

GAO

Testimony

Before the Subcommittee on Treasury, Postal Service, and
General Government, Committee on Appropriations, House of
Representatives

For Release on Delivery
Expected at
10:00 a.m.
Wednesday
February 1, 1995

TAX ADMINISTRATION

Tax Compliance Initiatives
and Delinquent Taxes

Statement of Jennie S. Stathis, Director
Tax Policy and Administration Issues
General Government Division



TAX COMPLIANCE INITIATIVES AND DELINQUENT TAXES

SUMMARY OF STATEMENT

JENNIE S. STATHIS

DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES

GENERAL GOVERNMENT DIVISION

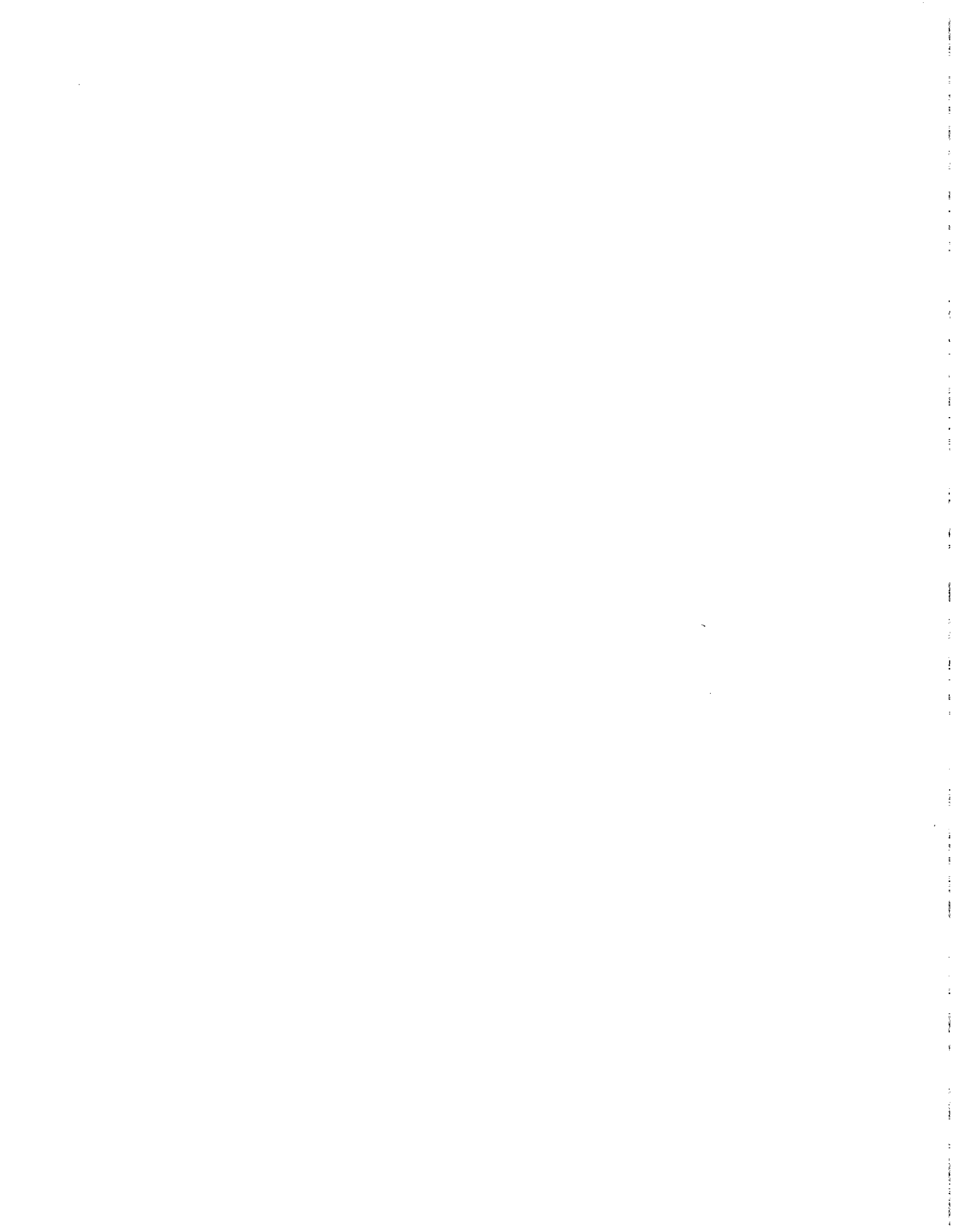
U.S. GENERAL ACCOUNTING OFFICE

The Internal Revenue Service (IRS) faces some formidable enforcement challenges such as (1) closing a tax gap that was last estimated at \$127 billion in tax year 1992 and (2) collecting tens of billions of dollars of tax debt. Past Congresses recognized the need to expand IRS' enforcement presence to help it deal with these challenges. Thus, every year but 1 since 1990, Congress has funded compliance initiatives that would add staff with the intent of increasing compliance and producing more revenue.

IRS has not fully implemented past compliance initiatives partly because of circumstances, such as underfunded pay raises, beyond its control. As a result, although the intent of the various initiatives was to increase IRS' enforcement presence, staffing levels in three of IRS' major enforcement programs actually declined between 1989 and 1994. A new set of compliance initiatives have been funded for fiscal year 1995. GAO believes the prospects are higher that IRS will implement these initiatives because the appropriations act restricted IRS' ability to use compliance funds for other purposes.

Some of the additional compliance staffing for 1995 is to be used to collect delinquent tax debts. However, increased staffing is not the only answer to the accounts receivable problem. IRS' problems in this area are more fundamental. First, IRS must improve the accuracy of its delinquent accounts inventory. Second, it needs to slow the growth of the inventory of tax debt. Finally, it needs to accelerate and increase the collection of overdue taxes. Since 1990, IRS has undertaken many efforts toward these objectives, however, it has not made much headway.

GAO identified five underlying causes that tend to perpetuate IRS' accounts receivable problems: (1) a lack of accurate and reliable information, (2) an outdated and inefficient collection process, (3) difficulty in balancing collection efforts with taxpayer protections, (4) a decentralized organizational structure, and (5) uneven staffing. IRS needs to demonstrate that its efforts will effectively deal with these causes--causes that cut across the agency and across lines of managerial authority and responsibility. IRS also needs to reengineer its outdated collection process and take greater advantage of private sector practices.



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist in your review of the Internal Revenue Service's (IRS) compliance initiatives and IRS' progress in collecting tax debts. Compliance initiatives are generally intended to provide IRS with more money for additional staff so that IRS can audit more tax returns, collect more tax debt, or do more in other areas to improve compliance with tax laws and thus increase tax revenues.

My testimony today makes the following points:

- IRS' enforcement presence is relatively low, and the potential revenues from more enforcement are substantial. Although there are ways to enhance IRS' presence without increased compliance staffing, it seems clear that increased staffing should help generate significant revenues over the long term, provided the increased staffing levels are maintained.
- Congress funded compliance staffing increases every year but one from 1990 through 1994. Yet IRS' compliance staffing declined in that time period. The compliance initiatives were often not implemented as Congress intended and IRS' tracking of results was incomplete.
- Congress again authorized additional compliance staffing for fiscal year 1995. The prospects are higher that IRS will implement these compliance initiatives because the appropriations act restricted IRS' ability to use compliance funds for other purposes. Initiative results should also be clearer because IRS has developed a better tracking methodology. The value of the results of that methodology, however, will depend on the quality of the data tracked.
- Some of 1995's added staffing is directed toward collecting tax debts. Despite the many efforts IRS has underway to deal with the accounts receivable problem, in some respects it is worse today than 5 years ago.
- In our view, IRS must collect more delinquent taxes and stem the growth in outstanding debts. The first task requires greater efficiency and productivity in the collection process. The second requires efforts throughout IRS to prevent delinquencies and avoid cluttering the system with invalid and uncollectible accounts.

POTENTIAL REVENUES FROM TAX
COMPLIANCE AND IRS' PRESENCE

Potential revenues from better tax compliance are high. IRS' latest estimate is that taxpayers did not report and pay about \$127 billion of income taxes in 1992. While the entire "tax gap" is not likely to be collected, IRS' estimate may also be low because it is old, is based largely on old data, and does not

include other kinds of taxes. So, an estimate for 1994 with more recent data might present a different picture of the gap--most likely a larger one. For example, the current estimate of \$127 billion does not reflect the estimated drop in voluntary compliance of small corporations from 81 percent in tax year 1980 to 61 percent in tax year 1987. In addition to the annual tax gap, the accumulated inventory of tax debts exceeds \$150 billion--perhaps a fifth of it collectible. And refund fraud has been growing rapidly.

At the same time, IRS' enforcement presence is relatively low. In fiscal year 1993, IRS audited less than 1 percent of the total number of income tax returns filed. IRS pursued fewer than 37 percent of the tax year 1990 cases of underreported income identified through document matching. And more than half of last year's delinquent accounts workload was still in backlog at the end of the year.

Some of these problems might be alleviated with more efficient use of existing IRS resources, simpler tax laws, or improved administrative processes. Additional enforcement resources may also help to generate more revenue over time, provided the increased staffing levels are maintained and staff are properly and effectively deployed. In terms of collecting delinquent taxes, we believe that long-term improvement requires improved operations and more emphasis on actions to prevent delinquencies from occurring in the first place.

It is also important to remember that revenue losses from some staffing increases are possible in the first year because of the lag between the time new staff are hired and the time they become productive. During this time, IRS incurs substantial opportunity costs because experienced staff are used to train new staff.

IRS' Problems in Implementing and Tracking Past Compliance Initiatives

Past Congresses recognized the need to expand IRS' enforcement programs to better ensure that taxes due the government were identified and collected. Thus, every year but 1 since 1990, Congress has funded compliance initiatives that would add staff with the intent of increasing compliance and producing more revenue.

However, IRS has not fully implemented past compliance initiatives partly because of circumstances, such as underfunded pay raises, beyond its control.¹ As a result, although the

¹Appendix I provides additional information on IRS' experience in implementing past initiatives. Appendix II includes a list of past GAO products dealing with IRS compliance initiatives.

intent of the various initiatives was to increase IRS' enforcement presence, staffing levels in three of IRS' major enforcement programs actually declined over this period, as shown in table 1.

Table 1: Staffing in Three IRS Enforcement Programs Since Fiscal Year 1989

Fiscal year	FTEs			
	Examination	Collection	Document matching	Total
1989	31,315	18,470	5,691	55,476
1990	28,788	18,034	5,683	52,505
1991	28,592	18,605	5,609	52,806
1992	28,393	18,518	4,394	51,305
1993	27,490	18,214	4,165	49,869
1994	27,066	17,742	3,644	48,452
1995 without compliance initiatives	26,037	16,606	3,115	45,758
1995 with compliance initiatives	28,788	18,387	3,360	50,535

Source: Data for 1989 through 1991 come from Tax Administration: Trends for Certain IRS Programs (GAO/GGD-93-102FS, May 26, 1993). Data for 1992 through 1995 come from IRS annual reports, IRS budget requests, IRS data relating to the compliance initiatives for fiscal year 1995, and IRS budget officials.

Our past work also disclosed problems with IRS' tracking of initiative results. For example, IRS' tracking system for the fiscal year 1991 compliance initiatives did not provide for offsetting any increased revenues from initiative staff with decreased revenues from reductions in baseline staffing. So that Congress would have a complete picture of the results of those initiatives, we recommended in 1992 that IRS revise its tracking approach to (1) compare total authorized staffing and total revenue expected with actual totals for staff and revenue achieved and (2) explain any differences in what Congress expected and what IRS achieved.²

²Tax Administration: Congress Needs More Information on Compliance Initiative Results (GAO/GGD-92-118, July 31, 1992).

Will Things Be Different for
the Fiscal Year 1995 Initiatives?

Congress again authorized compliance initiatives for fiscal year 1995, totaling \$405 million--the largest appropriation for compliance initiatives thus far. IRS has estimated that the appropriation will fund an additional 6,238 full-time equivalents (FTEs) who will generate at least \$9 billion in revenue over the next 5 fiscal years. IRS' estimate assumes that funding will be provided in the years after 1995 to maintain the increased staffing levels.

The fiscal year 1995 appropriation act (P.L. 103-329) provides that "the \$405,000,000 made available for the fiscal year 1995 tax compliance initiative shall not be expended for any other purposes." More significantly, the act further provides that "no funds shall be transferred from the 'Tax Law Enforcement' account during fiscal year 1995." Those provisions are to ensure that the funds are used as intended and prevent erosion of IRS' enforcement base as occurred in prior years.

It should be understood, however, that the fiscal year 1995 initiative funding was added to an already-eroded base. Without the compliance initiatives, the Administration's fiscal year 1995 budget request called for a 2,008 FTE reduction in IRS' enforcement staff--from an authorized level of 67,044 in fiscal year 1994 to 65,036 in fiscal year 1995. Thus about one-third of the FTEs paid from compliance initiative funding will not increase IRS' enforcement presence but merely retain staffing at fiscal year 1994's level.

As noted earlier, we have recommended changes in the way IRS tracked past compliance initiative results. IRS has a new methodology for tracking the results of the fiscal year 1995 initiatives that should provide more useful information with which to judge IRS' success. As described in documentation we received from IRS last week, for example, the new methodology calls for attributing results to the initiatives only after the base has been fully realized. IRS also plans to track results down to a greater level of detail than before. For this tracking to be most useful to Congress, it is important that IRS and the Subcommittee have a clear understanding of the base FTE and revenue levels to be used for tracking purposes.³ IRS will also need to clearly explain any adjustments to the base that may occur as tracking continues over the next several years.

³In describing its methodology, IRS says the "base and initiative FTE levels are based on the official IRS initial financial plan, dated September 26, 1994, with some minor realignments to cover unbudgeted pay increases and reclassification by employment categories."

Although IRS' tracking methodology has improved, the ultimate value of the results in documenting the benefits realized for the dollars appropriated will depend on the quality of the data tracked. According to IRS, the revenue data to be used in measuring the success of the compliance initiatives is to come from the Enforcement Revenue Information System (ERIS)--a relatively new system designed to account for actual collections resulting from IRS' enforcement programs and to enable IRS to more accurately measure and predict enforcement costs and revenues. ERIS is not yet fully operational, but IRS believes it will be by the end of the year.

We have some concerns about the reliability of IRS' ERIS data. Those concerns derive from an October 1993 IRS Internal Audit report which says, in part, that "information in ERIS reports is still not accurate, reliable or consistent". Based on a discussion with IRS officials, it is our understanding that a contractor was to have corrected the data deficiencies identified by Internal Audit, but those corrections have not yet been made because of contractual problems.

Although not enough time has passed to comment on IRS' success in generating additional revenue as a result of the fiscal year 1995 initiatives, IRS says it has made substantial progress in taking the first step toward generating those revenues--hiring the additional staff authorized by Congress.

COLLECTING DELINQUENT TAXES

Some of IRS' compliance initiatives have been directed toward collecting delinquent taxes. For example, of the 6,200 additional staff provided by the fiscal year 1995 compliance initiatives, IRS has targeted about 1,800 (or 29 percent) to go to the collection function, which is responsible for collecting delinquent taxes.

IRS' poor performance in collecting tens of billions of dollars in delinquent taxes has been a concern of this Subcommittee for several years. Also, IRS' overall management of accounts receivable is recognized as a high-risk area by the Office of Management and Budget, GAO, and IRS. This situation has not only lessened the revenues immediately available to support government operations but could also jeopardize future taxpayer compliance by leaving the impression that IRS is neither fair nor serious about collecting overdue taxes.

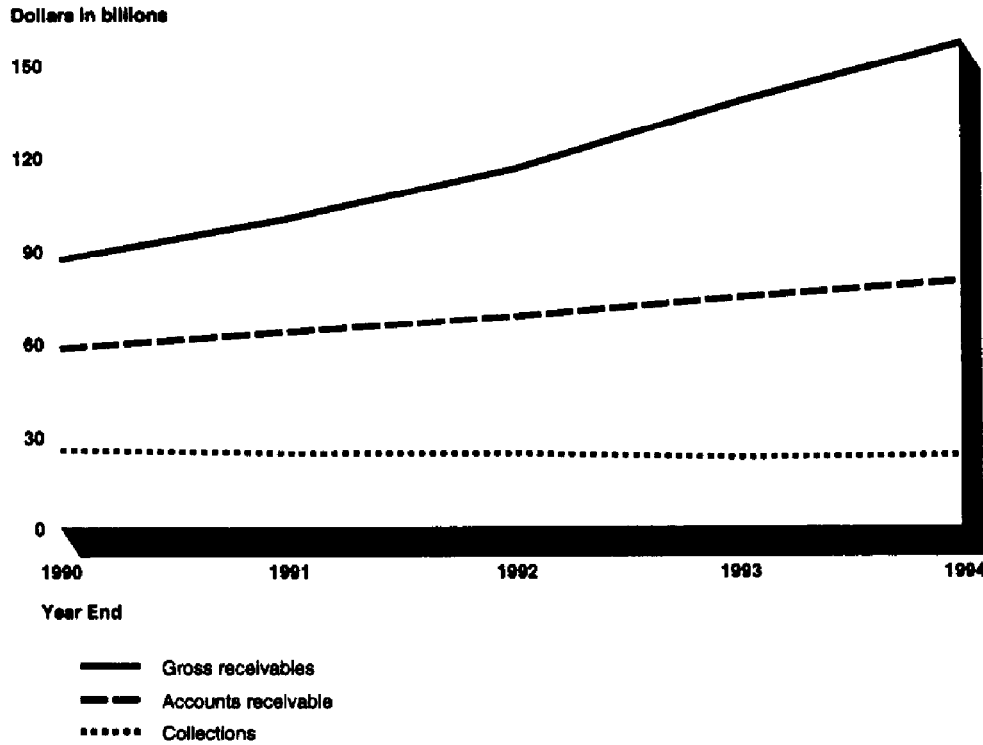
IRS has undertaken many efforts in trying to deal with the accounts receivable problem. These included correcting errors in master file records of tax receivables, targeting high dollar cases for prompt resolution, developing systems to better target compliance and prevention programs and to more accurately identify valid and collectible receivables, and settling some tax

debts for less than what taxpayers owe. Through such efforts, IRS is trying to (1) improve the accuracy of its delinquent accounts inventory, (2) slow the growth in the inventory, and (3) accelerate and increase the collection of overdue taxes.

Some of IRS' efforts to achieve these objectives are long term; and measurable results and improvements will take time. However, since 1990 there has been little improvement in the bottom line--inaccurate data are still a problem, the inventory continued to grow, and collections of delinquent taxes declined. As shown in figure 1, over the period 1990 through 1994, the gross inventory of tax debt⁴, as reported by IRS, grew about 80 percent--from \$87 billion to \$156 billion. And, during that same period, annual collections of delinquent taxes declined about 8 percent--from \$25.5 billion to \$23.5 billion. An increase was recorded between 1993 and 1994, but 1993's total was the worst debt collection result since 1988.

⁴The inventory of tax debt includes all outstanding debts owed by taxpayers that are in IRS' detailed accounting records, even though many are invalid. IRS currently cannot differentiate valid from invalid accounts in this inventory.

Figure 1: Inventory of Tax Debt, 1990 through 1994



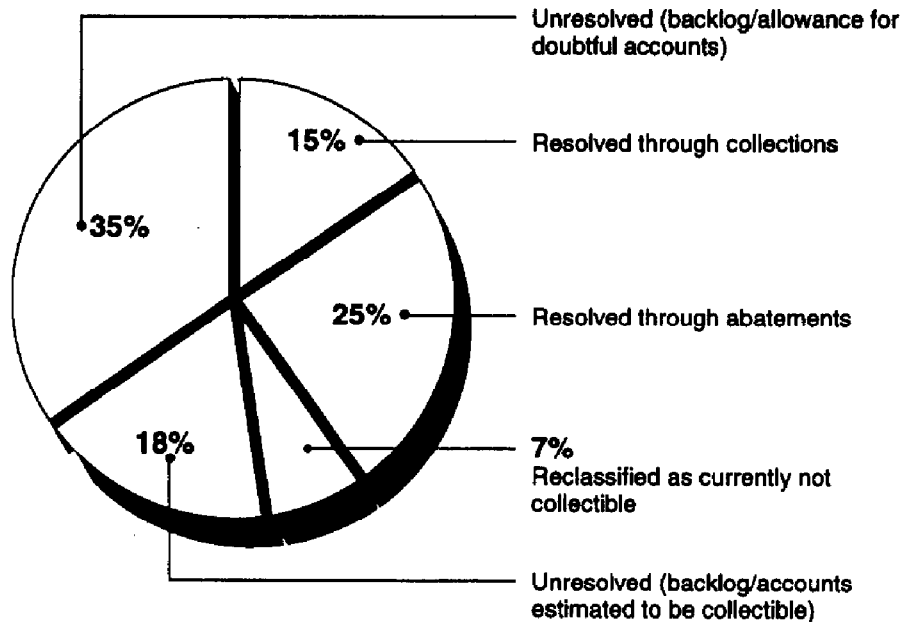
Note 1: Gross receivables include accounts categorized as currently not collectible. Receivables data represent year-end balances while collection data represent annual totals.

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

Source: IRS

And in 1994, IRS abated or suspended collection action on about \$2 of receivables for each \$1 it collected. (See figure 2.)

Figure 2: Accounts Receivable Dispositions, Fiscal Year 1994



Note 1: Data reflect the disposition of accounts receivable in working inventory at the beginning of the year and new receivables established during the year.

Note 2: Collectibility amounts are IRS estimates based on Research Division analysis of the accounts receivable inventory.

Source: IRS

IRS' gross accounts receivable inventory is an indication of IRS' collection workload. It does not reflect delinquent taxes actually owed. Because of overstatements in the inventory and errors by IRS and taxpayers, much of the gross balance is invalid. In addition, many valid accounts are considered uncollectible because IRS believes the delinquent taxpayers cannot pay or because IRS cannot find them. After considering all of the above, and assuming continuation of existing collection practices, IRS estimated that about \$29 billion of the September 30, 1993, accounts receivable balance of more than \$137 billion was then collectible.

The overall results since 1990 reflect the (1) pervasiveness of problems throughout IRS' processes that cumulate in the inventory and (2) difficulty in coming to grips with underlying causes. Many breakdowns or inefficiencies in other IRS programs contribute, such as:

- 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 an overdue account may perpetuate the receivable; and
- an IRS compliance effort which overstates a taxpayer's liability also inflates the inventory, makes additional work for collection personnel, and offers no guarantee of revenue generation.

We identified five underlying causes that tend to perpetuate problems in accounts receivable.

- First and foremost is IRS' lack of accurate and reliable information, which hinders efforts to effectively deal with tax debts. Priority must be given to this area because so many of IRS' ongoing and future efforts rely heavily on accurate and reliable information. IRS now can estimate the total value of its valid receivables based on statistical samples selected from its inventory. While these estimates are an improvement over past information, they are an interim step.

IRS needs to correct underlying account information to ensure that accurate information is used to develop new systems. Until accurate and reliable information on the validity and collectibility of the inventory of tax debts is available, IRS will continue to waste time and resources pursuing debts that are not real and will not generate revenue. IRS also needs to continue its ongoing efforts to collect and analyze information from internal and external databases so that it can design more effective compliance and prevention strategies and improve its collection programs.

- Second, IRS' collection process was introduced several decades ago and although changes have been made, the process remains outdated, costly, and inefficient. The three stage collection process--computer-generated notices and bills, telephone calls, and personal visits by collection employees--takes much longer and is more costly than those in the private sector. For example, IRS generally uses mail for up to 6 months to contact delinquent taxpayers before telephone contact is attempted. In the private sector, telephone contact is the primary tool and calls are made early in the collection process. IRS is expanding a program that it tested in two field locations in which certain delinquent taxpayers were contacted by telephone after 2 to 3 months. According to IRS officials, 700 additional staff have been added to expand the program nationwide. This change will put more emphasis on

contacting delinquent taxpayers by telephone rather than personal visits by revenue officers--a change we and the Subcommittee have recommended.

- 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 has been to hamper collections.

For example, the 1988 Taxpayer Bill of Rights prohibits IRS from evaluating staff on the basis of dollars collected. Without the use of this measure, IRS' staff have less incentive to collect taxes. Their evaluation does not distinguish between collection actions that essentially write off a tax debt and actions which result in collecting taxes owed--both are considered case closings. Such a 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 with the need to collect tax debts. While IRS must be fair and follow appropriate laws and regulations, taxpayers must also accept their respective tax obligations. By not doing so, all other taxpayers bear a disproportionate share of the tax burden.

- Fourth, IRS' highly decentralized organizational structure results in all 7 regions, 63 districts, and 10 service centers sharing responsibility for collecting tax debts. IRS has two ways--the Federal Managers' Financial Integrity Act and strategic management planning processes--to focus managers' efforts on the accounts receivable problem. Neither specifically addresses the interrelationship of the underlying causes of the problem.
- And fifth, staffing imbalances among field offices have resulted in staff being available in some offices to pursue small and large debts while in other offices large debts might go uncollected because of staff shortages. We have pointed out that adding more staff, particularly in the field, was not a long-term solution and would not guarantee increased collections. IRS tends to allocate two-thirds of its collection staff to this last stage of the collection process. IRS has taken some steps to address staffing imbalances among its field offices.

What More Needs to be Done?

In our view, IRS' primary task is two-fold: collect more delinquent taxes and stem the growth in outstanding debts. The

first part of the task requires greater efficiency and productivity in the collection process. The second requires changes in other IRS components to help prevent delinquencies and minimize cluttering-up the collection process with invalid and uncollectible accounts.

We recognize that IRS has numerous efforts under way that could help to resolve the accounts receivable problem and we support the intent of those efforts. IRS also needs to clearly demonstrate to Congress that its efforts will effectively deal with the five underlying causes of the accounts receivable problem--causes that cut across the agency and across lines of managerial authority and whose resolution, thus, requires an institution-wide focus.

Equally important is that IRS' strategy address ways to best reengineer its outmoded tax collection processes. Because most of these processes were designed decades ago, they have not kept pace with advances in technology or communications. As a result, IRS' ability to collect taxes has been hampered. IRS has also not taken full advantage of the vast experience that private sector collection companies have in areas such as locating debtors and managing accounts receivable. Testing the use of such companies to locate and contact delinquent taxpayers might be an appropriate step in reengineering IRS' tax collection processes.

Mr. Chairman, that concludes my remarks this morning. I would be pleased to respond to questions the Subcommittee may have.

IRS' HISTORY IN IMPLEMENTING COMPLIANCE INITIATIVES

In all but 1 year since 1990, Congress has appropriated IRS funds for various compliance initiatives. These initiatives were intended to provide IRS with additional staff so that IRS could, among other things, audit more returns, collect more delinquent taxes, and enhance international and criminal enforcement efforts. Although we have generally supported these initiatives in concept, our past work has shown that the initiatives were not implemented as Congress intended.

In 1990, IRS received funding for nine compliance initiatives and implemented only two. In 1991, Congress appropriated \$191 million for initiatives, and IRS used \$134 million for that purpose. No compliance initiatives were authorized in 1992. In 1993 and 1994, Congress authorized initiatives of \$43 million and \$115 million, respectively. IRS spent only \$9.3 million on the fiscal year 1994 initiatives.

IRS' inability to implement past initiatives stemmed from the use of initiative funds to cover unfunded costs in IRS' base operations. IRS has consistently used initiative funding to cover budget shortfalls that have ranged from \$80 million to \$200 million.

- IRS' fiscal year 1991 appropriation included \$191 million for 3,476 additional staff to implement nine compliance initiatives. IRS subsequently reduced the funding and staff for those initiatives to \$134 million and the 2,236, respectively. These reductions were made to (1) fund \$15 million in unbudgeted fiscal year 1991 costs, such as a portion of the fiscal year 1991 pay raise and (2) account for delays in hiring that occurred because IRS' appropriation was passed after the start of the fiscal year.
- IRS' fiscal year 1994 appropriation provided \$115 million for several initiatives that were intended to, among other things, help IRS collect more delinquent taxes, increase audit coverage, increase international compliance efforts and deal with various compliance issues, such as bankruptcy, independent contractors, nonfilers, and electronic filing fraud. According to IRS officials, IRS used most of the fiscal year 1994 initiative funds--\$105 million of the \$115 million--to fund locality pay. The President's budget as submitted to Congress did not provide for such funding.

PAST GAO PRODUCTS ON COMPLIANCE INITIATIVES

Tax Administration: Analysis of IRS' Budget Request for Fiscal Year 1995 (GAO/GGD-94-129, Apr. 20, 1994).

Tax Administration: IRS' Budget Request for Fiscal Year 1994 (GAO/T-GGD-93-23, Apr. 28, 1993).

Tax Administration: Congress Needs More Information on Compliance Initiative Results (GAO/GGD-92-118, July 31, 1992).

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

Tax Administration: IRS' Implementation of Certain Compliance Initiatives (GAO/GGD-92-45FS, Jan. 30, 1992).

Tax Administration: IRS' Budget Request for Fiscal Year 1992 and Status of the 1991 Tax Return Filing Season (GAO/T-GGD-91-17, Mar. 20, 1991).

Tax Administration: IRS' Budget Request for Fiscal Year 1991 and Status of the 1990 Tax Return Filing Season (GAO/T-GGD-90-26, Mar. 22, 1990).

Tax Administration: IRS Implementation of the 1987 Revenue Initiative (GAO/GGD-88-16, Dec. 2, 1987).

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested
