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Testimony

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AD-A263 329



For Release
on Delivery
Expected at
9:30 a.m. EST
Wednesday
March 13, 1991

IRS' Compliance Programs to Reduce
the Tax Gap

Statement of
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Before the
Subcommittee on Commerce, Consumer,
and Monetary Affairs
Committee on Government Operations
House of Representatives

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APR 27 1993



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93-08780

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IRS' COMPLIANCE PROGRAMS
TO REDUCE THE TAX GAP

SUMMARY OF STATEMENT BY
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U.S. GENERAL ACCOUNTING OFFICE

The Internal Revenue Service (IRS) could better use information returns to pursue people who do not file a tax return (nonfilers) or who file a return but do not report income (underreporters). Doing so could allow IRS to narrow the income tax gap--which is the difference between the amount of income tax that taxpayers owe and that they voluntarily pay for a tax year. In 1988, IRS estimated the gross tax gap to be \$85 billion for 1987 and projected it would reach \$114 billion by 1992. IRS' estimates show that nonfilers and underreporters accounted for about \$7 billion and \$48 billion, respectively, of the 1987 tax gap.

GAO found that IRS could improve its use of information returns to identify and pursue nonfilers and underreporters. For example, IRS' nonfiler program has an ironic imbalance that allows high-income nonfilers--or those who make over \$100,000--to more easily escape scrutiny than nonfilers with lower income. At three service centers that GAO reviewed, IRS did not fully pursue about half of the high-income nonfilers primarily because of a flaw in setting workload priorities and a decision to exclude high-income nonfilers from a program that creates a tax assessment for other nonfilers. Also, when IRS eventually received a delinquent return from a high-income nonfiler, it did not use the information returns, along with other data, to ensure that the nonfiler paid all taxes owed. Had IRS set priorities correctly, GAO estimated that these three service centers could have recommended up to \$10 million more in taxes.

GAO also found that IRS could improve its computer matching of information returns with tax returns to reduce the millions of underreporter cases that do not recommend additional taxes. Pursuing such unproductive cases wastes IRS' resources and burdens taxpayers who respond to IRS' inquiries. IRS could have avoided up to 40 percent of the unproductive cases in one service center by better using information returns, among other data, in its computer match. Had IRS done so and used the savings to pursue unworked cases, GAO estimated that the service center could have recommended over \$18 million in additional taxes.

Information returns are a valuable tool for improving voluntary compliance. But IRS has not used them as well as it could to ensure that high-income nonfilers pay their fair share of taxes and that taxpayers report all income. IRS must continue its efforts to improve these programs so that all American taxpayers pay their fair share. As a result of two reports that GAO is releasing today, IRS is making such improvements.

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Mr. Chairman:

I am pleased to be here today to testify on two GAO reports done at your request on IRS compliance programs. The reports discuss ways that IRS could better use information returns to identify and pursue people who do not file a tax return or who file a return but fail to report all income. Doing so could allow IRS to narrow the federal income tax gap.

As you know, IRS defines the gross tax gap as the difference between the amount of income tax that taxpayers owe and the amount they voluntarily pay for a tax year. In 1988, IRS estimated the gross tax gap to be \$84.9 billion for 1987 and projected that it would reach \$113.7 billion by 1992. IRS estimates that nonfilers and underreporters accounted for about \$7 billion and \$48 billion, respectively, of the 1987 tax gap.

Reducing the tax gap is an important challenge, given its potential harm to public confidence in the voluntary tax system and its potential importance for the federal budget deficit. More could be done to reduce the tax gap, but the questions are how and with what resources? To address these questions, you asked us to examine whether improvements to IRS' nonfiler and underreporter programs could help. Today, we are releasing two reports on these programs.

Our first report shows that high-income nonfilers, or those making over \$100,000 a year, have a better chance of escaping IRS scrutiny than nonfilers with lower income. IRS did not fully pursue most high-income nonfilers who did not respond to initial notices from three IRS service centers.¹ IRS did not do so primarily because its formula for deciding which cases to investigate did not properly account for the income of nonfilers. Also, after IRS eventually received tax returns from high-income nonfilers, it did not use the information returns, among other tools, to see whether all income was reported and taxes were paid.

Our second report discusses IRS' efforts to pursue people suspected of not reporting all their income when filing tax returns.² You asked us to determine whether more effective computer matching could reduce the millions of underreporter cases that now require labor-intensive reviews by service center staff only to find that no underreporting existed. We found that IRS could have avoided up to 40 percent of such unproductive cases in one service center by better using information returns, among other data, in its computer match. Pursuing unproductive cases is not only an inefficient use of IRS' resources, but it also burdens taxpayers who must respond to IRS' inquiries.

¹Tax Administration: IRS Does Not Investigate Most High-Income Nonfilers (GAO/GGD-91-36, Mar. 1991).

²Tax Administration: IRS Can Improve Its Program to Find Taxpayers Who Underreport Their Income (GAO/GGD-91-49, Mar. 1991).

Mr. Chairman, I would like to briefly discuss the findings in both of these reports, along with our recommendations to IRS.

BACKGROUND

IRS identifies potential nonfilers and underreporters by matching tax returns with related information returns for the taxpayer. Information returns are submitted by employers and other payers of income, such as banks paying interest. In 1989, payers submitted almost 1 billion information returns to report certain deductions and nearly every category of income, such as wages and dividends. When the match shows income but no corresponding tax return, a potential nonfiler case is created. When the match finds a filed return that does not report all income shown on information returns, a potential underreporter case is created.

IRS DOES NOT INVESTIGATE

MANY HIGH-INCOME NONFILERS

IRS estimates that \$7 billion in 1987 federal taxes--the latest year for which IRS did this estimate--were not paid because people did not file required income tax returns. IRS identified over 4 million potential nonfilers for 1987--a 24-percent increase since 1985. These nonfilers included about 40,000 who had high income, or over \$100,000. In the three service centers

we reviewed, IRS investigated about 12,000 of these high-income nonfilers, of which about 3,600 investigations were still unresolved after IRS sent two notices.

We tried to find out who these high-income nonfilers were. How did they earn a living? How old were they? To do so, we reviewed the results of 300 randomly-selected cases that IRS had pursued at the three service centers. We discovered that

- their average age was 46;
- 67 percent filed joint returns;
- a little more than half were employees with wages as their predominant source of income;
- about one-third were self-employed with non-employee compensation accounting for most of their total income;
- their median income was \$134,000;
- about one-quarter had incomes over \$200,000, and over 1 in 10 had incomes over \$300,000; and
- nearly 90 percent had been late in filing a federal income tax return for 2 or more years.

After identifying potential nonfilers, IRS uses a three-stage process to pursue them. First, IRS sends up to four notices that ask nonfilers to file a return or to explain why no return is required. Second, IRS sends unresolved cases to either-- depending on the amounts and types of income--(1) an automated call site, where a tax examiner tries to obtain the missing tax return; or (2) the Substitute for Returns program, where IRS estimates taxes owed, prepares a "substitute" return for the delinquent one, and assesses the tax. Third, cases unresolved at automated call sites are referred to an IRS district office where a revenue officer may attempt, depending on a case's priority and the workload, to contact the potential nonfiler about the missing return, along with any taxes owed.

To find out whether IRS could obtain more returns and taxes by changing its 3-stage process, we randomly selected a sample of 1,200 of the 3,600 high-income nonfiler cases that remained unresolved at 3 of IRS' 10 service centers after the second IRS notice.³ IRS then pursued these cases at our request. As a result, we estimated that 1,700 (or 47 percent) of the 3,600 cases would not have been fully pursued, meaning that a revenue officer would not investigate them or IRS would not assess a tax in earlier stages.

³The 1,200 cases included the 300 cases used to find out who comprised the high-income nonfilers at the 3 service centers.

Because of high workloads and too few revenue officers, IRS revenue officers do not work low priority cases that have low expected yields based on a formula that computes these yields on all types of cases. In addition to high-income nonfilers cases, these cases also include other types of nonfilers and cases where IRS already assessed taxes but the taxpayer had not paid them. District offices used this priority to assign cases with the highest scores to revenue officers. However, IRS' formula understated the yields for high-income nonfilers. Instead of distinguishing among different levels of income, the formula combined estimated yields from investigating all nonfiler cases. As a result, tax yields for lower income nonfilers pulled down the estimated yields for high-income nonfilers.

Had IRS separately estimated yields for high-income nonfilers, as we recommend, the estimated yields would have tripled, as well as the priorities. As a result, revenue officers would have been assigned over 800 more of the 1,700 unworked cases that were part of our sample and recommended an additional \$10 million in taxes.

Even with correctly estimated yields, IRS still would have too few revenue officers to investigate the remaining 900 (1,700 minus 800) unresolved cases. Rather, revenue officers would investigate other types of cases that the formula indicated would bring higher revenue yields. Whether IRS needs additional staff

to work more high-income cases nationwide depends on whether IRS can (1) reallocate staff from offices with low workloads to those with higher workloads or (2) become more efficient and thus work more cases with the same number of staff. Although we did not do this type of analysis, we believe that some additional staffing, while not the complete solution, may be necessary if IRS is going to present a credible threat to high-income nonfilers.

By not pursuing high-income nonfilers, IRS has created an ironic imbalance in its enforcement programs. While many high-income nonfilers are not pursued, lower income nonfilers are pursued through the Substitute for Returns program, which results in a tax assessment. IRS excluded high-income nonfilers from this program because it believes that they may have income not reported on information returns, and thus, the substitute return could understate their tax liability.

However, we believe that the alternative is worse--high-income nonfilers escaping any IRS tax assessment. We also found cases where high-income nonfilers received refunds from returns for later tax years. Had IRS assessed taxes owed through the Substitute for Returns program, the refunds to these high-income nonfilers would have been withheld pending resolution of the delinquency. For these reasons, we are recommending that the program include those high-income nonfilers that would otherwise escape any IRS action. These include those who revenue officers

either (1) could not convince to file a delinquent return or (2) did not pursue because other types of cases had higher priority.

We believe the Substitute for Returns program is a viable alternative to IRS' current process for pursuing high income nonfilers. Our case results showed that this program produced an estimated \$1,700 of revenue for every \$1 spent--a much higher yield than the \$60 to \$1 ratio of the current process.

We also found an ironic imbalance when high-income nonfilers eventually filed their tax returns. Unlike returns filed on time, IRS does not routinely review returns for noncompliance when they are filed late by high-income nonfilers. These reviews would occur if high-income nonfilers were in the Substitute for Returns program because all delinquent returns obtained in the program are checked for noncompliance. Because delinquent returns are often filed several years late, IRS also is less likely to select them for examination than returns filed on time. Further, delinquent returns from nonfilers are not computer-matched for unreported income as is done for returns filed on time.

In fact, nearly 12 years ago we recommended that IRS routinely review delinquent returns for unreported income and it still does not do this. Our current report found that almost half of the delinquent returns that we asked IRS to check had evidence

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employment were caused by taxpayers reporting the income on lines not matched.

To reduce the number of unproductive underreporter cases, we are recommending that IRS modify the computer match to search for income on as many tax return lines as possible without inadvertently screening out productive cases.

We found that if all of the more effective computer matching techniques described in our report were used, Fresno could have avoided up to 40 percent of the 61,000 unproductive cases. Had Fresno used these savings to pursue unworked but potentially productive wage and self-employment cases, we estimate they could have recommended up to \$18.7 million in additional taxes for 1987 at that service center alone. As discussed in our report, IRS has already made some changes to the computer match that could result in additional savings, and possibly tax revenues, for later tax years.

Although these estimated Fresno savings cannot be generalized to IRS' nine other service centers, we believe similar savings may be possible because the (1) computer matching process is done centrally at the Martinsburg Computing Center and (2) other service centers' workloads are similar for unproductive cases involving wage and self-employment income.

We also found that IRS was not notifying the Social Security Administration (SSA) after finding errors in wages that employers previously reported to SSA. For example, when pursuing underreporters, IRS may find that the wages were not paid to the taxpayer whose name and Social Security number appear on the Form W-2. In other cases, IRS found that the person did not receive all of the wages shown in SSA's records. For the Fresno cases where we had IRS' corrected wage data, we estimated that about \$44 million in wages shown in SSA's accounts could have been overstated, as of June 1990.

SSA needs this corrected wage data from IRS because when a person retires and applies for Social Security benefits, the average lifetime wages shown in SSA's account determine the amount of benefits that the person will receive. If SSA attributes wages to the wrong people, it could pay some too much money and others too little. As a result, we are recommending that IRS share the corrected wage data it finds when pursuing underreporter cases with SSA.

ENHANCING THE EFFECTIVENESS OF
THE INFORMATION RETURNS PROGRAM

Mr. Chairman, before concluding I would like to make one additional point that is not discussed in our two reports but certainly warrants discussion with this Subcommittee because of its key role in the development and oversight of IRS' information returns program.

As you know, IRS' studies have shown that a major benefit of information returns is stimulating taxpayers to voluntarily report their income on tax returns. Further, by providing more complete information to both the taxpayer and IRS, the information returns program plays a central role in encouraging voluntary compliance and deterring underreporting.

The voluntary reporting incentives had been buttressed by a penalty on taxpayers that did not report all income shown on information returns. Taxpayers failing to report this income were presumed to be negligent because they were provided with an information return from the payer reflecting such income. In fiscal year 1988, IRS assessed over 833,000 of these underreporter penalties with a revenue yield of \$114 million.

But in 1989, Congress repealed this penalty as part of its civil penalty reform. It is not clear why Congress did so. Although

some IRS officials at the time said the penalty was difficult to administer, we found no indication that this was a problem.

Repealing the penalty may weaken the voluntary compliance incentive for taxpayers to report all income shown on information returns. Without this penalty, underreporting can only be penalized through a time-consuming IRS effort to ascertain the taxpayer's negligence. Therefore, some taxpayers may be more tempted to underreport income.

If an increasing number of taxpayers fail to report income shown on information returns, the number of potential underreporter cases will escalate. That will only exacerbate the situation we are discussing today. We recommended in our September 1989 report that the penalty be retained and we continue to believe this would be an important step to improve voluntary compliance.⁴

CONCLUSIONS

Putting both reports in perspective shows that IRS must wisely manage its use of information returns if it is to maximize benefits and minimize costs. Information returns are a valuable tool for improving voluntary compliance. But our report on nonfilers shows that IRS is not using information returns as

⁴ Tax Policy: Options for Civil Penalty Reform (GAO-GGD-89-81, September 6, 1989)

effectively as it could to ensure that high-income nonfilers pay their fair share of taxes. Such people not only diminish the public's respect for our tax system, but they also place an unfair burden on honest taxpayers who currently must bear a larger share of the taxes. Similarly, our report on underreporters shows that IRS can use information returns more efficiently to identify and pursue taxpayers who fail to report all of their income.

IRS' efforts to improve these programs are crucial to better ensure that all American taxpayers pay their fair share. I am heartened to inform you that as a result of our studies, IRS is moving to resolve problems discussed in both of our reports. Regarding high-income nonfilers, IRS is making changes to increase the likelihood that they will be more fully pursued and to ensure that their returns receive more scrutiny. In the underreporters program, IRS is revising the computer match to screen out additional unproductive cases.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions.