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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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STATEMENT OF
JOHNNY C. FINCH, SENIOR ASSOCIATE DIRECTOR
GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE HOUSE COMMITTEE ON WAYS AND MEANS
ON THE ADMINISTRATION'S FISCAL 1986 BUDGET REQUEST
FOR THE
INTERNAL REVENUE SERVICE



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your Subcommittee in considering the adequacy of the administration's budget request for IRS for fiscal year 1986. Our testimony is based primarily on our overall experience gained from conducting audits of tax administration operations and activities. Over the past several years, we have reviewed and reported on most of IRS' major programs and activities.

The thrust of our testimony today, Mr. Chairman, is the same as it was when we testified before this Subcommittee regarding the fiscal 1982 budget request--that while administrative and legislative improvements would allow IRS to make more efficient and effective use of its existing resources, IRS needs additional resources to more effectively administer our nation's tax system.

IRS' workload continues to grow because of (1) the decline of voluntary compliance with the tax laws, (2) the rise in special compliance problems, (3) the increase in the scope and complexity of the laws IRS is charged with administering, (4) the increase in the number of returns filed, and (5) the increase in the number of requests for assistance from taxpayers. IRS' resources have not kept pace with these trends. In fact, the budget that the administration proposes for fiscal year 1986, in the face of these needs, plans to cut IRS' staff by 1.4 percent and funding by \$30 million. In addition, the request proposes to fund a portion of the January

1985 civilian pay raise by eliminating 802 positions which Congress has authorized for fiscal 1985.

IMPORTANCE OF TAX SYSTEM

The federal government's financial well-being depends, in large measure, on whether people are willing and able to support our nation's tax system. As shown in attachment I to my statement, our tax system provides about 90 percent of the revenues for financing the government's programs and activities. In 1984, the system provided about \$667 billion in revenue from all sources, and IRS' budget was \$3.3 billion. Thus, administering the tax system cost about 50 cents for each \$100 of tax paid.

To assure that the tax system provides maximum revenue at least cost, IRS must strive to obtain the highest possible degree of voluntary compliance with the tax laws. However, growing numbers of people in this country are not complying voluntarily, and even a slight decrease in compliance levels translates into billions of dollars of foregone tax revenue annually. This is very significant in view of the huge deficits the federal government incurs to meet its obligations. As attachment II shows, based on IRS projections, taxes owed but not paid from legal source income are equal to a significant portion of the federal budget deficit. For example, had taxpayers fully complied in 1981--the last year for which detailed estimates are available--the government would have had a surplus of \$2.5 billion instead of a deficit of \$79 billion.

--Tax on individual filers' unreported income (\$52.2);
--Tax on overstated individual personal deductions (\$6.6 billion);
--Tax on overstated business expenses (\$6.3 billion);
--Tax reported on the return but not fully paid (\$4.4 billion);
--Corporation tax gap (\$6.2 billion);
--Nonfilers net tax liability (\$2.9 billion);
--Withheld tax not paid by employers (\$2.4 billion); and
--Net math errors (\$.5 billion).

IRS' July 1983 report shows that not only is overall noncompliance a serious problem, but it has grown worse. IRS estimates that in 1976 the tax gap was about \$39 billion. IRS has projected that compliance will continue to fall despite increased recent congressional efforts to address the problem. Attachment II shows the expected decline in taxpayer compliance through 1990. By then, IRS estimates that the legal source tax gap will reach \$166 billion--double the 1981 level.

SPECIAL COMPLIANCE PROBLEMS CONTINUE
TO CAUSE ADMINISTRATIVE DIFFICULTY

Along with the general decline in voluntary compliance among both individual and corporate taxpayers, several special compliance problems and issues have emerged in recent years

which further jeopardize the tax system. These special problems require special handling. The resources devoted to these problem areas are being diverted from normal functions, thus reducing IRS' ability to maintain a significant overall presence. These special problems include: (1) abusive tax shelters; (2) use of overseas tax havens; and (3) illegal tax protesters. While each of these problems is complex enough to merit its own study, I would like to briefly highlight them and discuss their impact on the fiscal 1986 budget request.

One of the major compliance problems, both in terms of revenue involved and resources required, is the widespread use of abusive tax shelters. While tax shelters generally are transactions used by taxpayers to reduce their otherwise taxable income, abusive tax shelters have tax benefits not economic benefits, as their primary consideration. IRS defines abusive tax shelters as those shelters which utilize extreme, improper, or even illegal interpretations of the law or the facts to obtain tax benefits clearly disproportionate to the economic reality of the transactions.

IRS is using staff from at least 5 different IRS functions--Examination, Criminal Investigation, Returns Processing, Appeals, and Tax Litigation--to deal with the abusive shelter cases. Examination spent about 10 percent of its resources in fiscal 1984 on abusive shelters. As of December 1984, over 370,000 returns with tax shelter issues were in the examination process--more than twice the FY 1980 inventory of about 174,000.

About 24,000 of the 62,000 pending Tax Court cases involve tax shelter issues. IRS estimated for 1981 that the Treasury had an annual revenue loss of about \$3.6 billion attributable to abusive tax shelters.

Noncompliance relating to international taxation issues particularly tax havens, is another difficult and growing problem. In our April 1983 testimony before the House Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations, we stated that tax havens are a problem with no easy solution. The banking and commercial secrecy laws of tax haven countries limit IRS' access to information needed to assure compliance with U.S. tax laws. Further, imposition of a low or zero tax rate on all or certain categories of income combined with no currency controls on non-residents creates a strong incentive for U.S. individuals and businesses to establish shell corporations in tax havens in order to evade U.S. taxes.

IRS' efforts to detect and deter tax haven abuses are limited in most cases by the lack of available information. The normal types of taxpayer information such as wage and investment income statements (W-2s and 1099s), cancelled checks, and bank statements, are not generally available. Thus, IRS must rely on other means to identify taxpayers who are evading taxes through the use of tax havens.

In this regard, IRS' Criminal Investigation Division has become involved in efforts to detect those who are illegally

using tax havens. However, as we mentioned previously, the lack of available information makes such schemes difficult to uncover. As a result, such investigations are very labor intensive and costly. In 1984, about 7 to 10 percent of the Criminal Investigation Division's ongoing cases directly involved tax havens or money laundering activities. But, according to IRS officials, tax havens issues are so broad that estimates of total involvement are difficult to develop.

One special compliance problem with which IRS appears to have made progress since our last testimony before this Subcommittee is that of illegal tax protesters. IRS has taken action to address the tax protester problem through more effective use of its resources. From 1980 through 1983, illegal tax protester returns, such as those returns citing the Fifth Amendment to the Constitution as a justification for not completing the return, increased from 19,482 to 58,040--an increase of 38,558 or 198 percent. In 1984, the number of these protester returns decreased to 53,760 or 7.4 percent from 1983.

IRS officials believe this decrease can be directly attributed to their enforcement efforts which have targeted both the leaders and promoters of major protest groups and schemes with significant numbers of participants. For example, approximately 1,000 individuals who purchased mail order ministeries and illegally reported as contributions deductions they made to their own churches will be required to pay millions of dollars in back taxes and penalties. These cases usually

involve a "church" in the person's residence and the person's family is the "congregation." The person then deducts from income contributions made to pay personal living expenses.

In addition to civil actions, IRS has also had a high success rate in obtaining criminal convictions against tax protesters. From fiscal 1982 to 1984, IRS obtained indictments against 585 protesters. During the same period, 515 protesters were convicted and 412 prison terms were imposed. IRS officials commented that the high percentage of those indicted who are convicted and the high percentage of those convicted who receive prison sentences has significantly reduced the number of persons willing to file protester returns.

IRS has attacked the protester problem with staff from several functions. Criminal Investigation began 648 illegal tax protester investigations in 1984, an increase of over 50 percent since 1981. However, solving the tax protester problem will not necessarily decrease IRS compliance problems. IRS officials believe that many protesters are switching to other less obvious tax evasion schemes. For example, rather than filing a protest return, some protesters are now using abusive tax shelters and foreign tax havens to reduce their taxes. Thus, tax protest activity may add to problems which are already straining IRS resources.

SCOPE AND COMPLEXITY OF THE TAX
LAW CONTINUES TO INCREASE

Interrelated with the noncompliance problem is the scope and complexity of the tax laws which has added to IRS'

administrative burden. The complexity of the tax laws often makes IRS' audits of tax returns more difficult and produces numerous controversies between IRS and taxpayers. In addition, both IRS and taxpayers must spend considerable effort in adjusting to the continuing changes in the law.

New tax laws create new work throughout IRS for which adequate additional resources may not be provided. For example, IRS estimated that administering the Deficit Reduction Act of 1984 would require 1,060 staff years in 1985 and 1,624 in 1986. However, OMB allowed only 290 additional positions in examination for 1986 and no additional staff for 1985. As a result, if IRS is to effectively administer the new law, it will have to divert staff from other work.

The increasing complexity of and frequent changes to the law are also impacting other areas. For example, two major legislative efforts--the Tax Equity and Fiscal Responsibility Act (TEFRA) and the Deficit Reduction Act of 1984--while providing some simplification, have also created new complexities. TEFRA added, amended, or repealed 245 separate sections of the Internal Revenue Code. Changes to the law, such as these, in many instances require changes to the information which IRS provides to explain the law to taxpayers and their representatives. For example, these two acts have resulted in over 250 regulations projects. In 1984, IRS and the Treasury only closed 105 projects total. Given this rate of closure, the regulations arising from these two measures alone will

require over two years of the IRS' total regulations production.

The increasing impact of complexity can be seen in several other areas. Despite efforts to create a separate simple tax form, the 1040EZ, and to make the 1040A useable by additional taxpayers by allowing a schedule to be attached to the form, more taxpayers are filing the longer form 1040 each year. Form 1040 now makes up 63 percent of the individual returns filed--an increase from 61 percent in 1982.

These more complex returns being filed add to the difficulty in determining the correct tax when a taxpayer is audited. Examination time has increased by 11 percent from 1981 to 1984. IRS believes that part of the increase can be attributed to the increasing complexity of the returns being examined.

In addition, more taxpayers whose returns are audited are disputing the changes recommended by IRS examiners. IRS projects that taxpayers will appeal about 70,000 cases in 1986. In addition, the Tax Court expects to receive 65,600 new cases in 1986, a 50 percent increase over 1984.

THE NUMBER OF RETURNS
FILED HAS INCREASED

As the federal agency responsible for administering the nation's tax system, IRS must cope with an increasing workload created by the year-to-year growth in the taxpaying population

as evidenced by the increasing number of tax returns filed. To cope with this workload, IRS has one of the largest workforces of all federal nondefense agencies. However, IRS' resources have not kept pace with the growth in its workload.

For example, IRS expects 179 million tax returns to be filed in 1986--a 46 percent increase since 1976 when 123 million were filed. Of these returns, individual return filings will increase 25 percent from 83 million in 1976 to 104 million in 1986. While improvements in productivity--including increased use of computer technology--mean that increases in return filings do not necessarily require proportionate increases in IRS resources, it is still noteworthy that, between 1976 and 1986, IRS' resources will have increased by less than 3 percent. IRS has only grown from 84,300 to 86,500 staff years. If the current request is approved by the Congress, total IRS resources will have dropped 1.3 percent between 1984 and 1986. IRS' latest effort to modernize its computer systems will produce some productivity gains. However, these new systems will not replace the need to audit face to face, put liens on houses, investigate cases, or process documents.

INCREASES IN NEED
FOR TAXPAYER ASSISTANCE

To meet their responsibility to pay their taxes, taxpayers must be able to understand tax law requirements. However, taxpayers historically have had difficulty understanding IRS

forms and publications. For example, in our 1978 report on Further Simplification of Income Tax Forms and Instructions is Needed and Possible (GGD-78-74, July 5, 1978), we concluded that Form 1040 packages were written at a reading level beyond the comprehension of many taxpayers. As a result, IRS initiated actions to make forms and instructions easier to read and understand. By fiscal year 1983, IRS had simplified the 1040A, and introduced the 1040EZ, which was half as many lines as the 1040A. However, there are indications that IRS' efforts have not completely alleviated the problem.

Our report on the Need to Better Assess Consequences Before Reducing Taxpayer Assistance (GGD-84-13, April 5, 1984) indicated that a substantial number of taxpayers were still having difficulty understanding IRS' written materials. The questionnaire we sent to taxpayers during our 1982 study contained a question relating to the clarity of IRS tax forms, instructions, and publications. And, the responses we received indicated that, even after IRS' simplification efforts, a significant percentage of taxpayers continued to have difficulty in understanding IRS' written documents. For example, 41 percent of all taxpayers said they had difficulty understanding tax forms and instructions and 22 percent had difficulty understanding IRS publications.

Because the Internal Revenue Code has evolved into an extremely complicated array of exemptions, exclusions, deductions, and credits, taxpayers often need assistance in

meeting their tax obligations. In addition to the publications IRS also answers tax law questions over the telephone, at walk-in offices and through correspondence. According to IRS statistics, during fiscal year 1984, taxpayers called IRS 42.2 million times--an increase of 22 percent since 1980. Total taxpayer assistance activity also increased 14 percent from 43 million contacts to 50.1 million in 1984.

IRS RESOURCES HAVE
NOT KEPT PACE WITH
GROWING WORKLOAD DEMANDS

Attachment IV shows the staff resources and workload trends for major IRS components for selected fiscal years 1976, 1984, and 1986. To illustrate the increasing demands being placed on IRS resources, I would now like to discuss the fiscal year 1986 request for several specific IRS programs and activities.

Examination Activities

The largest single program that the IRS has is its examination effort, for which the administration is requesting 29,518 average positions for 1986--an increase of 1,468 since 1984. IRS data shows that IRS' examination resources have failed to keep pace with the increase in tax return filings. As mentioned earlier, filings will increase 46 percent from 1976 to 1986. However, for the same period examination staff will have increased by less than 5 percent. Thus the 46 percent increase in filings, combined with the increasing complexity of

the returns filed, will reduce examination coverage from 2.6 percent in 1976 to an expected 1.2 percent in 1986. As recently as 1980, IRS examined more than 2 percent of returns filed.

In addition to the positive impact examining returns has on overall compliance, devoting resources to the examination of returns has direct benefit to the revenue position of the government. For example, IRS actually assessed \$10.2 billion in additional taxes, penalties, and interest in 1984. Furthermore, IRS projects that the examinations which will be conducted in 1986 will eventually lead to assessments of \$14.4 billion.

Perhaps the best way to illustrate the benefit of increasing examination resources is to use an historical example. In a 1981 hearing before this Subcommittee, we suggested that IRS resources should be increased. Due in great part to this Subcommittee's efforts and support, a total of 5,000 additional staff were added to IRS' fiscal 1982, 1983 and 1984 budgets of which 1,000 were assigned to the examination function. IRS' examination model shows that the 1,000 staff added to the program recommended adjustments which will lead to about \$1 billion through additional examinations they made in fiscal year 1984.

The Grace Commission also suggested that additional resources could assist in raising revenue. Its report estimated that increasing the examination of returns could generate a net revenue gain of \$2.7 billion over 3 years. The commission proposed that 7,500 additional positions be added to

examination at a rate of 2,500 per year. The administration has endorsed this recommendation and has proposed to implement it beginning in 1987. Using more current yield and cost data, IRS estimates that this initiative would generate \$4.6 billion additional tax revenue between 1987 and 1989 at a cost of about \$600 million.

Collections Activities

As with the examination function, IRS' collections resources have also not kept pace with growing delinquent account and delinquent return inventories. IRS is proposing in its fiscal 1986 request to cut resources devoted to collection by 801 average positions.

According to IRS, tax revenue in active taxpayer delinquent accounts at the end of 1986 will be more than four times the 1976 level--increasing from \$1.7 billion involving 614,000 accounts to \$7.6 billion involving 1.7 million accounts. However, these figures understate the total collection problem because they refer only to the year-end inventories of active taxpayer delinquent accounts. On this basis, IRS reported \$8.5 billion in delinquent accounts at the end of fiscal year 1984--but the actual amount of total accounts receivable outstanding was \$30.1 billion. In addition to the \$8.5 billion, the \$30.1 billion included:

- Accounts which were in the notice process (\$8.8 billion);
- Accounts classified as currently not collectible (\$6.3 billion);

--Installments and deferred accounts (\$0.9 billion); and
--Other (\$5.6 billion).

Using the broad measure of total accounts receivable shows that collection of taxes owed may be an increasing problem. Attachment V shows that for the last five years total accounts receivable have been growing at a faster rate than net revenues collected by IRS. Even in 1983, when tax liabilities decreased as a result of tax cuts, accounts receivable grew by 5 percent. Not only have accounts receivable been growing relative to total collections, but, as shown in attachment VI, they have also been growing in absolute terms.

How much revenue is collected by the collections function relates to the size of the staff available to work the cases. To use the historical example I referred to previously, the other 4,000 staff added in the revenue initiative were assigned to the collections function. IRS reports that this added staff from fiscal years 1983 to 1985 collected \$4.7 billion from delinquent accounts and \$1.6 billion from securing additional delinquent returns from nonfilers. In spite of the revenue potential and the large delinquency inventories, IRS is continuing to reduce its collection staff.

While IRS has made significant progress in automating its collections operation, IRS has not been able to reduce its overall collections workload. In the fiscal 1986 budget request, most of the 802 positions to be eliminated are clerical staff. Because IRS is pursuing a number of automation

initiatives to improve control over cases and reduce paperwork, it is likely that IRS will be able to successfully absorb these reductions. However, the administration has not correspondingly increased the number of revenue officers. In fact, the current budget calls for a reduction of 19 revenue officer positions. However, work assigned to revenue officers in the field has increased since March 1983. At the end of March 1985, revenue officers were handling 1.1 million accounts worth \$7.4 billion and 324,000 delinquent returns investigations. Compared to the same period in 1983, the number of delinquent accounts has increased by 15 percent while the dollar amount of these cases has increased 27 percent. Similarly, the number of delinquent returns investigations has increased by approximately 32,000.

Returns Processing Activities

Another area where resources are being reduced in the face of growing workload is in processing tax returns at the service centers. Since 1982, the number of staff in returns processing has dropped 5 percent from 24,015 to 22,846. From 1982 to 1986 IRS has estimated productivity savings in Returns Processing of 5,210 staff years, an average of 1,042 a year. This has more than offset the 3,379 total staff years required from 1982 to 1986 for workload increases. In the 1986 request, however, the administration proposes to reduce staff by an additional 425 positions by using selective verification of tax data and by modifying procedures used to process tax returns.

Criminal Investigation Activities

Another area absorbing cutbacks while resource needs are growing is criminal investigation. IRS has planned to reduce its criminal investigation efforts in fiscal 1986 by 74 average positions (1.5 percent) primarily by reducing administrative support. IRS is also continuing its commitments to task forces on organized crime and drug enforcement. In fiscal 1986 IRS estimates that this effort will require 262 average positions in this program (about 5.9 percent of the staff). IRS expects that, as a result of the lower staffing levels and increasing outside commitments, it will only be able to undertake about 6,150 investigations in 1986, down from about 6,200 in 1984.

Taxpayer Assistance Activities

IRS also plans to make further reductions in its Taxpayer Assistance activities. The fiscal 1986 budget proposal for IRS requests a reduction of 156 staff years for taxpayer assistance.

To absorb the currently planned cutbacks in Taxpayer Assistance for 1986, IRS plans to increase the use of volunteers and hold the tele-tax system at current levels. As we discussed earlier, our April 1984 report questions whether there are ready substitutes for the person-to-person telephone assistance that IRS now provides to help taxpayers answer tax law questions. Alternatives such as volunteers and commercial assisters may not fill the gap.

We are also concerned that current levels of IRS' Taxpayer Assistance may be inadequate to meet the needs. In a recent survey we found, for example, that taxpayers could expect to reach a telephone assister on the first call 31 percent of the time in a two week period during the 1985 filing season of the We also determined that taxpayers could expect to contact an IRS telephone assister and get a tax law question correctly answered in five or fewer calls 52 percent of the time. The main reason for the low success rate was the inability to get through within 5 calls. When we did reach them, IRS staff correctly answered the questions 86 percent of the time.

Given the increasing inquiries being generated by the various tax law changes, increasing taxpayer population, and other factors, the planned reduction in taxpayer assistance may further reduce a taxpayer's chance of getting a tax question successfully answered.

ADMINISTRATIVE AND LEGISLATIVE
IMPROVEMENTS COULD HELP, BUT
ADDITIONAL RESOURCES ARE ALSO NEEDED

Various administrative and legislative actions would permit IRS to make more efficient and effective use of its existing resources. However, such actions alone would not be sufficient to counter the growth in workload brought on by

decreasing compliance, the increasing scope and complexity of the tax laws, and the increasing number of returns filed. Therefore, additional resources are needed if IRS is to maintain the integrity of the tax system and achieve maximum collection of federal revenues.

Available Resources Can
Be Used More Efficiently

Our work has shown that IRS can improve the management of its compliance programs and other activities to permit more efficient use of existing resources. As we testified in 1982, IRS was at a serious disadvantage in deciding how to best structure its compliance activities to encourage people to comply with the tax laws. IRS lacked sufficient data to understand how its compliance programs, individually and collectively, affect compliance. Since that time IRS has undertaken a number of research efforts to help it to better understand taxpayer noncompliance and the impact of its programs on the problem. IRS research in this area is continuing.

In the short run, IRS may want to reduce tax losses by giving greater emphasis to maximizing revenue in allocating resources among and within its compliance programs. To do that, IRS needs accurate data on the cost and revenue yield of its compliance programs. Generally, it has data showing only "average" dollar yields. IRS' management information systems do

allow measurements of yield "at the margin" for the examination program, but they do not provide marginal yield data for other compliance programs.

Although IRS' cost/yield data must be used with caution, we believe that small increases in resources in various programs would provide average revenue yields that significantly exceed average cost. This is particularly true for accounts receivable, where additional resources would have a sizable immediate impact on revenue collections. Unfortunately, however, the shortfall in IRS' management information is such that no one knows where diminishing returns will make further resource investment uneconomic at the margin.

IRS plans to implement a new, more comprehensive management information system as part of its current efforts to modernize its computer systems. This system, which is now in operation in some areas and is scheduled to be operational nationwide in January 1986, will supply much of the data needed to make these allocation decisions and to better support IRS resource requests. However, IRS believes that, given current resource constraints, nationwide operation of the comprehensive system may be delayed.

One segment of the comprehensive information system is now available to help the IRS determine what is the effect of various levels of resources. Already, IRS is able to use average yield data from its various compliance programs to model the effect of adding small numbers of staff to various

programs. This enables IRS to develop projections of potential revenue yield from increasing resources available to the various compliance programs. IRS can also estimate costs of adding staff, including staff in other functions such as Returns Processing. IRS used this system to model the effects of the proposed 7,500 staff year revenue initiative and to develop yield and cost data.

This management information system is just one example of how administrative changes can improve IRS efficiency. In the course of our work we have identified a number of other changes which IRS can make to improve its operations. In addition to these administrative changes, legislative actions can also help in addressing significant problems. Let me just cite briefly one example where we are finding significant improvement in taxpayer compliance as a result of Congressional action.

One of the most serious compliance problems is the continuing growth of unreported legal source income. According to IRS' most recent estimates, the tax gap stemming from this area has risen dramatically since 1973. According to IRS, in 1981, \$249 billion of legal source income for individuals was not reported. IRS estimates that as a result of this underreporting of legal source income over \$52 billion of federal income taxes was not paid.

Congress has taken steps to deal with broad segments of this area. It has given IRS new tools to better detect unreported income. Now much of this unreported income is

subject to an effective compliance tool--information reporting. Generally, only those areas subject to withholding have higher compliance rates than those subject to information reporting.

One compliance problem area now subject to this requirement is restaurant tips. IRS estimates that for 1981, taxpayers failed to report and pay taxes on over \$8.5 billion of tip income--a compliance rate of less than 20 percent. This income accounted for about 41 percent of the \$18.9 billion total wage reporting gap for filers in 1981. The Congress addressed the tip income noncompliance problem in TEFRA. The act imposes additional reporting requirements on the owners of certain food and beverage establishments. IRS estimates that voluntary reporting of tip income has doubled as a result of these changes.

However, some income is not covered by information reporting. Information reporting is difficult to use as a method for increasing voluntary compliance from sole proprietorships, partnerships, and small business corporations. Another example is the unreported income involving cash related to informal arrangements--the core of the underground economy. These payments are not subject to information reporting. Yet, IRS found that taxpayers only report 20.7 percent of this income voluntarily. Accordingly, these areas represent compliance problems that may require other solutions.

During our work at IRS, we have identified a number of other areas where legislative changes are needed. Attachment VII to my statement lists open legislative and administrative recommendations which we have made which would contribute to improved compliance and/or IRS efficiency.

More Resources Are Needed

Even though IRS can use its resources more efficiently and effectively, the magnitude of the compliance problem and the increase in both the number and complexity of return filings pose demands for IRS so great that program efficiencies, including optimal resource allocations among programs, will go only so far in protecting the tax system. In our view, an increase in IRS' resources is warranted. Such an increase, within reason, would not increase the federal budget deficit. This is because IRS' compliance programs, on the average, generate tax revenue in amounts that far exceed the programs' cost. For example, in 1984 the average-yield-to-cost ratio was 10.4 for examination of returns and 19.4 for taxpayer delinquent accounts, according to data compiled by IRS. Additional information on program yield for each dollar spent is given in attachment VIII.

While we know that the problems with the nation's tax system require attention, we cannot state precisely to which programs additional resources should be allocated to optimize use of all available resources. We do know, however, that additional resources in some programs will result in a large and

immediate flow of tax revenue to the Treasury. These resources are not only justified by the potential revenue gains, but, of equal or more importance, by the need to cope with IRS' increasing workload due to decreasing voluntary compliance, increasing tax law complexity, and increasing taxpaying population.

There are fundamental questions of fairness and of taxpayers' perception which, we think, should also be kept in mind when considering IRS' budget request. Is it fair that the vast majority of taxpayers pay their proper share, while

- the returns of many taxpayers with high potential for tax change go unaudited,
- tax evasion goes uninvestigated, and
- unpaid taxes are written off?

Taxpayers' perceptions that others can get away with not complying with the tax laws jeopardizes the entire system.

In closing, let me set forth some considerations that the Congress should keep in mind in deliberating on the desirability of providing IRS with more resources.

First, the Congress should be mindful of IRS' unique revenue collection role. IRS collects the majority of the revenues used to finance federal government programs and activities and produces about \$100 in tax revenues for every 50 cents it spends. Therefore, government-wide reductions applied

to IRS could result in reducing the revenues available to fund other government programs.

Second, it is important to keep in mind that IRS' various compliance activities do no more than require citizens to pay those taxes that were properly due in the first place, and that in fact were so paid by most of them. Effective compliance should not be viewed as representing a special burden on the public; rather it is aimed at ensuring that all pay their fair share.

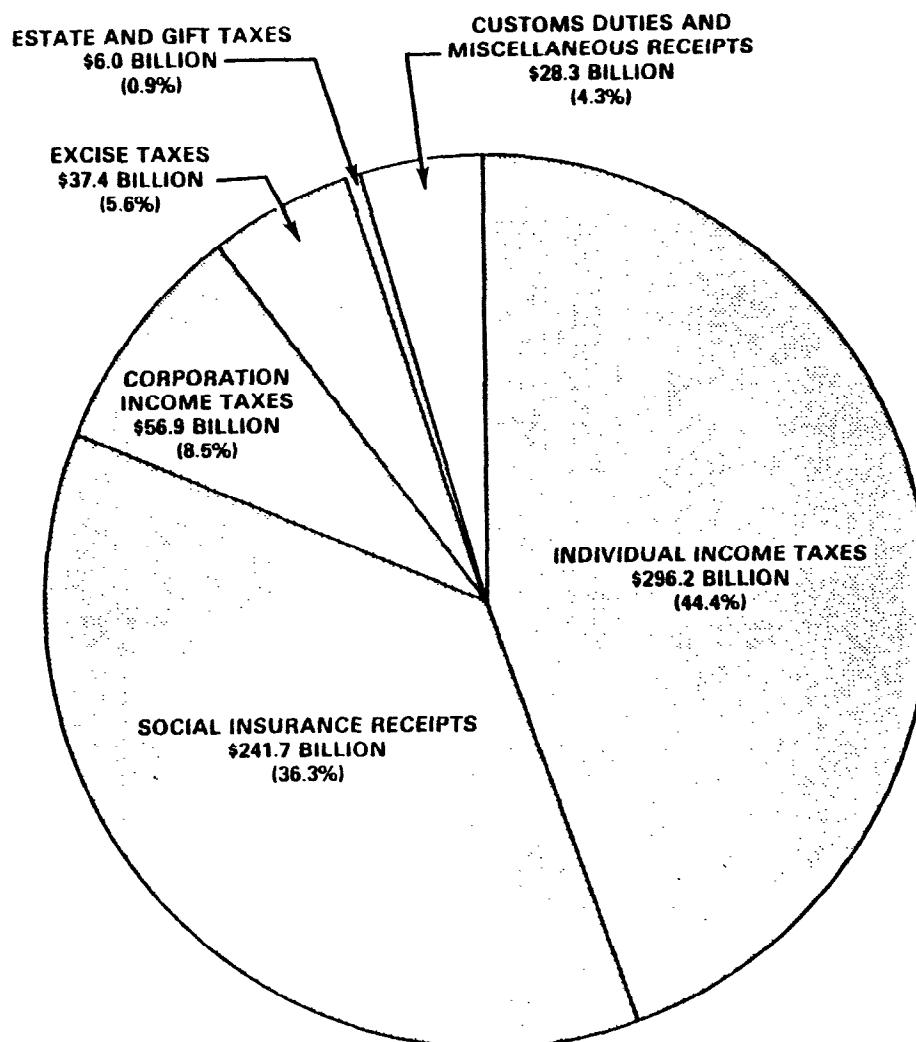
Finally, with respect to the question at hand, namely how many additional resources should IRS be provided with, let me offer the following. There is no doubt that IRS can return in added revenue some multiple of the additional funds it is provided. The problem, however, is trying to identify the optimum application of any finite amount of such resources. It is important that any additional resources provided to IRS not be more than IRS can effectively recruit, train, and assimilate. Given the lack of available data for making optimum allocations, the best approach might be to ask IRS for its informed judgment on how various incremental funding increases would be applied. For example, as before, Congress could task IRS with calculating the operational, revenue, and cost impacts of personnel gains of some staff-year increment, 500 for example, ranging up to perhaps a total increase of 5,000 people.

The Subcommittee could also consider asking IRS what would be the effect if, with regard to this fiscal 1986 budget request, the Congress were to:

- Eliminate proposed cuts in collection, criminal investigation, and taxpayer service.
- Provide supplemental funds for the January 1985 pay raise instead of funding most of the raise through an 802 staff year reduction.
- Begin the three year, 7,500 staff year increase for examination in fiscal 1986 instead of fiscal 1987.

That concludes my prepared statement. I would be pleased to answer any questions.

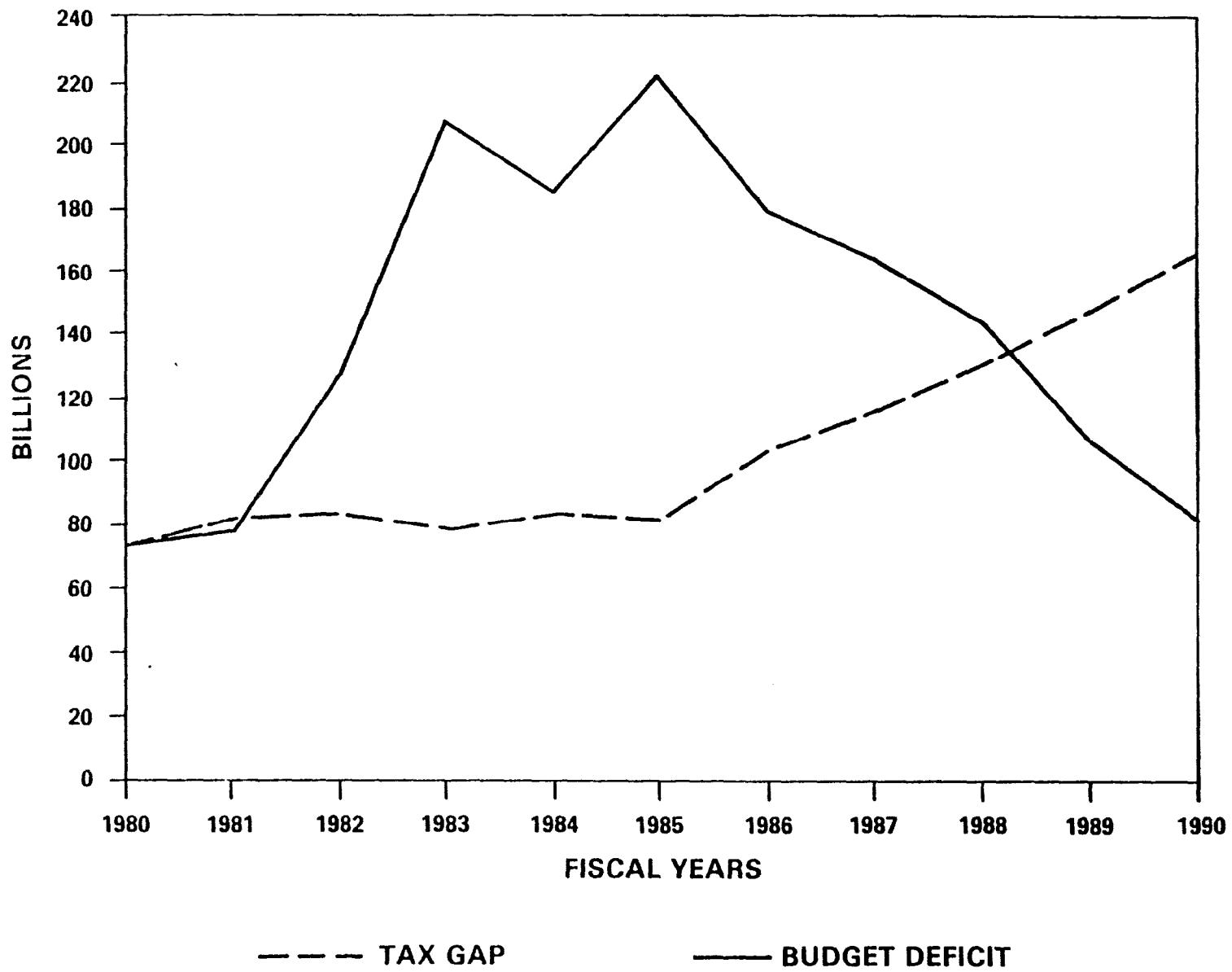
FEDERAL REVENUES
FISCAL YEAR 1984 ACTUAL



SHADED PORTION INDICATES COLLECTIONS MADE BY IRS

NOTE: THIS CHART SHOWS RECEIPTS ONLY. IT DOES NOT SHOW THAT PORTION OF THE BUDGET FINANCED THROUGH BORROWING. ALSO, A SMALL PORTION OF THE EXCISE TAX COLLECTIONS IS THE RESPONSIBILITY OF THE BUREAU OF ALCOHOL, TOBACCO AND FIREARMS, DEPARTMENT OF THE TREASURY.

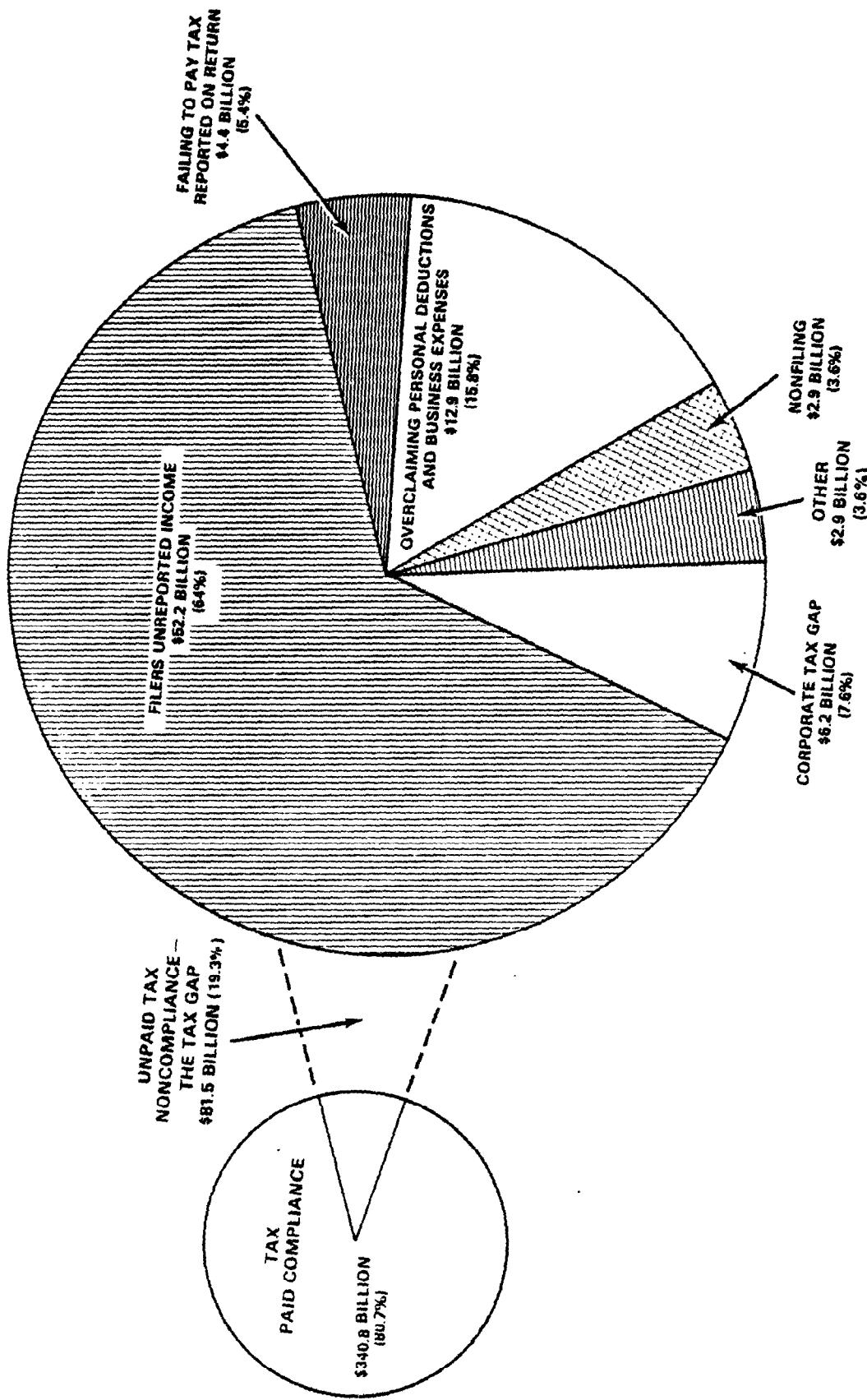
**LEGAL SOURCE TAX GAP COMPARED
TO BUDGET DEFICIT – 1980 TO 1990**



ATTACHMENT III

ATTACHMENT III

ESTIMATED INCOME TAX OWED IN 1981
TOTAL \$422.3 BILLION



IRS Resources and Workload By Program
Fiscal Years 1976, 1984, 1986

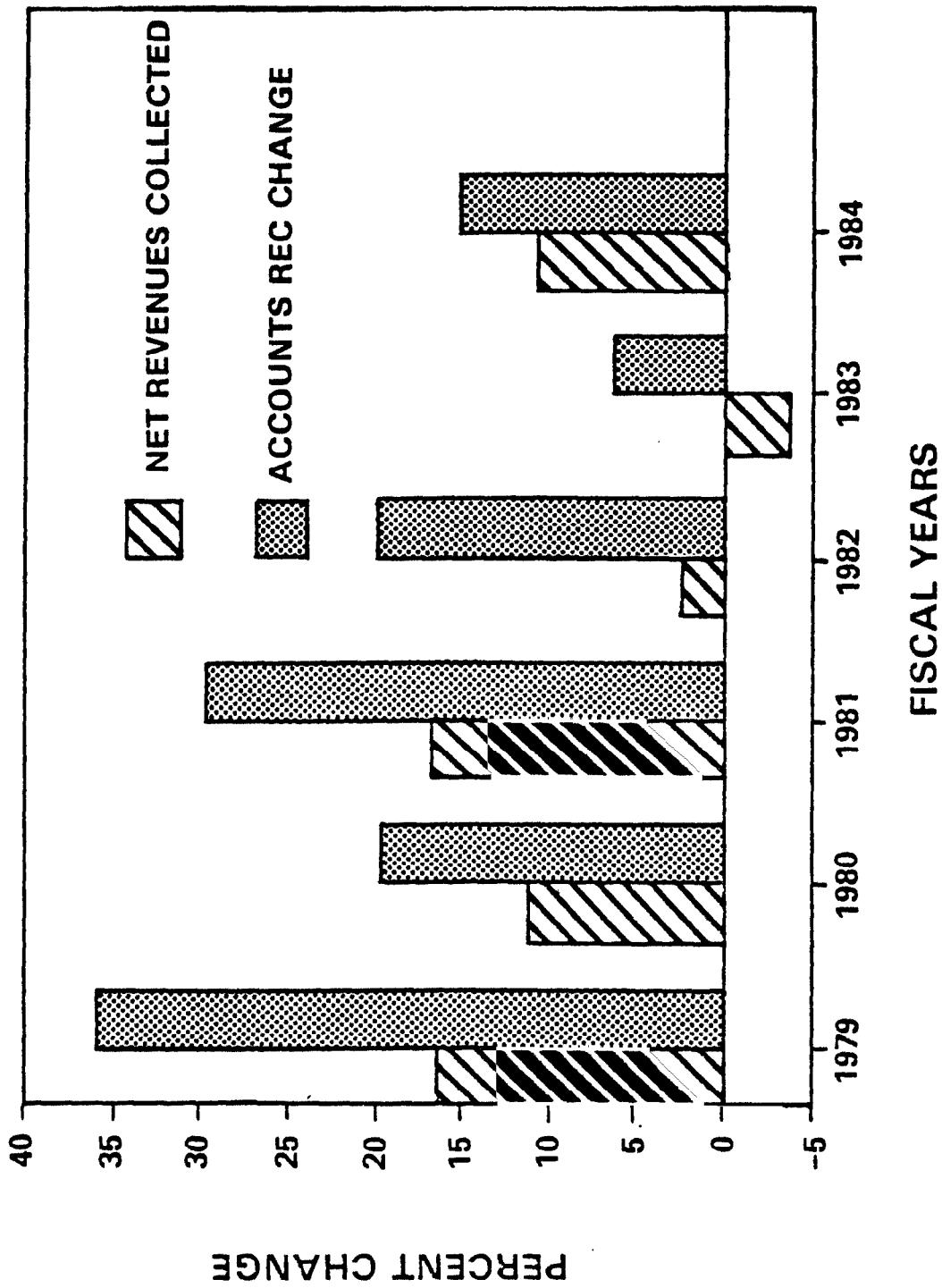
<u>Program</u>	<u>1976</u>		<u>1984</u>		<u>1986</u>		<u>Change 1976-86</u>	<u>Workload (percent)</u>	<u>Staff year (percent)</u>
	<u>Workload (000)</u>	<u>Staff years (note a)</u>	<u>Workload (000)</u>	<u>Staff years (note a)</u>	<u>Workload (000)</u>	<u>Staff years (note a)</u>			
Examination (note c)	123,361	28,164	129,258	28,050	136,788	29,518	+ 10.9	+ 4.8	
Collection Delinquent accounts	614 accounts	9,415	1,934	14,670	1,738	12,452	+183.1	+ 32.3	
Delinquent returns	281 returns	1,849	618	4,389	564	3,469	+100	+ 87.6	
Returns compliance	248 returns	442	10	135	10	135	- 96.0	- 69.5	
Criminal investigation	8.1 invest.	4,090	6,194	4,474	6,150	4,413	- 24.1	+ 7.9	
Information returns (note b)	462,000 doc. rec.	1,700	692,000	3,651	1,046,000	4,972	+126.4	+192.5	
Returns Processing	123,101	26,436	164,626	21,743	178,732	22,846	+ 45.2	- 13.6	
Total IRS staff years		84,264		87,635		86,489		+ 2.6	
Total IRS appropriation	\$1,691,520 (000)		\$3,325,630 (000)		\$3,511,200 (000)			+107.6	

^a1976 staff years are not adjusted to reflect organizational shifts.

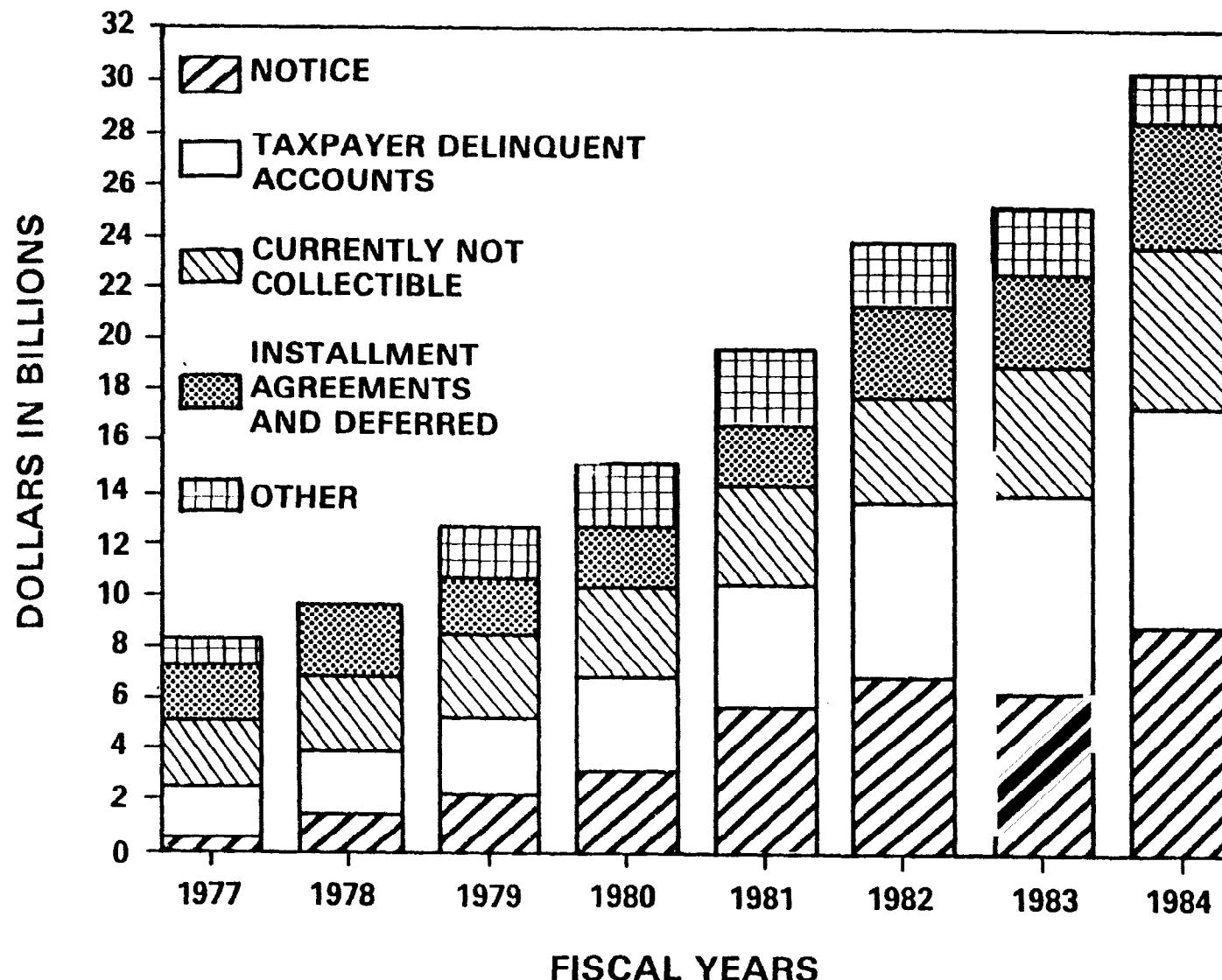
^bInformation returns is a multifunctional program and some of the staff years shown for that program are also included in the staff years for the other programs listed above.

^cExamination workload is prior calendar year filings.

**PERCENT CHANGES IN
ACCOUNTS RECEIVABLE AND COLLECTIONS**



STATUS OF TAX ACCOUNTS RECEIVABLE AT FISCAL YEAR END



OPEN GAO RECOMMENDATIONS TO THE CONGRESS AND IRS
TO IMPROVE COMPLIANCE AND/OR IRS EFFICIENCY

Congressional Recommendations

- | | |
|---|-----------------------|
| 1. Impose mandatory withholding on agricultural employees. | B-137762
3-26-75 |
| 2. Adopt standards for determining whether an individual is an employee or self-employed. | GGD-77-88
11-21-77 |
| 3. Revise educational expense deduction to clarify tax status of educational grants. | GGD-78-72
10-31-78 |
| 4. Modify disclosure provisions of 1976 Tax Reform Act. | GGD-80-76
6-17-80 |
| 5. Modify summons provisions of 1976 Tax Reform Act. | GGD-80-76
6-17-80 |
| 6. Streamline legal review of criminal tax cases. | GGD-81-25
4-29-81 |
| 7. Make pension plan determinations by IRS mandatory for tax qualification. | HRD-81-117
9-30-81 |

Recommendations to the Commissioner of Internal Revenue (note a)

- | | |
|--|-----------------------|
| 1. Streamline legal review of criminal tax cases. | GGD-81-25
4-29-81 |
| 2. Clarify the description of information that corporations should report concerning the sale/purchase of stock. | GGD-81-81
4-30-81 |
| 3. Develop procedures to determine taxpayer filing compliance on pension payouts. | HRD-81-117
9-30-81 |
| 4. IRS should focus on increasing tax revenue as an interim enforcement strategy. | GGD-82-34
7-23-82 |
| 5. Better cost/tax revenue data are needed for resource allocations. | GGD-82-34
7-23-82 |
| 6. With better management information IRS' efforts against abusive tax shelters could be improved. | GGD-83-63
3-25-83 |
| 7. IRS needs to examine compliance impact of taxpayer assistance programs before making cutbacks. | GGD-84-13
4-5-84 |
| 8. IRS should determine the need for further consolidation of its telephone assistance sites | GGD-84-13
4-5-84 |

	<u>Source</u>
9. IRS needs to determine whether benefits could be derived from expanding use of library audit tapes.	GGD-84-13 4-5-84
10. Treasury needs to properly account for Net Windfall Profit Tax Revenues.	GGD-84-15 6-18-84
11. IRS' Windfall Profit Tax Examination Program can be improved.	GGD-84-15 6-18-84
12. IRS needs to assure that Windfall Profit Tax has been assessed and paid on oil in multiple transactions.	GGD-84-15 6-18-84
13. IRS needs to develop effective procedures for examining net income limitation claims and adjustments.	GGD-84-15 6-18-84
14. IRS' reconciliation of Windfall Profit Tax returns may be needed.	GGD-84-15 6-18-84
15. IRS' Criminal Investigation Division needs to begin information gathering projects pertaining to the Windfall Profit Tax Program.	GGD-84-15 6-18-84
16. Reclaimed Tank Bottom Oil presents revenue loss possibilities and tax evasion opportunities.	GGD-84-15 6-18-84
17. Extending the time in which withholding adjustments can be made could improve Windfall Profit Tax administration.	GGD-84-15 6-18-84
2/ As of April 1985, IRS had many of these recommendations at various stages of implementation.	

YIELD/AVERAGE COST ESTIMATES
FOR SELECTED IRS PROGRAMS
FISCAL YEARS 1976 THROUGH 1986 (note a)

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Examination											
Yield	\$4,500	\$4,100	\$5,000	\$4,900	\$6,300	\$6,700	\$8,600	\$10,000	\$10,700	\$10,400	\$10,600
Cost	601	632	675	720	780	836	904	970	1,020	1,125	1,126
Ratio	7.49	6.49	7.41	6.81	8.08	8.01	9.51	10.31	10.49	9.24	9.41
Criminal Investigations											
Number of invest.	8,797	8,361	8,733	8,700	7,114	6,608	6,498	5,910	6,194	6,151	6,150
Cost	100	105	121	130	154	151	169	178	204	214	209
Cost per invest. (note c)	11367	12558	13855	14942	21647	22851	26008	30118	32935	34791	33984
Accounts Receivable											
Yield	3,492	3,069	3,315	4,900	6,000	5,584	7,060	9,553	8,928	9,232	9,512
Cost	179	188	201	213	219	255	288	403	461	490	468
Ratio	19.51	16.32	16.49	23.00	27.40	21.90	24.51	23.70	19.37	18.84	20.32
Delinquency Investigations											
Yield	407	363	435	839	1,309	1,403	1,863	1,856	2,190	2,584	3,049
Cost	35	36	b/	62	73	91	103	129	139	129	130
Ratio	11.63	10.08		13.53	17.93	15.42	18.09	14.39	15.76	20.03	23.45
Returns Compliance											
Yield	133	138	125	21	18	14	11	10	17	17	17
Cost	8	10	b/	6	6	4	4	5	4	5	5
Ratio	16.63	13.80		3.50	3.00	3.50	2.75	2.00	4.25	3.40	3.40
Document Matching											
Yield	b/	695	1,514	1,562	2,226						
Cost	b/	84	107	116	160						
Ratio								8.27	14.15	13.47	13.91
											12.16

^aYield is measured in millions of dollars of net assessments except for the Criminal Investigations and the Accounts Receivable Programs. The Criminal Investigations Program is measured in total investigations; the Accounts Receivable Program in millions of dollars collected.

^bData not currently available.

^cCost per investigation is total dollar cost.

TAXPAYER COMPLIANCE
CONTINUES TO DECLINE

Despite the importance of our nation's tax system, it is facing severe strains. There is a trend toward contempt and abuse of the system which seriously undermines the basic concept of voluntary compliance on which the system is based. Extensive evidence is available to show that noncompliance among both corporate and individual taxpayers is a serious problem.

IRS and others have conducted detailed surveys attempting to determine why people do not comply and the extent to which they fail to comply. For example, in a December 1984 study conducted for IRS by Yankelovich, Skelly and White, Inc. almost twenty percent of the sampled population admitted to cheating on their federal income taxes. The study found that the personal definitions of honesty and the belief that most people are noncompliant were the most significant reasons people did not comply.

That survey helps to validate IRS' July 1983 report on income tax compliance research. In this study the IRS developed estimates of the extent, composition, and growth of taxpayer noncompliance. It shows that for tax year 1981 individual and corporate taxpayers did not pay taxes totaling \$81.5 billion on income from legal sources, a noncompliance rate of 19.3 percent. Attachment III shows that for 1981, the \$81.5 billion income tax gap consisted of: