunct corporations, while the remaining 60 cases represented entities that either could not pay or could not be located. These cases represented $12 billion of the $26 billion included in accounts greater than $10 million.

The age of the receivable also does not reflect the additional time it took for IRS to actually assess the taxes in the first place. In many cases, IRS' processing and use of certain taxpayer-related information to identify delinquent debt is a significant factor in determining the ultimate collectibility of the debt. Enforcement tools, such as its matching programs and tax examinations, may take up to 5 years from the date the tax return is due, thus reducing the likelihood that the outstanding amounts will be collected.

The age factor significantly affects the collectibility of the debt because, as both private and public sector collectors have attested, the collectibility of debt becomes more problematic the older the debt becomes. Because of

these and other factors, IRS considers many of the accounts in the inventory to be uncollectible.

IRS estimated that only about $35 billion of the $166 billion inventory of tax debt was collectible. However, for 3 of the 4 years we audited IRS' financial statements,[9] we could not determine the reliability of IRS' estimate of accounts receivable and the related estimated collectable amount. We were only able to do so for fiscal year 1992, the first year we audited IRS. That year, we tested the validity of amounts IRS reported using a statistical sample. This resulted in an estimate of $28 billion in collectable accounts receivable. For the subsequent 2 years (fiscal years 1993 and 1994), IRS performed its own statistical sample to determine the collectability of its accounts receivable. As part of our audit, we assessed the reasonableness of these samples and found that we could not validate IRS' estimates. Our inability to rely on these estimates was based on discrepancies between underlying documentation we audited and IRS' reported balances.

Long-Standing Problems Continue

As we reported in our February 1995 high-risk report,[10] IRS's accounts receivable problems reflect pervasive problems throughout IRS' processes that cumulate in the tax debt inventory and IRS' difficulties in addressing the underlying causes of these problems. For example,

- the failure of returns processing to correctly account for a taxpayer's payment may result in the creation of an invalid account receivable;
- the failure of taxpayer service to promptly resolve a taxpayer's inquiry about a delinquent account may perpetuate the receivable; and
- an IRS compliance effort that overstates a taxpayer's liability also inflates the inventory, makes additional work for collection personnel, and offers little guarantee of revenue generation.

In our February 1995 report, we identified five underlying causes that tend to create and perpetuate problems in accounts receivable. First and most significant is IRS' lack of accurate and reliable information, which hinders efforts to deal effectively with tax debts. Until accurate and reliable information on the validity and collectibility of the inventory of tax debts

[9]Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995).

[10]High-Risk Series: Internal Revenue Service Receivables (GAO/HR-95-6, February 1995).

is available, IRS will continue to waste time and resources pursuing debts that are not real and thus do not generate revenue. Improving data accuracy and reliability is a key objective of TSM, but progress has been slow and the future success of TSM is uncertain.

In addition, until IRS can effectively identify who owes the tax receivables and successfully implements a financial management system that ties its collection results to its operations, it is difficult, if not impossible, to gauge the return achieved from its collection efforts or how effective IRS or anyone could be in collecting outstanding tax receivables.

Second, IRS' collection process was introduced several decades ago and, although some changes have been made, the process generally is rigid, costly, and inefficient. The three-stage collection process—computer-generated notices and bills, telephone calls, and personal visits by collection employees—takes longer and is more costly than collection processes in the private sector.

While the private sector emphasizes the use of telephone collection calls, a significant portion of IRS' collection resources are devoted to personal visits made by revenue officers. IRS has initiated programs and made procedural changes to speed up the collection process, but historically it has been reluctant to reallocate resources from the field to the earlier, more productive collection activities. Due to budget cuts, however, IRS is in the process of temporarily reassigning about 300 field staff to telephone collection sites to replace temporary employees who were terminated.

In addition to IRS' problems with identifying who currently owes taxes and the amount it can expect to collect, it has lacked the capability to accurately track the revenues realized from its various collection efforts. To address this problem, IRS has been developing the Enforcement Revenue Information System (ERIS). ERIS was designed to account for actual collections resulting from IRS' enforcement efforts and to enable IRS to more accurately measure and predict enforcement costs and revenues. However, its implementation was delayed because of inaccuracies found in the system's data; we are currently reviewing the system to assess its reliability.

IRS has also undertaken efforts to reengineer the collection process, but several of these were recently discontinued without changing the current processes. This, in part, was a result of IRS' decision to rethink its overall goals and objectives in light of changing budget priorities. IRS is now

planning to implement a reengineering project that will involve all IRS activities that enable taxpayers to fulfill their tax obligations.

Third, while Congress has given IRS strong tools, such as levies and seizures, to collect delinquent taxes, it has also established a number of statutory safeguards to prevent their unwarranted use. An unintended result of these safeguards has been to hamper collections. For example, the 1988 Taxpayer Bill of Rights prohibits IRS from evaluating the performance of its staff on the basis of dollars collected. Without the use of this measure, which is used by most private-sector collectors, IRS staff have less incentive to collect taxes. Their performance evaluations do not distinguish between collection actions that essentially write off a tax debt and actions that result in the collection of taxes owed—both are considered case closings. This practice may be one reason why IRS field collection staff have been declaring more tax debts "currently not collectible" each year than they collect.

We understand the importance of balancing the need to protect the rights of taxpayers against the need to collect tax debts. While IRS must be fair and follow appropriate laws and regulations, taxpayers must also accept their lawful tax obligations. Those who evade this obligation cause all other taxpayers to bear a disproportionate share of the overall tax burden.

Fourth, IRS' organizational structure, with its considerable sharing of responsibility for collecting tax debts, provides little accountability for results. IRS is in the process of rethinking and restructuring its organization, including reducing the number of employees and the number of regional and district offices and service centers, but the impact of these changes, if any, on the accounts receivable problems will not be felt for several years.

Fifth and finally, staffing imbalances among IRS field offices have resulted in staff being available in some offices to pursue both small and large debts, while in other offices even large debts might go uncollected because of staff shortages.

In addition, as mentioned earlier, IRS historically has allocated two-thirds of its collection staff to the field, which comprises the last and least productive stage of the collection process. This is in contrast to private-sector collectors, who devote most of their resources to the earlier telephone stage.

Several staffing-related projects have been affected by IRS' actions taken in response to its reduced appropriations for fiscal year 1996. One of these projects was focused on redesigning the operation of collection groups in the field to improve productivity and reduce costs. Although preliminary results appeared to IRS to be positive, IRS decided to stop the project in October 1995 for budgetary reasons.

This Subcommittee's concern of several years' duration about IRS' delinquent tax collection efforts led to the provisions contained in IRS' fiscal year 1996 appropriations bill that earmark $13 million for a pilot program to test the use of private law firms and debt collection agencies to help collect delinquent tax debts. IRS issued a request for proposals from prospective participants in the pilot program on March 5, 1996. If done successfully, this program may open a new avenue for addressing some of IRS' collection problems.

We recognize that IRS has many initiatives under way that could help to resolve the accounts receivable problem. But, we also recognize that IRS has pursued many initiatives over the years without bringing about the desired change. IRS is in the process of rescoping many of its planned modernization and operational initiatives because of changed budget priorities. However, a comprehensive strategy to guide IRS' efforts to improve collections and accounts receivable has not been developed. This strategy, which is critical to the successful resolution of IRS' accounts receivable problems, must recognize and address the five underlying causes of the problem—causes that cut across the agency and across lines of managerial authority and responsibility.

Return-Free Filing

Almost 100 million American taxpayers currently must file tax returns, even though most have fully paid their taxes through the withholding system. Given its potential for reducing taxpayer burden and IRS paper processing, we have been studying return-free filing systems and the potential impact they would have on the federal income tax system.

While we are still in the process of finalizing our results, we can provide some preliminary information on (1) the two most common types of return-free filing, (2) the number of American taxpayers that could be affected by return-free filing, and (3) some of the issues that would need to be addressed before such a system could be used.

In countries with return-free filing, the most common type of system we identified was that termed “final withholding.” Under this system, the withholder of income taxes determines the taxpayer’s liability and withholds the correct tax liability from the taxpayer. With the final year-end payment to the taxpayer, the withholder makes a final reconciliation of taxes and adjusts the withholding for that period to equal the year’s taxes.

Another type of return-free filing—known as “agency reconciliation”—depends entirely on information reporting and allows the tax agency to determine the taxpayer’s taxes based on these information documents. The tax agency then sends the taxpayer either a refund or a tax bill based on the tax liability and the amount of withholding. We identified 36 countries that use some form of return-free filing—34 with final withholding and 2 with tax agency reconciliation.

Given the extent of withholding and information reporting that exists under our current tax system, we estimated that about 18.5 million American taxpayers whose incomes derive from only one employer could be covered under a final withholding system. Alternatively, an estimated 51 million taxpayers could be covered under the agency reconciliation system.

We estimate that taxpayers could save 52 million hours in preparation time and millions of dollars in tax preparation costs under the final withholding system, and 170 million hours and millions of dollars in preparation time and costs under the tax agency reconciliation system. IRS would also save an estimated $45 million in processing costs under the final withholding system, and about $36 million under the tax agency reconciliation system, in processing and compliance costs. Employers would face additional burden and costs under the final withholding system, but we were unable to determine how much.

Several changes to the current tax system would be needed, however, in order to implement return-free filing. Under both systems, taxpayers would continue to provide information on their filing status and number of dependents. Employers would need to be authorized by law to compute tax liabilities under final withholding. Consideration would need to be given to certain states where the state income tax is tied to the federal income tax return. For example, IRS would have to speed up the processing of information documents under the tax agency reconciliation

system so that tax liabilities could be determined before April 15, which is also the tax filing deadline for some states.

IRS' own 1987 study of return-free filing recognized this processing problem and recommended against return-free filing for that reason. However, given the many processing changes envisioned with the modernization of IRS' computer systems, this problem may be less of an obstacle than it was in 1987.

Given the current tax system, a tax agency reconciliation system has the potential to reduce the filing burden on more taxpayers and also put less burden on payors than a final withholding system.

In summary, IRS' TSM and delinquent debt collection efforts remain a serious concern to us. Although IRS is attempting to address some of the problems, their underlying causes remain and continue to hinder the potential for significant improvement. TSM, in particular, is at serious risk, and until the weaknesses are corrected, we believe that IRS' ability to successfully complete the program will remain highly questionable.

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