



## Testimony

Before the Committee on Finance, U.S. Senate

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# TAX ADMINISTRATION

## Information on Selected IRS Tax Enforcement and Collection Efforts

Statement of Michael Brostek, Director, Tax Issues



G A O

Accountability \* Integrity \* Reliability

## **Form SF298 Citation Data**

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| <b>Supplementary Notes</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |                                                |                                                         |
| <b>Abstract</b><br>I am pleased to join you today as you address a number of issues related to the role of the Internal Revenue Service (IRS) in enforcing the nations tax laws. As you requested, I will discuss two topics: (1) the relationship between IRS audits of taxpayers and other programs IRS uses to ensure that taxpayers returns are accurate, and (2) how IRS is managing the increased workload in two of its programsoffers-in-compromise and innocent spouse claims. My testimony primarily is based on our past work and reviews we are doing of the offer-in-compromise and innocent spouse programs. I will summarize my main points before providing more detail on these topics. |                                                |                                                         |
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Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

I am pleased to join you today as you address a number of issues related to the role of the Internal Revenue Service (IRS) in enforcing the nation's tax laws. As you requested, I will discuss two topics: (1) the relationship between IRS audits of taxpayers and other programs IRS uses to ensure that taxpayers' returns are accurate, and (2) how IRS is managing the increased workload in two of its programs—offers-in-compromise and innocent spouse claims. My testimony primarily is based on our past work and reviews we are doing of the offer-in-compromise and innocent spouse programs. I will summarize my main points before providing more detail on these topics.

IRS audited over 600,000 taxpayers in fiscal year 2000, either face-to-face or through the mail. However, audits do not fully reflect IRS' efforts to ensure that taxpayers accurately report their tax liabilities. IRS has several programs that use computerized screening procedures to review all tax returns to detect certain types of errors, such as underreporting of interest or other types of income. These programs result in millions of contacts with taxpayers to inform them of adjustments IRS made to their tax liabilities, seek explanations for errors IRS believes were made, or ask taxpayers to check whether they erred on their returns. The programs vary in their similarity to audits; some of the programs are most similar to audits that IRS conducts through the mail. However, audits have statutory limitations—IRS is generally limited to one examination of a taxpayer's books and records for each taxable year. This limitation does not apply to the other programs IRS uses to ensure that tax returns are accurate. Further, the programs IRS uses to detect errors on tax returns are completely reliant on information that taxpayers report on the tax returns and that IRS receives from third parties. Therefore, audits remain an important tax enforcement tool. This is especially true for taxpayers whose income and other tax characteristics are not subject to routine third-party reporting to IRS. IRS' computerized checks on the accuracy of tax returns could help to free up staff to audit these taxpayers.

Recently, much attention has been focused on declines in IRS' audit rates for individual taxpayers, which in fiscal year 2000 fell 40 percent below the lowest previously reported audit rate. These declines are of concern because taxpayers may take low audit rates as a signal that underreporting or underpaying of taxes is unlikely to be detected, which might lead to declines in voluntary compliance. However, noncompliance can also be unintentional, for instance if a taxpayer errs due to misunderstanding a tax rule. If declining audit rates do affect voluntary compliance, the effect might be offset in part by use of IRS' other programs to detect inaccurate tax returns or by IRS' efforts to better inform taxpayers of their tax responsibilities and to answer their tax-related questions. However, the net effect of these factors on voluntary compliance is not known, principally because IRS has not measured voluntary compliance in reporting tax liabilities since 1988.

The offer-in-compromise program was established to provide a means for taxpayers to settle tax debts that cannot be paid in full while providing for payment of some portion of the taxes owed. Under the innocent spouse program, IRS can relieve a spouse of tax debts based on equity considerations, such as not knowing that their spouses failed to pay taxes due. In 1998, Congress encouraged greater use of both of these programs. Since that time, the workload in both programs has increased substantially, leading to rising inventories of cases and concerns about the time taken to process cases. IRS' ending inventory of unresolved workable offers has almost tripled from fiscal year 1997 to fiscal year 2000. IRS' innocent spouse program, which received about 3,000 new cases in the 4 months prior to the IRS Restructuring and Reform Act (Restructuring Act), now receives on average about 5,000 new cases each month. IRS has taken a number of steps in both programs, including reassigning staff from other duties, to handle the increased workload. In the past two years, the offer-in-compromise program has experienced a greater rise in its workload and is not as far along as the innocent spouse program in implementing processes that IRS believes will help gain better control over the workload. Given how recently changes have been made in both programs, it is not yet clear whether the steps IRS has taken and plans to take will enable it to significantly reduce case inventories.

## **Audits and Other Programs for Ensuring the Accuracy of Tax Returns**

IRS uses several programs to ensure that tax returns include all of the information necessary for properly determining taxable income and the tax due on that income. Although audits are a key program for ensuring that tax returns are accurate, they represent a small portion of the activities IRS undertakes for this purpose. Briefly, the key programs include the following:

**Audits:** Section 7602 of the Internal Revenue Code gives IRS the authority to examine a taxpayer's books and records as well as to take testimony to ensure the accuracy of tax returns. Section 7605(b) restricts IRS' exercise of this authority by allowing not more than one examination of a taxpayer's books of account for each taxable year, unless the taxpayer requests otherwise or unless authorized by the Treasury Secretary. Section 6501 generally requires that examinations of a taxpayer's books and records must occur within 3 years of the taxpayer's due date for filing the tax return unless the taxpayer agrees to an extension of this period. IRS conducts face-to-face audits from its field offices (referred to hereafter as field audits) and correspondence audits out of its 10 service centers. Correspondence audits are conducted through the mail. They cover less complex issues than field audits and generally address only one or two issues on the tax return.

**Information returns:** Under various sections of the Code, third parties are required to file information returns with IRS and taxpayers to report tax-related information such as wages, interest, dividends, or other income paid to taxpayers. In its information returns program, IRS uses computers to compare that information to the information that taxpayers provide on their tax returns, checking whether (1) taxpayers included income on their tax returns that information returns indicated had been paid to them (underreporter program), and (2) taxpayers filed a tax return when information returns indicated that they had received income (nonfiler program).

**Math errors:** When a tax return is received and before it is accepted, IRS uses computers to identify and correct clerical and mathematical errors and to check the accuracy of Social Security numbers shown on the return. These clerical and mathematical error checks rely solely on information provided by the taxpayer on the return, while the Social Security number checks compare Social Security numbers on the return to data on Social Security numbers provided to IRS by the Social Security Administration. Section 6213 of the Internal Revenue Code identifies the specific items on the return that can be checked under IRS' math error authority. Table 1 provides some information about the workload in fiscal year 2000 for each of these programs.

Table 1: Fiscal Year 2000 Workload for IRS' Key Programs to Ensure Compliance by 125 Million Taxpayers

| <b>Fiscal year<br/>2000 activities</b>            | <b>Key programs to ensure taxpayers have filed accurate returns</b> |                       |                            |                 |                       |
|---------------------------------------------------|---------------------------------------------------------------------|-----------------------|----------------------------|-----------------|-----------------------|
|                                                   | <b>Audits</b>                                                       |                       | <b>Information returns</b> |                 | <b>Math<br/>error</b> |
|                                                   | <b>Field<sup>a</sup></b>                                            | <b>Correspondence</b> | <b>Underreporter</b>       | <b>Nonfiler</b> |                       |
| Percent of filed returns screened by computer     | 100%                                                                | 100%                  | 100%                       | N/A             | 100%                  |
| Number of taxpayers contacted                     | 237,561                                                             | 380,204               | 1,353,545                  | 1,251,375       | 5,751,000             |
| Percent of taxpayers with filed returns contacted | 0.19%                                                               | 0.30%                 | 1.08%                      | N/A             | 4.50% <sup>b</sup>    |

<sup>a</sup> For this figure, "field audit" refers to all face-to-face audits done by IRS.

<sup>b</sup> The rate for audit and underreporter cases was calculated using the 125 million taxpayers who filed in 1999 because it was from these taxpayers that IRS selected returns to audit and identified taxpayers to receive underreporter contacts in 2000. We used 127.7 million tax returns filed in 2000 to calculate the coverage for math error because it was these returns that were reviewed for math errors.

Source: IRS data.

As table I shows, in fiscal year 2000, all individual tax returns were screened for accuracy by IRS computers. For example, all tax returns are analyzed and scored by IRS' computers to determine which returns are most likely to be subject to a change if audited. Although the various programs screen all returns, not all items on the returns

are reviewed, with the elements screened depending on the type of program. Also, the number of taxpayers who were contacted under each program varied. The largest numbers of taxpayers contacted in fiscal year 2000 were contacted under the math error program—about 5.75 million taxpayers, or 4.5 percent of all taxpayers. IRS did about 617,000 audits, of which over 60 percent were correspondence audits, and sent about 1.4 million underreporter notices and 1.3 million nonfiler notices.

In addition to these programs, IRS also has certain special programs that focus on the accuracy of specific tax reporting issues. For instance, IRS checks to determine whether the dependent Social Security numbers on a return also appear on returns filed by other taxpayers—a duplicate Social Security number check. IRS also checks whether an individual who has self-employment income has paid self-employment tax. These and other checks can generate what IRS calls “soft notices.” The soft notices ask taxpayers to review their return for certain types of errors, but do not assess or propose assessing additional tax or otherwise change the tax returns. For the duplicate Social Security number and self-employment checks, IRS essentially screens all tax returns through its computers for these potential problems. In calendar year 1998, IRS sent about 1.9 million soft notices to taxpayers in connection with duplicate Social Security number and self-employment checks according to the most recent data we have from IRS.

#### How Audits Compare to Other Programs for Checking Tax Returns and How Audits Have Evolved Over Time

IRS’ field audits clearly differ from IRS’ math error, information return, and soft notice efforts since these audits are done face-to-face rather than through the mail. However, over 60 percent of the audits—correspondence audits—are less obviously different from the other programs for checking tax returns’ accuracy because these audits are done through the mail. Correspondence audits are most like, but not identical to, some of the contacts IRS has with taxpayers in the information returns program and are least like the contacts in the math error program.

Information returns program and correspondence audit contacts with taxpayers can appear to be similar because, among other things, they both

occur through mail originated in an IRS service center;  
usually involve an error that IRS believes it has detected in the accuracy of some item on a tax return;  
result in IRS' contacting a taxpayer after his or her return has been processed and, in most cases, the taxes have been paid or refund made;  
ask taxpayers to respond by agreeing or disagreeing that the error exists, and by providing at least some explanation of their position if they disagree;  
use an IRS employee known as a tax examiner who is to review any responses and is to accept taxpayer responses that appear to reasonably support their positions; and  
can result in IRS' assessing an additional tax liability if taxpayers do not respond.

However, differences also exist along many of these dimensions.

Unlike the information return program, correspondence audits trigger the section 7605(b) restriction that limits IRS to one inspection of a taxpayer's books of account for each taxable year, unless authorized by the taxpayer or the Secretary of the Treasury. Correspondence audit notices generally ask taxpayers to provide information from their books and from records such as birth certificates and school records. Information returns program notices do not specifically ask taxpayers to provide copies of information from their books and records. Rather, taxpayers are asked only to explain the discrepancy between their returns and what IRS had reported to it on information returns. According to IRS officials, most taxpayers do so in a letter without sending copies of books and records.

The potential taxpayer errors covered by the information returns program deal with types of income reported on information returns—such as wages, interest, and

dividends.<sup>1</sup> Correspondence audits can deal with income as well as deductions, exemptions, and credit items that can be audited through the mail. Over 80 percent of correspondence audits that closed during fiscal year 2000 dealt with earned income tax credits.

The tax examiners in the information returns program are not trained to do audits. Therefore, if the taxpayer sends in books and records that need more review, these tax examiners are to send the case to the correspondence audit unit.

These differences, particularly the section 7605(b) limitation, are significant. However, if taxpayers have had little experience in dealing with IRS, they may not understand the differences between correspondence audits and information returns program contacts. From these taxpayers' perspective, IRS has sent them a letter in either case that questions the accuracy of an item on their tax return and requires that they respond if they believe IRS is incorrect. If taxpayers do not respond, IRS ultimately can assess the additional taxes on the basis of the evidence it has in its files.

Math error contacts are more limited in their similarity to correspondence audit contacts. For example, both types of contacts can change the tax liability that taxpayers reported on the filed tax return, and both contacts are handled through the mail. Otherwise, math error contacts differ from audit contacts. For example, the math error program screens returns for errors before being accepted by IRS as valid returns. If an error is found, taxpayers are sent a notice within a few weeks after submitting their return. The math error notices do not ask taxpayers for information about the return, as would correspondence audit notices. Rather, math error notices inform taxpayers that they have made an error, and that IRS has made changes that increase or decrease their tax liabilities. If taxpayers disagree with the change, they can follow procedures to request that IRS abate, that is, reduce or rescind, the change in their taxes.

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<sup>1</sup> IRS also receives information returns for the mortgage interest tax deduction and may contact taxpayers about discrepancies related to it.

Although audits have the distinguishing characteristic of requiring taxpayers to submit books and records for IRS review, what is counted as an audit can change over time. For instance, in 1994, IRS concluded that certain service center contacts were no different than other types of contacts counted as correspondence audits. Subsequently, IRS has counted these contacts as audits. This change shifted a couple hundred thousand contacts to the correspondence audit program during that time period.

A movement in the opposite direction occurred in 1996. In 1996, Congress amended the statutory definition of a mathematical or clerical error to include missing or invalid Social Security numbers in claims for dependency exemptions and the earned income credit.<sup>2</sup> This change resulted in about 700,000 cases moving out of the correspondence audit program and into the math error program during fiscal year 1997.

In a broader perspective, the evolution of technology and the law has enabled IRS to make greater use of computers to perform what had required reviews of books and records by IRS auditors. The information returns program is such a case. Before Congress enacted laws requiring various institutions to file “information returns” on income paid, IRS had little choice but to ask for taxpayers’ books and records to determine whether they had underreported their income. IRS could only do this for a small portion of all taxpayers. With passage of the various information reporting laws and expansion of their use beginning in the 1970s, IRS began to receive copies of materials that were part of books and records without having to ask taxpayers directly for the information. As IRS’ computing capacity grew in the 1970s and 1980s, it was able to match virtually all of the information returns it received with individual tax returns. IRS’ enhanced computer capacity allows it to substantially verify all the income reported on tax returns by many individual taxpayers. In 1996, we reported that 45 percent of the taxpayers claimed the standard deduction and that all the income they reported on their tax returns was subject to information reporting.<sup>3</sup> Because IRS does not have to directly

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<sup>2</sup> P.L. 104-188 and P.L. 104-193.

<sup>3</sup> *Tax Administration: Alternative Filing Systems*, (GAO/GGD-97-6, Oct. 16, 1996).

ask taxpayers for information from books and records, none of these specific income verifications count under the definition of audits.

However, computerized checks on the accuracy of tax returns are limited in that they depend on information provided by taxpayers and third parties. Because a significant portion of income received by some individuals is not subject to third party information reporting, and because other items affecting tax liability such as most itemized deductions, also are not subject to information reporting, audits remain an essential program for ensuring that taxpayers file accurate tax returns. To the extent that the computerized checks that are now available to IRS help free up audit staff, IRS may be able to redirect the staff to audit taxpayers whose income and deductions are not well-covered by the information matching programs.

#### Measuring Voluntary Reporting Compliance Is Key to Understanding the Effect of IRS' Audits and Other Actions to Promote Compliance

The falling audit rates since fiscal year 1995 have generated concerns about increases in noncompliance because taxpayers may feel they can underreport income or otherwise underpay taxes with little fear of being caught. In fiscal year 2000, IRS audited 0.49 percent of the income tax returns filed by individual taxpayers. This rate was about 45 percent lower than the audit rate in 1999, over 70 percent lower than the rate in 1995, and about 40 percent lower than the lowest previous audit rate of 0.8 percent, which occurred in 1990.

An increase in the use of other programs, such as the math error and the information returns program, may help offset any tendency towards lowered compliance. However, the number of contacts in these programs has also been falling since fiscal year 1995. For example, the number of information returns program contacts for unreported income has fallen about 50 percent since 1995.

Other factors may also help to encourage overall voluntary compliance levels. IRS initiatives to help taxpayers better understand the tax law and their tax responsibilities

may offset unintentional noncompliance resulting from such things as misunderstanding tax requirements. If these programs are reducing unintentional noncompliance, the overall voluntary compliance rate could hold steady, or even increase, even if some taxpayers intentionally underpay their taxes due to the signal that falling audit rates may send.

Neither IRS nor external observers know the net effects that the decline in audit rates and changes in other IRS programs have on voluntary reporting compliance. One reason is that IRS does not have current, reliable information on the levels of voluntary reporting compliance. IRS last measured overall income tax compliance for tax year 1988. IRS and others are concerned that the compliance information is out of date because the tax laws have changed, and because IRS has completely reorganized itself and refocused its philosophy to become more taxpayer service-oriented.

Because each of the programs IRS uses is best suited to identifying and correcting a specific type of noncompliance, it is important for IRS to know specifically where taxpayers are not reporting accurately. For example, the information returns program is best suited to identifying taxpayers who underreport income such as wages, interest, and dividends. Similarly, the math error program can best identify taxpayers who use an incorrect Social Security number for dependents or make a calculation error. However, at this time, only an audit enables IRS to identify noncompliance in reporting items that affect business net profit or loss, personal income not covered on information returns, and most personal deductions.

Having more information about the specific types and level of errors made by taxpayers in reporting items on tax returns has potential benefits beyond better targeting IRS' enforcement efforts. With this information, IRS also can analyze ways to improve voluntary compliance through nonenforcement efforts—such as better education, service, and forms—as well as to improve resource allocation and the training of all types of IRS staff.

IRS is currently developing plans to again measure voluntary compliance. A draft business plan has been developed, and IRS is in the process of contacting various stakeholders to obtain their input. The project, called the National Customer Research Study, will measure all three areas of compliance--obtaining information on the proportion of returns that were filed properly, that reported the tax liabilities accurately, and that fully paid these tax liabilities. Because a voluntary compliance measure is key to understanding the effects of IRS' efforts to properly administer the tax laws, we are currently reviewing IRS' National Customer Research Study.

### **IRS' Offer-in-Compromise Program**

An offer-in-compromise is a contract between IRS and an individual or business taxpayer to settle a tax debt for less than the amount of the debt. Taxpayers can submit an offer for all types of taxes, as well as interest and penalties, arising under the Internal Revenue Code. Generally, offer agreements require the taxpayer to file returns and pay taxes for 5 years from the date IRS accepts the offer. Failure to do so permits IRS to begin immediate collection actions for the original amount of the liability. The offer-in-compromise program is currently administered by IRS' Small Business/Self-Employed (SB/SE) Division.

Offers were not widely used to resolve tax debts until 1992, when IRS adopted a new offer policy that placed more emphasis on the use of offers as a means to enhance overall compliance and to help manage the inventory of delinquent tax accounts. The goal of the new offer policy was to achieve collection of what was potentially collectible at the earliest possible time and at the least cost to government.

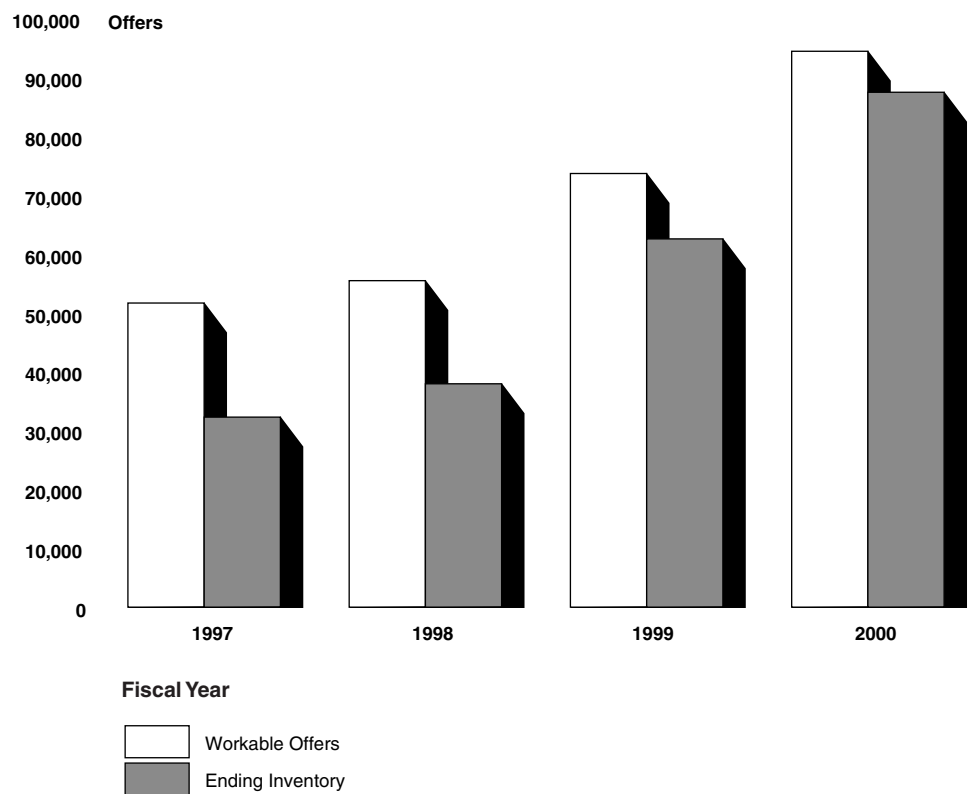
More recently, the Restructuring Act called for certain changes in the offer program directed at providing greater consideration to the taxpayer in resolving collection issues through compromise. Among other things, the Restructuring Act required that IRS (1) consider the facts and circumstances of each case when evaluating offers, (2) not reject offers from low-income taxpayers solely on the basis of the amount offered, and (3) independently review all proposed offer rejections before notifying taxpayers and allow

taxpayers to appeal any such rejection. These changes were effective upon enactment of the act on July 22, 1998.

### Trends in Offer Workload

IRS data show that its workload for the offer-in-compromise program has significantly increased in recent years. The number of workable offers-- that is, offer applications that meet IRS' criteria to process them--has increased by 83 percent, from about 51,700 offers in fiscal year 1997 to about 94,500 offers in fiscal year 2000. Because IRS was unable to keep up with this increase in offers received, IRS' ending inventory of unresolved workable offers almost tripled, from about 32,300 in fiscal year 1997 to about 87,500 in fiscal year 2000. Figure 1 shows these trends in workable offers and ending inventory.

Figure 1: Trends in Workable Offers and Ending Inventory

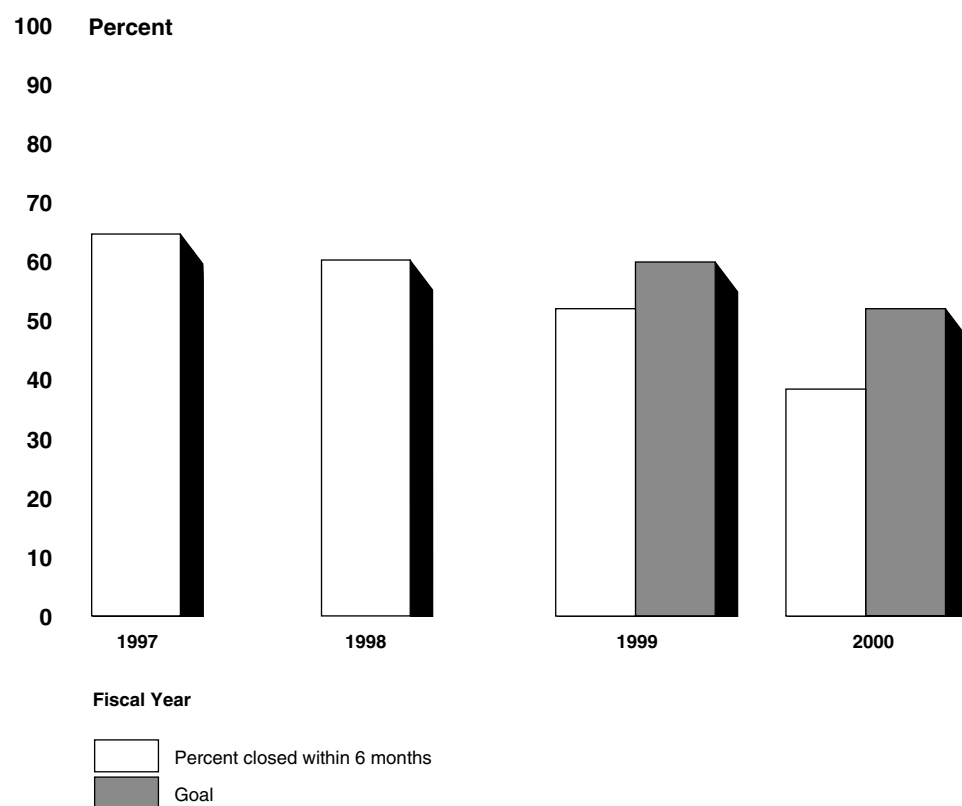


Source: IRS data.

According to IRS, several factors contributed to the growth in the number of workable offers. First, the publicity resulting from the outreach and marketing efforts of IRS and tax practitioners brought the revised program to the attention of taxpayers and their practitioners. Second, prior to fiscal year 1999, IRS would not accept an offer-in-compromise application for processing if it was incomplete in providing such things as financial information or if the offer was missing the taxpayer's signature. In 1999, IRS began accepting all offer applications for processing except those from taxpayers in bankruptcy proceedings or taxpayers who had not filed all required federal tax returns. Instead of returning an incomplete offer, IRS now accepts the offer for processing and works with the taxpayer to obtain the information needed. Finally, IRS previously had installment agreements with many taxpayers that extended for up to 15 years and longer. In 1999, IRS decided to halt the practice of agreeing to such long-term installments and decided instead to work with the taxpayers on an offer-in-compromise with a deferred payment schedule. This shifted some of the workload from the installment agreement program into the offer-in-compromise workload.

IRS measures its timeliness in working offers-in-compromise by the percent of offers it completes within 6 months of the date the offer is accepted for investigation. As shown in the figure below, the percentage of offers IRS completed within 6 months has declined from 64 percent in fiscal year 1997 to 38 percent in fiscal year 2000. For fiscal year 1999, IRS established a goal to close 59.3 percent of offers within 6 months of the date the offer is accepted for investigation. It set a goal of closing 51.4 percent of offers within 6 months for fiscal year 2000. IRS did not meet either of these goals: it closed 51.4 percent of its workable offers within 6 months in fiscal year 1999 and 37.9 percent in fiscal year 2000. In addition, the percentage of cases in the ending inventory over 6 months old increased from 19 percent to 43 percent between fiscal years 1997 and 2000. Figure 2 shows the trend in offers closed within 6 months for fiscal years 1997 through 2000 and IRS' goals for fiscal years 1999 and 2000.

Figure 2: Percentage of Offers Closed Within 6 Months in Fiscal Years 1997-2000 and IRS' Goals for Fiscal Years 1999 and 2000



Source: IRS data.

According to IRS officials involved in the offer program, several program changes have contributed to IRS' inability to meet its 6-month goal for processing offers. These include:

Relaxing the criteria for accepting offer applications for processing. The change in criteria for accepting applications, discussed previously, resulted in the time taken to obtain required information for a complete offer application being counted in IRS' processing time.

Expanding the basis for accepting offers to include factors such as hardship and equity.<sup>4</sup> IRS officials said that this was done because they believed, in considering and passing the Restructuring Act, Congress expressed its intent that IRS should be more flexible in working with taxpayers who want to settle tax debts. IRS officials said that they first consider the offer under their normal criteria for evaluating offers, and then the taxpayer must demonstrate that an exceptional circumstance exists that would make payment of the tax a hardship, unfair, or inequitable. Whenever these factors are considered, the process takes longer.

Implementing the Restructuring Act requirement that IRS perform an independent administrative review of all proposed offer rejections. IRS has also included as part of this review all proposed decisions to return an offer because of a taxpayer's failure to provide information IRS requested. According to IRS officials, these reviews have increased processing time by almost a month for those offers that were reviewed.

The relationship between the number of workable offers and the capacity of staff to process them affected inventory levels. In an attempt to manage the growing numbers of workable offers and cases that have been in inventory more than 6 months, IRS shifted staff to the offer program from other field collection activities, such as tax delinquent account investigations. The total direct time charged to the offer program increased by 77 percent, from an equivalent of about 350 full-time equivalent positions (FTE)<sup>5</sup> in fiscal year 1997 to about 619 FTEs in fiscal year 2000. However, with the reassignment of more staff into the program, IRS officials said its most productive offer staff were taken off of casework in order to provide newly assigned staff on-the-job training and coaching, which decreased productivity. During the same period, the time directly charged to collection activities by all collection field staff decreased by 33 percent from an

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<sup>4</sup> Under IRS regulations prior to this change, IRS generally accepted offers based on doubt as to collectibility (taxpayers owe tax but cannot pay the entire debt) and doubt as to liability (taxpayers claim they do not owe all or part of the tax in question). Most offers were accepted based on doubt as to collectibility.

<sup>5</sup> An FTE generally consists of one or more employed individuals who collectively complete 2,080 work hours in a given year. Therefore, either one full-time employee or two half-time employees equal one FTE.

equivalent of 6,098 FTEs to 4,114 FTEs. Table 2 shows the trends in FTE utilization in the offer-in-compromise program for fiscal years 1997 through 2000.

Table 2: Direct Field Collection FTE Utilization for Fiscal Years 1997 to 2000

|                                     | <b>FY 1997<br/>FTEs</b> | <b>FY 1998<br/>FTEs</b> | <b>FY 1999<br/>FTEs</b> | <b>FY 2000<br/>FTEs</b> | <b>Percent<br/>Change<br/>FYs 1997-<br/>2000</b> |
|-------------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|--------------------------------------------------|
| Offer-in-compromise program         | 350                     | 356                     | 414                     | 619                     | 77 %                                             |
| Total for all collection activities | 6,098                   | 5,487                   | 4,532                   | 4,114                   | (33 %)                                           |

Source: IRS data.

With the decline in staff assigned to all collection activities and an increase in collection staff working offers, the share of total direct collection FTEs devoted to the offer-in-compromise program has grown from about 6 percent of all collection activities to 15 percent between fiscal years 1997 and 2000.

#### Key Actions Taken by IRS to Address Offer Workload Concerns

In recent years, IRS has taken various actions to address its offer workload concerns. The key actions IRS has taken, designed in part to reduce inventory backlog and processing times, include

- assigning more staff to the offer program, as discussed previously;
- streamlining the offer process for certain cases; for example, IRS changed its investigation and processing procedures in 1999 by requiring less documentation for low risk offers and raised the maximum liability for streamlined offers from \$25,000 to \$50,000;

creating an offer specialist position for revenue officers assigned to work offers;  
developing training programs for offer specialists, independent administrative reviewers, and walk-in and call-site employees so that they can better answer taxpayer questions about the offer program;  
developing an Internet-based self-help interactive offer application; this tool provides background information on the offer process, instructions, and electronic offer forms to assist taxpayers to prepare quality offers and thereby reduce up-front processing time--this effort was part of SB/SE's most recent strategic plan and was implemented at the end of fiscal year 2000;  
revising offer forms and instructions to make them more user-friendly;  
simplifying the deferred payment option by eliminating the collection of interest on the accepted amount; and  
contracting to study how to reengineer the offer process to reduce processing time.

#### Key Actions Planned by IRS to Address Offer Workload Concerns

SB/SE's fiscal year 2001 strategic plan sets forth two actions that IRS is to undertake to improve the efficiency of its offer-in-compromise program. They are to

centralize the processing of new offers-in-compromise at two sites by August 2001 to improve offer quality, timeliness, and efficiency (The two sites are to assemble the initial case files used in processing all offers and fully process offers with liabilities under \$50,000 that meet certain criteria. Offers with liabilities over \$50,000 are to be sent to IRS field offices for evaluation and final processing. To carry out this action, SB/SE's plan states that 650 lower-graded offer staff would be needed at the centralized locations. These staff reportedly would free up over 600 higher-graded revenue officer FTEs for other work by fiscal year 2004. IRS expects that centralization will enable its field staff to completely work its inventory backlog by fiscal year 2004 if the number of new offers received remains constant.); and  
consolidate onto one platform the key databases used by collection personnel to perform the administrative legal requirements for processing liens, bankruptcies, and

offers-in-compromise. (This action is intended to allow more efficient access to information in these databases. The plan states that the database integration is to occur after fiscal year 2002.)

In addition, IRS is planning to revise the offer application package to better explain to taxpayers the requirements for submitting financial information with the offer application.

### Summary and Observations

Through fiscal year 2000, the workable offers and the inventory of existing offer cases increased rapidly, and IRS' performance in meeting its goals for processing cases within 6 months deteriorated. In response, IRS reassigned staff who would have been performing other collection activities into handling offers. Faced with potential continuing high workloads, IRS has adopted a more long-term strategy of centralizing the processing of offers and hiring lower-graded staff to specialize in this function to free up collection staff for other activities. The centralization is planned to begin later this fiscal year. Among other things, it will require reassigning hundreds of employees and providing them facilities, equipment, and training. Although centralization and IRS' other initiatives may enable it to gain control over its growing inventory, success will require careful management of the centralization process and a leveling off in the growth of workable offers received by IRS. Consequently, it remains to be seen how much progress IRS will make and how quickly.

### **IRS' Innocent Spouse Program**

Under tax law, married couples who file joint tax returns are treated as a single unit, which means that each spouse becomes individually responsible for paying the entire amount of the tax associated with that return. Accordingly, an "innocent spouse" can be held liable for tax deficiencies assessed after a joint return was filed, even if those liabilities were solely attributable to the actions of the other spouse.

However, if certain conditions are met, the innocent spouse may be able to obtain relief from the tax liability. The Restructuring Act revised the conditions for obtaining relief to make it easier for taxpayers to qualify for innocent spouse relief. The act liberalized the former conditions and added new conditions. Simply stated, the three basic provisions related to innocent spouse relief are as follows:<sup>6</sup>

When the innocent spouse had no knowledge that there was an understatement of tax attributable to erroneous items of the other individual filing the joint return, and considering all facts and circumstances, it would be inequitable to hold the innocent spouse liable for the tax.

When the innocent spouse otherwise qualifies, he or she may request to have the tax deficiency from a jointly filed return recalculated to include only items allocable to him or herself.

When the tax shown on a joint return was not paid with the return, the innocent spouse may obtain “equitable relief” if he or she did not have knowledge that the funds intended to pay the tax were not used for that purpose. Equitable relief is also available for understatements of tax for which relief under the above two conditions was not available.

Each condition above has different eligibility requirements and provides different types of relief. Relief is generally available to taxpayers for liabilities arising after July 22, 1998, the date the act was enacted, and for liabilities that arose before that date but remained unpaid as of that date.

Currently, IRS’ Wage and Investment (W&I) Division has overall responsibility for managing the innocent spouse program. W&I has an agreement with SB/SE whereby SB/SE field staff work innocent spouse cases requiring face-to-face contact with taxpayers. Prior to IRS’ reorganization, the former Examination Division handled innocent spouse relief requests.

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<sup>6</sup> IRC § 6015, and IRC § 66(c).

## Workload Concerns Developed After the Restructuring Act's Changes

Limited data exist to determine the trend in innocent spouse workload. However, existing data suggest that workload increased substantially after the Restructuring Act's changes. Prior to the Restructuring Act, IRS administered innocent spouse relief as part of its process of examining tax returns and did not keep statistics on the number of cases in which innocent spouse relief was requested or on the disposition of those requests. According to a statement by the IRS Commissioner, in the approximately 4 months before enactment of the Restructuring Act, IRS received about 3,000 innocent spouse cases. In the first 7 months after IRS established a system for more reliably tracking innocent spouse cases, it received over 43,000 innocent spouse cases.

Although innocent spouse submissions increased after the enactment of the Restructuring Act, data are not available to document the increase because IRS did not systematically track innocent spouse cases until March 1999.<sup>7</sup> Since cases have been tracked, it appears that the annualized innocent spouse workload has been relatively stable even though the submissions have not spread evenly over the fiscal year. The limited trend information currently available show that submissions tend to be lower in the early months of the fiscal year—October through January—then climb substantially during and after the tax filing season, before falling off again. Taking this pattern into account, the 43,255 cases received in the seven months after IRS instituted its case tracking system were within 12 percent of the volume received in the same 7 month period of fiscal year 2000—38,695. Further, the 16,422 cases received through March 6 of this fiscal year is slightly less than the 18,643 received during the comparable period the prior year.

When an innocent spouse case is received, IRS screens the case to determine whether it meets basic eligibility requirements before thoroughly investigating it. IRS data shows that the percentage of cases received that IRS determined met the eligibility

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<sup>7</sup> IRS began limited tracking of innocent spouse cases on March 6, 1999 when it implemented the innocent spouse tracking system. If a taxpayer files a claim for innocent spouse relief covering more than one tax

requirements for consideration has declined substantially after fiscal year 1999. For the 7 months of fiscal year 1999 that IRS tracked the cases, about 90 percent of them were judged by IRS to be eligible for further review to determine if innocent spouse relief should be granted or denied. In fiscal year 2000, 54 percent of cases were judged to be eligible for further review. IRS data for fiscal year 2001—October 1, 2000 through March 6, 2001—shows that about 59 percent of cases received warranted further investigation to assess their merits for relief consideration.

On the whole, however, because IRS was unable to process this influx of new cases as rapidly as they were arriving, the inventory of cases being worked at the end of fiscal years 1999 and 2000 reached 33,232 and 39,552 cases, respectively. As of March 6, 2001, the inventory of cases in inventory remained similar in size to that at the end of the prior fiscal year. Table 3 shows basic workload statistics for the innocent spouse program since IRS began tracking the cases on March 6, 1999 through March 6, 2001.

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year or tax period, IRS evaluates the merits of the claim for each tax year individually to determine whether relief should be granted. Therefore, the claim for each tax year is counted as a case.

Table 3: Statistics on the Innocent Spouse Workload<sup>8</sup>

| <b>Dates received</b>                                      | <b>Cases Received</b> | <b>Cases eligible for review</b> | <b>End-of-period inventory</b> | <b>Completed cases<sup>a</sup></b> |
|------------------------------------------------------------|-----------------------|----------------------------------|--------------------------------|------------------------------------|
| Between March 6, 1999, and September 30, 1999 <sup>b</sup> | 43,255                | 38,992                           | 33,232                         | NA                                 |
| Between October 1, 1999, and September 30, 2000            | 60,987                | 32,762                           | 39,552                         | 32,202                             |
| Between October 1, 2000, and March 6, 2001                 | 16,422                | 9,681                            | 39,111                         | 10,122                             |

<sup>a</sup> We have included closed cases as well as cases for which IRS has reached its determination and sent a letter to the taxpayer, but for which the taxpayer's period to appeal the determination is still open.

<sup>b</sup> Figures up to September 30, 1999, are approximate. Data on the number of cases completed up to September 30, 1999, are not available.

Source: IRS Innocent Spouse Tracking System data.

According to IRS, the increase in the number of innocent spouse cases received pursuant to the liberalized relief provisions led to its substantial inventory of open cases for several reasons:

The Restructuring Act provisions were effective upon enactment of the law, giving IRS limited time to estimate likely increases in workload and determine appropriate staffing levels and make staffing assignments. The volume of cases received exceeded IRS' expectations, leading IRS to assign additional staff to the effort.

The expanded innocent spouse relief provisions were especially complex. IRS had to develop guidance for the new and revised relief provisions and provide training for existing and newly assigned staff.

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<sup>8</sup> IRS had about 7,000 cases in inventory that were closed before the tracking system was implemented that are not included in these numbers.

In response to the increased inventory of innocent spouse cases, in fiscal year 2000 IRS increased program staff more than anticipated: it had planned to devote 717 FTEs; it actually used 887 as shown in the following table.<sup>9</sup>

Table 4: FTEs for Processing IRS' Innocent Spouse Claims in Fiscal Year 2000

| <b>Fiscal year</b> | <b>Projected</b> |              | <b>Actual</b>  |              | <b>Total</b>     |               |
|--------------------|------------------|--------------|----------------|--------------|------------------|---------------|
|                    | <b>W&amp;I</b>   | <b>SB/SE</b> | <b>W&amp;I</b> | <b>SB/SE</b> | <b>Projected</b> | <b>Actual</b> |
| 2000               | 115              | 602          | 119            | 768          | 717              | 887           |

Source: IRS.

For fiscal year 2001, IRS projected that W&I and SB/SE would use 169 and 409 FTEs, respectively. IRS attributes the decrease in projected FTE usage by SB/SE primarily to expected efficiencies in case processing pursuant to a plan to move workload back to the W&I's centralized case processing facility.

#### Key Actions Taken by IRS to Address Innocent Spouse Workload Concerns

IRS has taken a number of actions to better manage its inventory of innocent spouse cases and help ensure that the claims are being processed in a timely, accurate, and consistent manner. Some of the actions were based on recommendations by the Treasury Inspector General for Tax Administration (TIGTA), and others were done on IRS' own initiative.

In April 1998, as the Restructuring Act was being considered, IRS designated the Cincinnati Service Center as a central processing site for innocent spouse cases. The service center was to screen new cases. Those cases over a certain dollar threshold or that required face-to-face contact with taxpayers were to be sent to field offices to resolve, while the less complex and low dollar cases were to be handled by service

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<sup>9</sup> IRS does not have good data on FTE usage for the program prior to fiscal year 2000.

center staff. IRS officials believed that this centralization would facilitate more rapid and consistent processing of cases because staff in the service center would specialize in the innocent spouse cases and follow consistent procedures and processes in resolving cases.

In March 1999, IRS established an innocent spouse tracking system to more accurately assess the status of cases in inventory and resource needs.

In May 1999, IRS added a national project manager, and in November 1999 three issue specialists were selected to help manage and oversee the nationwide operations of the program.

In June 1999, IRS announced the establishment of a centralized innocent spouse review process for closed cases in order help ensure that case decisions were made as accurately and consistently as possible among the IRS offices involved in the program. Initially, 100 percent of the field office cases and a 10-percent sample from the Cincinnati Service Center were to be sent to the centralized review office. A sampling procedure is now being used to determine how many cases from the field should be forwarded to the centralized review office.<sup>10</sup> IRS set a goal for fiscal year 2000 that the centralized review process would concur with the decisions made by the submitting offices in 85 percent of the cases reviewed. The concurrence rate achieved for fiscal year 2000 was 82.3 percent. The goal is 90 percent for fiscal year 2001.

In April 2000, IRS made an internal web page available to examiners and other IRS staff as a central reference for information about the innocent spouse program.

In January 2001, the first phase of an innocent spouse integrated case processing (ICP) system was implemented at the Cincinnati Service Center. The ICP uses algorithms that direct examiners through a series of questions leading to a decision about what, if any, relief is due to the taxpayer. The ICP also automatically prompts the examiner to create a documented case file. The ICP is intended to increase the accuracy and consistency of determinations since it is designed to help ensure that examiners consider all pertinent aspects of a taxpayer's case in accordance with the

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<sup>10</sup> The sampling methodology was set up by IRS' Atlanta District Office of Research and Analysis and is a projectible representative sample for each field office.

law. IRS is planning future enhancements to the ICP that would make it easier for examiners to access and update taxpayer data. IRS projects that the system will save about 50 FTEs in its first year and 60 in its second year of use.

Although IRS has undertaken many initiatives to better deal with the innocent spouse workload, it has experienced a number of problems in coping with the increasing workload and in implementing some of its initiatives. For example:

The volume of cases received was considerably above IRS' expectations.

To deal with the unanticipated increases in workload, IRS added temporary employees to the service center staff. However, according to a report by TIGTA on IRS' innocent spouse program, those employees spent a majority of their 90-day details being trained by permanent staff on how to work these complex cases.<sup>11</sup> This depressed the productivity of experienced staff without realizing much benefit from the additional temporary employees. When the service center could not keep up with the volume of cases, IRS distributed cases to the field offices that it had hoped to be able to process centrally.

Between the July 22, 1998, passage of the Restructuring Act and December 7, 1998, IRS was developing interim regulations to implement the equitable relief provisions of the new law. Therefore, cases for which equitable relief could apply had to be held in the service center until the regulations were promulgated at which point their processing could be resumed and completed.

Although W&I is responsible for the innocent spouse program, when contacts with taxpayers are needed to resolve cases, the SB/SE division staff make those contacts. In our work, we found that several SB/SE field offices had completed only a small number of innocent spouse cases. The national innocent spouse program manager in W&I lacked authority to direct SB/SE managers to adjust staffing levels for innocent spouse cases to ensure more uniform processing of taxpayers' claims. In December of 2000 and January of 2001, a memorandum of understanding was signed by the

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<sup>11</sup> *Increased Attention Is Needed to Ensure Timely, Accurate Determinations on Innocent Spouse Claims for Relief*, May 2000.

Commissioners of W&I and SB/SE, respectively, on the use of field staff to work innocent spouse cases.

#### Key Actions Planned by IRS to Address Innocent Spouse Workload Concerns

IRS has identified operational priorities and improvement projects to help address workload case quality concerns.

The W&I division plans to

develop an additional training course related to marital abuse and the equitable relief provision, improve the innocent spouse tracking system so that program performance data are more quickly available to program officials, and improve outreach to taxpayers and tax practitioners.

The SB/SE plans to

begin moving innocent spouse cases back to the centralized case processing facility in Cincinnati to improve case processing, reduce cycle time, and reduce existing inventories. SB/SE would continue to work cases generated in the field offices,<sup>12</sup> but IRS estimates that new case starts in SB/SE field locations will decrease in fiscal year 2001.

#### Summary and Observations

Several factors suggest that IRS may be gaining better management control over the innocent spouse workload. Unlike the offer-in-compromise program, the workload for the innocent spouse program appears to have leveled off after increases following enactment of the Restructuring Act. With this leveling off and enhancements in its case processing capacity such as the new integrated case processing system, IRS plans this

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<sup>12</sup> IRS field staff are to investigate any potential innocent spouse issue that comes up during contacts with taxpayers. Some of these contacts end up as innocent spouse cases and would be handled by the SB/SE field staff.

fiscal year to move many cases back into its centralized case processing facility, potentially freeing up hundreds of field staff to return to other examination-related duties. IRS also established a review process for innocent spouse cases to better ensure that the law is applied accurately and uniformly. IRS did not achieve its goal of an 85-percent concurrence rate between the determinations made in the review process and those that had been made in the field or the centralized processing facility, but did achieve an 82.3 percent concurrence rate. The automated integrated case processing system that has been implemented at the central case processing facility holds promise in helping IRS further improve accuracy and uniformity in applying the innocent spouse provisions because it standardizes the questioning process for determining eligibility and better ensures that all appropriate documentation is considered. Although these factors suggest growing managerial control over the innocent spouse inventories, considerable uncertainty remains. For example, we know little about why the portion of cases found eligible for detailed review has decreased or whether innocent spouse workloads will be remain roughly stable.

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We look forward to continuing to work with this Committee and Congress in considering the issues I have discussed today as well as other issues related to our tax system. This concludes my prepared statement. I will be happy to answer any questions you or other Members of the Committee may have.

#### **GAO Contacts and Staff Acknowledgements**

For more information regarding this testimony, please contact Michael Brostek, Director, Tax Issues, and Assistant Directors Charlie W. Daniel and Thomas Short on (202) 512-9110. Sharon Caporale, John Gates, Susan Malone, Louis G. Roberts, and Michael Tropauer also made key contributions to this statement.

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