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December 1994

# TAX COMPLIANCE

## Status of the Tax Year 1994 Compliance Measurement Program





**General Government Division**

B-259285

December 30, 1994

The Honorable Daniel Patrick Moynihan  
Chairman  
The Honorable Sam Gibbons  
Acting Vice Chairman  
Joint Committee on Taxation  
Congress of the United States

This report presents the status of the Internal Revenue Service's (IRS) plans for conducting the Taxpayer Compliance Measurement Program (TCMP) for tax year 1994.<sup>1</sup> It also identifies the potential effects of these plans on measuring taxpayer compliance. This report was prepared, not at the request of the Committee, but as part of our continuing efforts to provide information and analysis to improve tax administration.

TCMP results play an important role in tax policy and administration decisions. IRS uses the data for measuring compliance levels, estimating the tax gap (i.e., the difference between the amount of income tax owed and the amount voluntarily paid), identifying compliance issues, developing formulas for objectively selecting returns to audit, and allocating audit resources. Congress and federal and state agencies use TCMP data for policy analysis, revenue estimating, and research. Because of TCMP's importance, we have been monitoring IRS' plans to develop and implement the 1994 TCMP.

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## Background

After the last TCMP survey for tax year 1988, IRS concluded that TCMP was too costly, too burdensome, and too time consuming. To mitigate these concerns, the former Commissioner of Internal Revenue asked IRS staff to redesign TCMP, reducing the sample size by over half and limiting the scope of the audits.

In April 1993, we reported on the importance of TCMP, indicating that the proposed changes to the size and scope of TCMP appeared unjustified and would undercut its benefits.<sup>2</sup> We reported that TCMP was not too costly because past TCMP results had been used to more efficiently allocate billions of dollars in enforcement resources and to recommend tax law changes that generated billions of dollars of revenue a year. We also noted that the burden was small compared to the benefits derived from the TCMP

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<sup>1</sup>IRS collects TCMP data by auditing every line on tax returns for a random sample of taxpayers.

<sup>2</sup>Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993).

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audits. TCMP audits actually reduce overall burden on taxpayers to the extent that they reduce the number of compliant taxpayers that are selected for other IRS audits. Finally, we identified ways in which IRS could make TCMP results more timely.

Congress' Joint Committee on Taxation also opposed IRS' proposed changes to TCMP, arguing that the changes were unlikely to provide data with the same quality and usefulness as those data found in prior TCMP surveys. Moreover, as IRS began organizing its compliance efforts around more objective data, IRS recognized the value of TCMP as an important source for such data. Out of this recognition came the 1994 TCMP for which audits are slated to begin in October 1995.

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## Results in Brief

The 1994 TCMP survey may be the most comprehensive TCMP effort ever undertaken. Currently planned to include over 150,000 tax returns, this TCMP is being designed to obtain compliance information for individuals, small corporations (i.e., those with assets of \$10 million or less), partnerships, and S corporations.<sup>3</sup> Across these four types of taxpayers, IRS plans to further analyze compliance characteristics by disaggregating the sampled returns into 24 types of businesses and three types of individual taxpayers. Most sample results are planned to be sufficiently precise to measure compliance at the national level as well as at smaller geographical areas across the country.

IRS plans to implement several promising changes to the way past TCMP surveys were conducted. First, IRS plans to have auditors use computers to record audit adjustments, the tax issues involved, and the reasons for the adjustments. Moreover, IRS plans to provide auditors with tax return data for 1994 and the 2 prior years as well as other tax information on each taxpayer. To help uncover erroneous tax return information, IRS is training auditors to use an "economic reality" audit technique, which compares the taxpayer's lifestyle to the information reported on the tax return. These planned changes can improve the value of TCMP if the changes are implemented soon enough for all auditors to be properly trained to use them and all supporting data are available when needed.

Recognizing these promising changes, we still are concerned with IRS' ability to meet its milestones so that TCMP audits can begin as planned in October 1995. For example, as of November 16, 1994, IRS had not met its

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<sup>3</sup>An S corporation is taxed similar to a partnership. A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders will then include in their income their share of the corporation's separately stated items of income, deduction, loss, and credit.

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September 1994 milestone for deciding on the data to be recorded and the computer system on which the data are to be entered. IRS needs to make these decisions soon to allow enough time for developing and testing the computer software and for training auditors in how to use it. IRS officials said that missing planning milestones for determining TCMP data and software requirements would not affect other milestones and that audits would begin as scheduled in October 1995.

While IRS can make up for missing this milestone, it is too early to determine whether IRS can complete its TCMP planning tasks on time. It is important that IRS meet its October 1995 schedule to begin auditing tax year 1994 returns. Even with this start date, the TCMP results cannot be used to fully measure compliance levels or develop audit selection formulas until the end of 1998. By this time, the data will already be 4 years old. The older the 1994 data get, the less reliable those data will be as an indicator of compliance problems. Continued top management attention to planning could help ensure that the 1994 TCMP will start on time and produce useful data.

We also noted that IRS' TCMP plans were missing some important pieces. IRS is now working to address these issues.

- IRS does not have a research plan that specifically defines the research questions and the data to be collected that would answer these questions. With such a plan, IRS would be better able to collect all the necessary data with a minimum of superfluous data. IRS officials believe they are collecting sufficient information to answer almost any questions that may arise.
- IRS had not planned to collect information on all income and deduction items for partnership and S corporation returns. Nor does it plan to collect data needed to determine the tax impact of audit adjustments to these returns. With this information, IRS would be better able to more fully estimate the tax gap and more precisely measure voluntary tax compliance for these businesses, which represent 21 percent of the business taxpayers in the sample. IRS now plans to collect all income and deduction data from these business returns, but not the data on tax impact.
- IRS had not planned to collect information on employees who incorrectly file tax returns as self-employed workers. With this information, IRS would be better able to identify the magnitude and nature of a problem on which it has devoted considerable resources. IRS now plans to collect this information.

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- IRS had not planned to collect information on other known compliance problems such as those dealing with the earned income tax credit and wage reporting. This information could be used to better determine the scope and causes of these problems. IRS now plans to collect this information.
  - IRS had no plans for developing a mechanism that would electronically retrieve TCMP audit workpapers for IRS and other researchers. Developing such a system would make it easier for IRS to obtain additional information on the reasons for noncompliance so that it can develop effective compliance strategies. IRS is considering ways to accomplish this.

We raise these concerns so that IRS can consider them and make any necessary changes in an informed manner rather than waiting until the last minute. We have prepared this status report so that IRS, as well as others, will have more confidence that the TCMP audits not only will start in October 1995, but also produce more useful data.

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## Objectives, Scope, and Methodology

Our objectives were to (1) determine the status of IRS' 1994 TCMP planning effort and (2) identify the potential effects of this plan on measuring taxpayer compliance.

To determine the status of the 1994 TCMP, we discussed IRS' TCMP action plan with responsible officials in the Research Division and the Examination Division. We obtained information on the status of the plan and discussed with IRS officials their progress in meeting the milestones established by the plan.

To identify the possible effects of the plan on measuring taxpayer compliance, we talked to IRS officials responsible for planning the survey and reviewed documents describing the scope of the 1994 TCMP. We discussed the sampling methodology with officials from IRS' Statistics of Income who participated in the sample design phase. We also discussed IRS' plans for conducting the audits with officials from IRS' Examination Division. We also reviewed IRS' draft documents on information to be gathered during the TCMP audits. We questioned IRS officials in various divisions and other users of TCMP data, including staff from the Joint Committee on Taxation, on whether this TCMP would meet their data needs.

Our observations in this report are based on the work we have done over the years on IRS' compliance programs as well as specific work on TCMP over recent years. We issued a report in May 1994 on all such work.<sup>4</sup>

We did our work between August and November 1994 in accordance with generally accepted government auditing standards. On November 16, 1994, we obtained oral comments from officials responsible for planning and implementing TCMP in IRS' Examination and Research Divisions, including the Director of Examination Quality and Support and a representative for the Director of Research. We have reflected these comments in the appropriate sections of this report.

## Many Potential Improvements to TCMP Look Promising

Current plans indicate the 1994 TCMP will differ significantly from previous TCMP surveys, ranging from the sample design to the audit methods. As discussed below, these changes should provide for more comprehensive and useful data on compliance issues. But the success of each change depends on critical steps.

### Improved Sample Design

For the 1994 TCMP sample, IRS plans to audit over 150,000 tax returns filed by individuals, small corporations, S corporations, and partnerships—about 40,000 more returns than the aggregate for these entity types in prior surveys. On the basis of our evaluation of IRS' sampling plan, the sample is large enough to provide sufficiently precise estimates to measure compliance both nationally and for some of IRS' 29 District Office Research and Analysis (DORA) sites, which are located throughout the country.<sup>5</sup>

The 1994 TCMP sample stratifies tax returns by market segments—not by type of return, income amount, or assets as in prior TCMP samples. A market segment represents a group of taxpayers with similar characteristics, such as those in manufacturing. This time, IRS plans to stratify taxpayers into 24 business (including 1 international business) and 3 nonbusiness (individuals) market segments. IRS believes that stratifying in this manner will allow it to more effectively use TCMP data for identifying noncompliance trends and selecting cases for audit. To ensure comparability with previous TCMP surveys, the sample can also be

<sup>4</sup>Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994). This report has a bibliography of tax compliance-related reports that we have completed since 1982.

<sup>5</sup>IRS recently established 29 DORA sites throughout the country to do compliance research at the district and regional office level.

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stratified into the traditional groupings (i.e., type of return). Appendix I shows the number of planned sample cases for each market segment by return type.

For TCMP users, the 1994 sample is intended to provide reliable comparative information across both return types and market segments, at the national level. For example, users should be able to estimate the national compliance of a particular market segment, such as health and medical services, and compare the compliance of these businesses organized as corporations, partnerships, and sole proprietors. Due to limitations in the sample size, however, such estimates at some DORA sites will be limited to either market segment or return type. In the example above, a DORA site may only be able to measure either the compliance for all health and medical services or the compliance of all corporations covered by the TCMP, regardless of market segment. Even so, the sample size and methodology are likely to make the 1994 TCMP the most comprehensive survey ever conducted and, therefore, potentially the most useful for measuring compliance.

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### Improved Case Information

IRS plans to provide more information to its auditors on each sample case in this TCMP. For each case, auditors are to receive 3 years of tax returns (1994 and the 2 prior years), information return transcripts, and other taxpayer-specific tax data. Additionally, DORA sites are supposed to develop specific industry profiles for each market segment in their geographical area. These profiles may include information such as average gross receipts and net profits by industry. DORA sites may also provide other information for the TCMP cases, such as state and local tax data.

IRS believes this additional information will help auditors identify more sources of noncompliance and improve the value of TCMP audit results. The information, however, will only be useful to the extent that auditors are properly trained and encouraged to use it. Because IRS established the DORA sites in 1994, information provided by these sites may be limited until they have enough staff trained in research and analysis techniques.

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### Improved Audit Technique

IRS is training its auditors to audit the taxpayer as well as the tax return. Described as the economic reality approach, this audit technique should help auditors look for inconsistencies between the taxpayer's lifestyle and the amount of disposable income shown on the return. IRS believes that

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this approach will allow auditors to identify noncompliance that might otherwise have gone undetected.

This audit technique may require more time than simply auditing the tax return, as has been done in the past. However, IRS officials believe that the benefits from identifying more noncompliance will more than offset the cost associated with increased audit time. Finishing the training before the audits start and ensuring that auditors use the technique will improve the likelihood of achieving these benefits.

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### Improved Efforts to Identify Causes of Noncompliance

Unlike prior surveys, IRS plans to require auditors to identify the cause for most instances of noncompliance found on the return and determine the associated tax issue. IRS officials believe that knowing the specific tax issue involved and understanding the reasons for noncompliance will help IRS develop programs to more effectively improve compliance.

Identifying the cause of noncompliance will not be easy. IRS has identified and plans to use 27 causal codes in TCMP, ranging from “engaging in illegal activities” to “relying on a friend’s advice.” Some of the causal codes are very subjective, depending on the auditors’ judgment, while others rely primarily on the testimony of the taxpayer. The validity and usefulness of these causal codes depend, in part, on auditors applying the codes uniformly. Uniform application of the codes will only be as good as the criteria, instructions, and training provided to auditors as well as the quality of supervisory reviews.

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### Improved Data Collection Mechanism

In past TCMP surveys, auditors manually recorded audit adjustments on a checksheet, which was later transcribed into the TCMP database by regional or district office clerical staff. IRS officials have long had a concern about errors occurring during this data entry process that were not detected until data analysis began, which was long after the audits had been completed. For the first time, IRS plans to require that all TCMP audit information be entered onto computers by the auditor. To ensure that accurate data are entered, the computer software is to be programmed to do consistency checks on the data. If data fail to pass the consistency checks, the auditor should be able to correct the errors while audit workpapers are still available for reference.

Using such computerized input should reduce the potential for transcription errors and improve the quality of the data transmitted to the

TCMP database maintained at IRS' Detroit Computing Center. While the concept of such computerization is commendable, the computer system has not yet been developed and tested. Until this is done, it will not be possible for auditors to be trained in its use.

Table 1 summarizes the potential improvements being planned for TCMP, as well as the critical steps that remain if IRS is to achieve its goals. IRS officials recognize that these activities are necessary to completely implement the improvements.

**Table 1: Potential Improvements to the 1994 TCMP Survey**

Issue	Improvement	Critical steps
Sample size and methodology	Covering four types of taxpayers, the sample is to be comprehensive enough to allow some analysis at the local level. Although drawn by type of business and individual taxpayer, the sample is also to be stratified nationally by income and assets, as in previous TCMP surveys.	Adequate data are needed to allow analysis by either return type or type of business at the local level.
More information provided to auditors	In addition to the 2 prior years' tax returns and information returns, profiles by type of business are planned to be developed by local research staff and included in each TCMP case.	Properly trained auditors and research staff will improve the quality of audits and data provided to auditors.
Economic reality audits	Economic reality auditing requires auditors to review not only the tax return but also the taxpayer's lifestyle and living conditions to identify potentially hidden income and assets.	Any new approach relies on follow-through with training, supervising, and quality review to make it effective in practice.
Obtaining causes for noncompliance by tax issue	In past TCMP databases, the causes of noncompliance were not shown. Knowing the causes can help IRS to develop better compliance programs.	Causal codes will only be as good as their definitions and uniform application. Instructions, training, and follow-through will be needed.
Use of computers to collect information on returns	Instead of collecting most information manually on checksheets, auditors are to start entering all information directly into the computer, thereby reducing the chance of errors.	This approach depends on computer software being developed and tested early enough so that auditors can receive adequate training before the 1994 TCMP audits begin.

## GAO Concerns With the 1994 TCMP

The 1994 TCMP offers IRS an opportunity to obtain information on the compliance characteristics of a broad segment of the taxpaying population. Below, we discuss our concerns that IRS may not be taking full advantage of this opportunity and may not be able to meet its goal of starting audits in October 1995. We also discuss our concerns about the data that IRS does not plan to collect.

## Meeting Milestones Is Critical to the Success of TCMP

A key element of any undertaking of this magnitude is effective planning. With less than a year remaining until the planned start of audits, our review showed that a significant amount of work remains to be done. To provide perspective, table 2 outlines the status of IRS' key TCMP planning efforts.

**Table 2: Status of Key Planning Milestones as of November 16, 1994**

Key planning elements	Planned start date	Estimated completion date	Current status
Data recording			
Develop sampling plan and sample size	Unknown <sup>a</sup>	February 1994	Completed
Determine data needs and define data recording requirements	Unknown <sup>a</sup>	September 1994	Draft completed
Develop and test data recording mechanism	October 1994	June 1995	Started
Training auditors			
Develop training program	Unknown <sup>a</sup>	March 1995	Not started
Train auditors	Unknown <sup>a</sup>	September 1995	Not started
Collecting audit data			
Select sample cases	January 1995	December 1995	Not started
Compile data on sample cases	March 1995	June 1996	Not started
Begin sample case distribution	August 1995	June 1996	Not started
Begin auditing sample cases	October 1995	April 1998	Not started

<sup>a</sup>IRS' Action Schedule does not show dates for these items.

Source: IRS Action Schedule dated September 26, 1994, and subsequent discussions with IRS officials.

IRS has many preparatory tasks to complete before TCMP audits can begin in October 1995. All of these tasks must be completed with five staff members, about half the nine staff members employed during the planning stage in the last TCMP survey, even though this 1994 TCMP survey is more complex with about three times as many returns. It is important that IRS meet its October 1995 schedule to begin auditing tax year 1994 returns.

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Even with this start date, the TCMP results cannot be used to fully measure compliance levels or develop audit selection formulas until the end of 1998. By this time, the data will already be 4 years old. The older the 1994 data get, the less reliable those data will be as an indicator of compliance problems.

It is too early in the planning stage to tell whether IRS' specific milestones will be met. IRS has missed its September 1994 milestone for defining data needs and data collection requirements. IRS officials indicated that IRS could make up the time lost from missing this milestone, even with the increased workload and reduced staffing. The officials said that work had been continuing and that audits would begin by October 1995. Continued close monitoring by IRS management of these milestones can help to determine whether additional actions may be required to meet the milestones.

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### IRS Has No Research Plan That Identifies Uses of TCMP Data

A key element of any research project is a plan that defines the goals and describes the questions the researcher hopes to answer. The research plan defines the data to be gathered and data analysis to be done. We are concerned that IRS has no such research plan for the 1994 TCMP survey even though it will be much more complex and comprehensive than prior surveys.

The very elements of this TCMP that make it unique (e.g., 4 entity types stratified by 27 market segments) require that certain research questions be addressed before IRS finalizes the TCMP data requirements. For example, IRS has not determined how market segment compliance levels will be measured or how compliance levels for income and deduction items will be measured across return types. Such determinations may have an impact on the types of data IRS collects.

A research plan would be useful for explaining how compliance will be measured by DORA sites. IRS has emphasized that DORA sites will be a primary customer for the 1994 TCMP data. According to IRS officials, however, the 1994 TCMP data may have limited use at some DORA sites because the sample size is often too small to be useful to statistically estimate compliance by both market segment and return type. Consequently, analysis of compliance data at the DORA sites will have to be done on entire market segments, without regard to entity type. IRS officials said that these sampling concerns can be addressed by consolidating the samples either by market segments, DORA sites, or return types.

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IRS has not developed a compliance measure across the four entity types. IRS' primary measure of compliance is the tax liability that was voluntarily reported divided by the reported tax liability plus the additional tax recommended in the audit. This measure, called the Voluntary Compliance Level, can only be used as a compliance measure for individuals and corporations because they are taxable entities. Partnerships and S corporations are not taxed directly. The income (or loss) of these entities flow to the partners or shareholders who calculate and pay the tax. A standard measure of compliance across entity types would aid in analyzing TCMP data.

Also, IRS has no measure to account for differences in specific types of income and deductions across return types. For example, the types of income reported on the corporate tax return include income from gross receipts, rents, interest, royalties, and capital gains. In contrast, income reported on returns for sole proprietors consists primarily of gross receipts. Similar differences exist for business deductions, such as commissions and car and truck expenses, that sole proprietors are to itemize on their tax returns but that corporations are to aggregate under a tax return line for "other" expenses. A detailed research plan could help IRS devise a measure to account for such differences.

After reviewing a draft of this report, IRS officials acknowledged that they had no research plan, but said that they believe sufficient data will be collected to develop compliance measures. While agreeing that such measures are needed, IRS officials indicated that they needed to see the data before developing these measures. Although IRS will be collecting a lot of data, we cannot judge such sufficiency without seeing the research plan and the related measures. Developing these measures as soon as possible before the audits start could help ensure sufficient data collection and analysis to meet the goals for TCMP.

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### IRS Had Not Planned to Collect Significant Compliance Data on Partnerships and S Corporations

The compliance of partnerships and S corporations is becoming an important issue as these entity types become a larger proportion of the business population. However, IRS' draft data collection instrument indicated that significant partnership and S corporation data will not be collected. These two entities each report income and deductions as well as the allocations of net profits or losses on two tax documents. Partnerships report on Form 1065, "U.S. Partnership Return of Income," and Schedule K, "Partners' Shares of Income, Credits, Deductions, etc.," while S

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corporations use two similar forms, Form 1120S (i.e., their income tax return) and Schedule K.

IRS planned to collect data from Forms 1065 and 1120S, but not the Schedules K because it could not determine how to fit such data into the data collection instrument. This would have left out certain types of income such as rental income and portfolio income (e.g., interest, dividends, and royalties) that are generally reported only on Schedule K. For tax year 1992, Statistics of Income data indicate that about one-half of partnership net income appeared only on the Schedule K. Collecting Schedule K data would allow IRS to get a more complete picture of tax compliance by partnerships and S corporations, which represent about 21 percent of the TCMP sample population for business taxpayers.

IRS also does not plan to collect information on partners and shareholders because of the potential volume of such information. While IRS officials told us that the Taxpayer Identification Number (TIN) of corporate officials shown on the Form 1120S is to be transcribed into the TCMP database, IRS does not plan to transcribe the TINs of individual partners and shareholders. As a result, IRS will not be able to accurately track the tax consequences of adjustments to partnership and S corporation returns to the individual taxpayers.

IRS has recently stated an objective of increasing voluntary compliance to 90 percent by the year 2001. Tracking the tax impacts of all adjustments to partnership and S corporation returns would help IRS measure its progress towards achieving this objective.

We obtained comments on a draft of this report from IRS Research Division officials who said that they now plan to obtain Schedule K data for partnerships and S corporations, but not data on individual partners and shareholders. As an alternative to collecting data on these individuals to estimate the tax impacts of partnership and S corporation audit changes, IRS could calculate a rough estimate by multiplying the marginal tax rate for individuals by the amount of the audit adjustments.

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## IRS Had Not Planned to Collect Complete Information on Potentially Misclassified Workers

Workers can be classified as either “employees” or “independent contractors” (self-employed individuals who provide services). Under common law, the degree of control, or right to control, that a business has over a worker governs the classification. If a worker must follow instructions on when, where, and how to do the work, he or she is more

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likely to be an employee. It is important for IRS to know whether a worker is correctly classified because employees who have their taxes withheld are generally more compliant than independent contractors.<sup>6</sup>

This classification issue has plagued IRS for decades. Because of the tax and nontax impacts, many concerns have also been expressed by the business community over worker misclassification and IRS' enforcement approach to it. Having information that is more recent and statistically based may help to resolve some of the concerns expressed by both IRS and the business community.

For the 1994 TCMP survey, IRS officials told us that auditors will evaluate businesses with workers to determine whether the workers were properly classified as employees or independent contractors. Auditors will be instructed to indicate on the TCMP data collection instrument whether businesses with questionable classification practices were referred to IRS' Employment Tax Branch for a more detailed audit of the classification issue.

This approach may allow IRS to estimate the number of businesses represented by the TCMP population that potentially misclassified workers. However, it will not allow IRS to fully estimate the number of workers who are misclassified, the potential income tax loss associated with misclassified workers, or the compliance characteristics of misclassified workers. To make these estimates, IRS would have to record data on the misclassified workers identified in the classification audits. This would allow IRS to estimate the number of workers misclassified by the businesses represented by the TCMP sample.<sup>7</sup>

Another approach to estimating the tax compliance of misclassified workers would be to have TCMP auditors identify self-employed individuals who may have been misclassified. IRS employment tax specialists could develop criteria to help TCMP auditors identify these workers. This approach would allow IRS to estimate the magnitude of the problem as well as the compliance characteristics of the potentially misclassified

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<sup>6</sup>Classification also has significant nontax impacts. Federal and state laws governing employee benefits, unemployment compensation, minimum wage and hours, among others, protect employees but also raise employers' costs. These issues are further discussed in our report entitled *Tax Administration: Approaches for Improving Independent Contractor Compliance* (GAO/GGD-92-108, July 23, 1992).

<sup>7</sup>The TCMP sample excludes some employers such as governments, corporations with assets over \$10 million, and nonprofit groups.

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workers. Determining whether these workers were actually misclassified would require separate IRS audits.

IRS has devoted considerable enforcement resources to the misclassified worker problem on the premise that it is a sizable one. Information on the magnitude and compliance characteristics of misclassified workers can be used to improve IRS' compliance programs. It also can help answer policy questions that have been long debated on the use of employees versus independent contractors.

After reviewing a draft of this report, IRS officials agreed with our points and indicated that they will provide a space for the auditor to indicate whether a return was referred to the employment tax group for a classification audit. The officials said they still needed to finalize the criteria for referral and the magnitude of employment tax audits for which the results will be collected in a separate TCMP database.

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## IRS Did Not Plan to Collect Other Important Data

We found that IRS was not planning to collect causal data describing the reasons for noncompliance on some tax return items. Nor did IRS plan to collect data on compliance in filing certain information returns.

IRS' draft data collection instrument indicates that causal data will not be collected on several important items, such as on erroneously claimed earned income tax credits. The preliminary results of an IRS study of returns filed in a 2-week period in January 1994 showed that an estimated \$358 million of \$1.5 billion (24 percent) in earned income tax credits claimed in this period were erroneously claimed. Considering the size of this compliance problem and the limited information available, it is important to determine its cause so that corrective action can be taken.

IRS planned to collect data on payor compliance in filing information returns on income such as interest and rent. However, IRS did not plan to collect similar data on taxpayers' compliance with filing Forms W-2, Wage Statement. IRS uses the Forms W-2 to detect taxpayers who underreport wage income or fail to file tax returns. Knowing the Form W-2 compliance level is important given the size of the potential noncompliance. In its 1987 small corporation (assets of \$10 million or less) TCMP, the data showed that these corporate employers failed to file Forms W-2 on \$4.5 billion in wages, about 1 percent of the total wages that should have been reported.

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Similarly, IRS was not planning to collect data on whether the TCMP taxpayer filed other types of required returns such as employment tax returns. Further, while IRS plans to collect information on adjustments to prior and subsequent years for individual returns, no similar information will be collected for corporate or partnership returns. This information would be important for estimating the total amount of noncompliance found as a result of the TCMP audit.

After reviewing a draft of this report, IRS Research Division officials said that they plan to collect causal data on the earned income tax credit. The officials also said that they will collect data on payor compliance on which we raised concerns.

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## Two Data Collection Mechanisms Are Being Developed

It is important to develop a data collection mechanism as soon as possible because other steps in the planning process, such as auditor training, depend on it. IRS is concurrently developing two data collection mechanisms for TCMP. One system, the Totally Integrated Examination System (TIES), has been under development for use in non-TCMP audits. TIES is intended to increase auditors' productivity by automatically calculating the new tax liability that would be based on audit adjustments the auditor enters into the system. TIES is also intended to automatically generate the Revenue Agent Report, which would explain the audit adjustments to the taxpayer.

Because TIES is still in the development stage, IRS was uncertain whether TIES would be able to meet the TCMP data requirements. Consequently, IRS is developing a backup system designed specifically for collecting TCMP data. Regardless of which system is used, IRS will need to test the system, develop training materials, and train auditors on how to use it. Our concern is that IRS has little time to complete these tasks and address the inevitable problems that arise in systems development. The sooner IRS makes a decision on the data collection system it will use for the TCMP audits, the sooner it can test the system and train auditors.

IRS officials acknowledged the difficulty of developing two systems for the same purpose. They emphasized, however, that the second system was an insurance plan to be used in case the primary system does not work.

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## Access to TCMP Workpapers Would Benefit Analysis

IRS plans to enter codes into its TCMP database on the causes of noncompliance and the related tax issue. However, these data may not be sufficient for developing compliance strategies. The TCMP workpapers to

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be created by auditors potentially provide more detailed information on the reasons for noncompliance.

In recent years, we have used such workpapers to help us more clearly understand the nature and causes of noncompliance. For example, we used workpapers from the 1988 individual TCMP to determine the potential for identifying taxpayers, through computer matching, who inappropriately claimed dependent exemptions.<sup>8</sup> We would have been unable to make such a determination using the TCMP database because it lacked information on why the dependent exemption had been disallowed (e.g., insufficient financial support or lack of documentation).

IRS' recent strategic plans have identified the need for detailed information on noncompliance. For example, IRS envisions using DORA sites to develop strategies to address reporting accuracy by cash businesses. Without detailed information on the reasons for this noncompliance and the audit techniques used to identify the noncompliance, DORA sites will find it difficult to develop and test compliance strategies.

To obtain such detailed information from the workpapers, however, requires that each audited return be ordered from IRS storage facilities and the workpapers reviewed manually. This is time-consuming and, in some cases, the returns and workpapers are not available. These problems limit the usefulness of the workpapers. A more effective strategy could be to make the workpapers available through electronic media. That way, the workpapers would be readily accessible for compliance research.

After reviewing a draft of our report, IRS officials agreed that access to TCMP workpapers would provide valuable information, but they were concerned about costs. At a minimum, IRS agreed to explore the feasibility of retaining the computer disks on which auditors prepare their workpapers.

Table 3 summarizes our concerns with the status of the TCMP planning, data needs, and collection mechanisms and IRS' responses.

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<sup>8</sup>Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993).

**Table 3: GAO Concerns With the 1994 TCMP Survey**

<b>Concern</b>	<b>Conditions</b>	<b>Agency comments</b>
<b>Planning needs</b>		
Will IRS meet its TCMP action plan schedule?	Fewer staff were assigned to planning and designing the 1994 TCMP than other less complex TCMP surveys. Some IRS milestones had not been met.	IRS believes it will meet its milestones but it will continue to monitor the TCMP plan.
Does IRS have a research plan for TCMP?	IRS did not have a plan that identified data needs and uses. IRS may not be gathering sufficient information to measure compliance.	IRS believes it will gather sufficient information to make compliance estimates.
<b>Additional data needs</b>		
Will IRS obtain adequate data on partnership and S corporation returns?	IRS had not planned to collect data on some audit adjustments to partnerships and S corporations returns. As nontaxable entities, their income and losses flow to the partners or shareholders. IRS did not plan to track adjustments to this level.	IRS now plans to collect all adjustments to partnership and S corporation returns. It does not plan to collect partner and shareholder adjustments.
Will IRS collect data on potentially misclassified workers?	IRS did not plan to collect data that are needed to determine the number of misclassified workers or the compliance of those who are being misclassified.	IRS now plans to collect these data.
Will IRS fulfill other TCMP data needs?	IRS did not plan to collect data on the (1) causes of noncompliance with the earned income tax credit, (2) compliance with wage reporting requirement, and (3) changes to related returns.	IRS now plans to collect these data.
<b>Data collection mechanisms</b>		
Will data collection mechanism be ready when needed?	IRS planned to develop two data collection mechanisms. One is already under development, the other is being developed specifically for TCMP.	IRS believes it needs a backup system in case the primary system does not work.
Will IRS analysts be able to readily obtain audit workpapers?	TCMP workpapers have been useful for obtaining more comprehensive data on compliance issues than are shown on the TCMP database. However, the workpapers can be hard to obtain and use.	IRS agreed to explore the feasibility of retaining disks on which workpapers are prepared.

## Conclusions

In its 1994 TCMP plans, IRS has gone a long way in improving its collection of compliance data. Better data provide the foundation for better compliance efforts that may also lessen the burden for compliant taxpayers. The TCMP sample, about one-third larger than the total for all entity types from past TCMP efforts, allows for more sophisticated and powerful analyses. New audit techniques and more information should help auditors do higher quality audits. However, the many changes and added complexity (e.g., causal codes, four types of taxpayers) increase the importance of adequate training and supervisory review for the auditors.

This TCMP offers great promise; but, it is important that IRS obtain the results as soon as possible. We are concerned that IRS may not complete

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the significant amount of work that remains before the planned October 1995 starting date for audits. For example, the TCMP data collection system has to be designed and tested, training courses have to be developed and provided to auditors, and tax returns have to be selected and prepared for audits. These steps take time. However, IRS has already missed its September 1994 milestone for defining TCMP data requirements. Subsequent milestones, such as computer software development and testing, cannot be met without these data requirements. IRS officials said that missing this milestone would not delay the October 1995 milestone for starting audits.

Given that IRS plans to extensively use data from this TCMP for compliance research, we were also concerned about data that IRS was not planning to collect. We believe that obtaining audit adjustment data on all partnerships and S corporations income and deductions would enhance IRS' compliance planning and research. Similarly, obtaining better information on misclassified workers would be very useful for identifying their compliance. Finally, obtaining additional data on the causes of noncompliance, and the compliance with wage reporting requirements would allow IRS to make better use of TCMP information in designing compliance programs.

IRS agreed that these data were important for compliance planning and research, and IRS now plans to collect these data. Also, IRS officials said that they would consider ways of making audit workpapers more readily available to analysts to help them clarify the tax issues identified in the audits.

As noted in our April 1993 report on TCMP, we continue to believe that TCMP is a good investment. TCMP is IRS' principal tool for objectively measuring compliance with tax laws. Accordingly, it is important that IRS managers monitor the TCMP planning and development effort closely to ensure that TCMP remains on target.

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Copies of this report are being sent to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others upon request.

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Major contributors to this report are listed in appendix II. Please contact me on (202) 512-5407 if you have any questions about the report.

*Jennie S. Stathis*

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Director, Tax Policy and  
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## Abbreviations

DORA	District Office Research and Analysis
IRS	Internal Revenue Service
TCMP	Taxpayer Compliance Measurement Program
TIES	Totally Integrated Examination System
TIN	Taxpayer Identification Number

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# Sample Populations for IRS' 1994 TCMP

**Table I.1: Market Segments and Sample Sizes for IRS' 1994 TCMP—Individuals**

Market segment	Number of returns to be sampled		Percent of sampled 1040 returns
	1040s	All returns	
Nonbusiness—no schedules	5,042	5,042	100.0
Nonbusiness—no Schedules C, E, or F	15,175	15,175	100.0
Nonbusiness with Schedule E	7,958	7,958	100.0
Very small business	5,105	5,105	100.0
Farm business	6,852	8,602	79.7
Building trade contractors	3,135	5,851	53.6
All other construction	2,759	6,049	45.6
Manufacturing	1,502	6,313	23.8
Mining and minerals	1,502	3,457	43.4
Agricultural services	1,506	3,067	49.1
Wholesale trade	2,167	7,792	27.8
Direct sales to individual	1,506	1,595	94.4
Auto and boat dealers and service stations	1,504	3,965	37.9
Food and beverage	2,841	4,931	57.6
Apparel, furniture, and general merchandise	1,506	3,540	42.5
Retail—all other	1,526	4,268	35.8
Real estate	1,506	5,759	26.2
Finance and insurance	1,758	4,040	43.5
Air, bus, and taxi	1,508	2,805	89.4
Other transportation and utilities	1,522	3,703	41.1
Amusement, recreation, and motion pictures	1,507	3,671	41.1
Medical and health	2,042	5,034	40.6
Business and personal services	1,682	6,144	27.4
Hotel, lodging, and automotive	1,509	5,473	27.5
Unable to classify	12,024	15,317	78.5
Miscellaneous business and personal services	2,382	2,382	100.0
Miscellaneous services	3,159	5,496	57.5
<b>Total</b>	<b>92,185</b>	<b>152,534</b>	<b>60.4</b>

Source: IRS' 1994 TCMP Sampling Plan.

**Appendix I**  
**Sample Populations for IRS' 1994 TCMP**

**Table I.2: Market Segments and Sample Sizes for IRS' 1994 TCMP—Corporations**

Market segment	Number of returns to be sampled		Percent of sampled 1120 returns
	1120s	All returns	
Nonbusiness—no schedules	0	5,042	0.0
Nonbusiness—no Schedules C, E, or F	0	15,175	0.0
Nonbusiness with Schedule E	0	7,958	0.0
Very small business	0	5,105	0.0
Farm business	538	8,602	6.3
Building trade contractors	1,615	5,851	27.6
All other construction	2,175	6,049	36.0
Manufacturing	3,662	6,313	58.0
Mining and minerals	665	3,457	19.2
Agricultural services	444	3,067	14.5
Wholesale trade	4,502	7,792	57.8
Direct sales to individual	0	1,595	0
Auto and boat dealers and service stations	1,369	3,965	34.5
Food and beverage	936	4,931	19.0
Apparel, furniture, and general merchandise	917	3,540	25.9
Retail—all other	1,625	4,268	38.1
Real estate	2,967	5,759	51.5
Finance and insurance	994	4,040	24.6
Air, bus, and taxi	382	2,805	13.6
Other transportation and utilities	963	3,703	26.0
Amusement, recreation, and motion pictures	963	3,671	26.2
Medical and health	1,708	5,034	33.9
Business and personal services	3,173	6,144	51.6
Hotel, lodging, automotive	2,680	5,473	49.0
Unable to classify	2,002	15,317	13.1
Miscellaneous business and personal services	0	2,382	0.0
Miscellaneous services	1,080	5,496	19.7
<b>Total</b>	<b>35,360</b>	<b>152,534</b>	<b>23.2</b>

Source: IRS' 1994 TCMP Sampling Plan.

**Appendix I**  
**Sample Populations for IRS' 1994 TCMP**

**Table I.3: Market Segments and Sample Sizes for IRS' 1994 TCMP—S Corporations**

Market segment	Number of returns to be sampled		Percent of sampled 1120S
	1120S	All returns	
Nonbusiness—no schedules	0	5,042	0.0
Nonbusiness—no Schedules C, E, or F	0	15,175	0.0
Nonbusiness with Schedule E	0	7,958	0.0
Very small business	0	5,105	0.0
Farm business	591	8,602	6.9
Building trade contractors	598	5,851	10.2
All other construction	594	6,049	9.8
Manufacturing	595	6,313	9.4
Mining and minerals	597	3,457	17.3
Agricultural services	596	3,067	19.4
Wholesale trade	595	7,792	7.6
Direct sales to individual	0	1,595	0.0
Auto and boat dealers and service stations	596	3,965	15.0
Food and beverage	597	4,931	12.1
Apparel, furniture, and general merchandise	596	3,540	16.8
Retail—all other	593	4,268	13.9
Real estate	594	5,759	10.3
Finance and insurance	598	4,040	14.8
Air, bus, and taxi	599	2,805	21.4
Other transportation and utilities	594	3,703	16.0
Amusement, recreation, and motion pictures	594	3,671	16.2
Medical and health	595	5,034	11.8
Business and personal	593	6,144	9.7
Hotel, lodging, and automotive	593	5,473	10.8
Unable to classify	595	15,317	3.9
Miscellaneous business and personal services	0	2,382	0.0
Other miscellaneous services	598	5,496	10.9
<b>Total</b>	<b>12,501</b>	<b>152,534</b>	<b>8.2</b>

Source: IRS' 1994 TCMP Sampling Plan.

**Appendix I**  
**Sample Populations for IRS' 1994 TCMP**

**Table I.4: Market Segments and Sample Sizes for IRS' 1994 TCMP—Partnerships**

Market segment	Number of returns to be sampled		Percent of sampled 1065 returns
	1065s	All returns	
Nonbusiness—no schedules	0	5,042	0.0
Nonbusiness—no Schedules C, E, or F	0	15,175	0.0
Nonbusiness with Schedule E	0	7,958	0.0
Very small business	0	5,105	0.0
Farm business	621	8,602	7.2
Building trade contractors	503	5,851	8.6
All other construction	521	6,049	8.6
Manufacturing	554	6,313	8.8
Mining and minerals	693	3,457	20.0
Agricultural services	521	3,067	17.0
Wholesale trade	528	7,792	6.8
Direct sales to individual	89	1,595	5.6
Auto and boat dealers and service stations	496	3,965	12.5
Food and beverage	557	4,931	11.3
Apparel, furniture, and general merchandise	521	3,540	14.7
Retail—all other	524	4,268	12.3
Real estate	692	5,759	12.0
Finance and insurance	690	4,040	17.1
Air, bus, and taxi	316	2,805	11.3
Other transportation and utilities	624	3,703	16.9
Amusement, recreation, and motion pictures	607	3,671	16.5
Medical and health	689	5,034	13.7
Business and personal services	696	6,144	11.3
Hotel, lodging, and automotive	691	5,473	12.6
Unable to classify	696	15,317	4.5
Miscellaneous business and personal services	0	2,382	0.0
Miscellaneous services	659	5,496	12.0
<b>Total</b>	<b>12,488</b>	<b>152,534</b>	<b>8.2</b>

Source: IRS' 1994 TCMP Sampling Plan.

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