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TAX ADMINISTRATION

IRS' Fiscal Year 1996 Budget
Request and the 1995 Filing
Season

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IRS' FISCAL YEAR 1996 BUDGET REQUEST
AND THE 1995 FILING SEASON

SUMMARY OF STATEMENT

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IRS' fiscal year 1996 budget is for about \$8.2 billion and 114,885 staff, an increase of about \$739 million and 922 staff over IRS' expected fiscal year 1995 operating level. Most of the increase is for Tax Systems Modernization (TSM). Other increases are to help IRS deal with two important filing season issues--the need to better control refund fraud and the difficulties taxpayers experience in trying to reach IRS by telephone. GAO's statement makes the following points:

. After 8 years and an investment of almost \$2 billion in TSM systems, IRS has realized only marginal improvements in its operations.

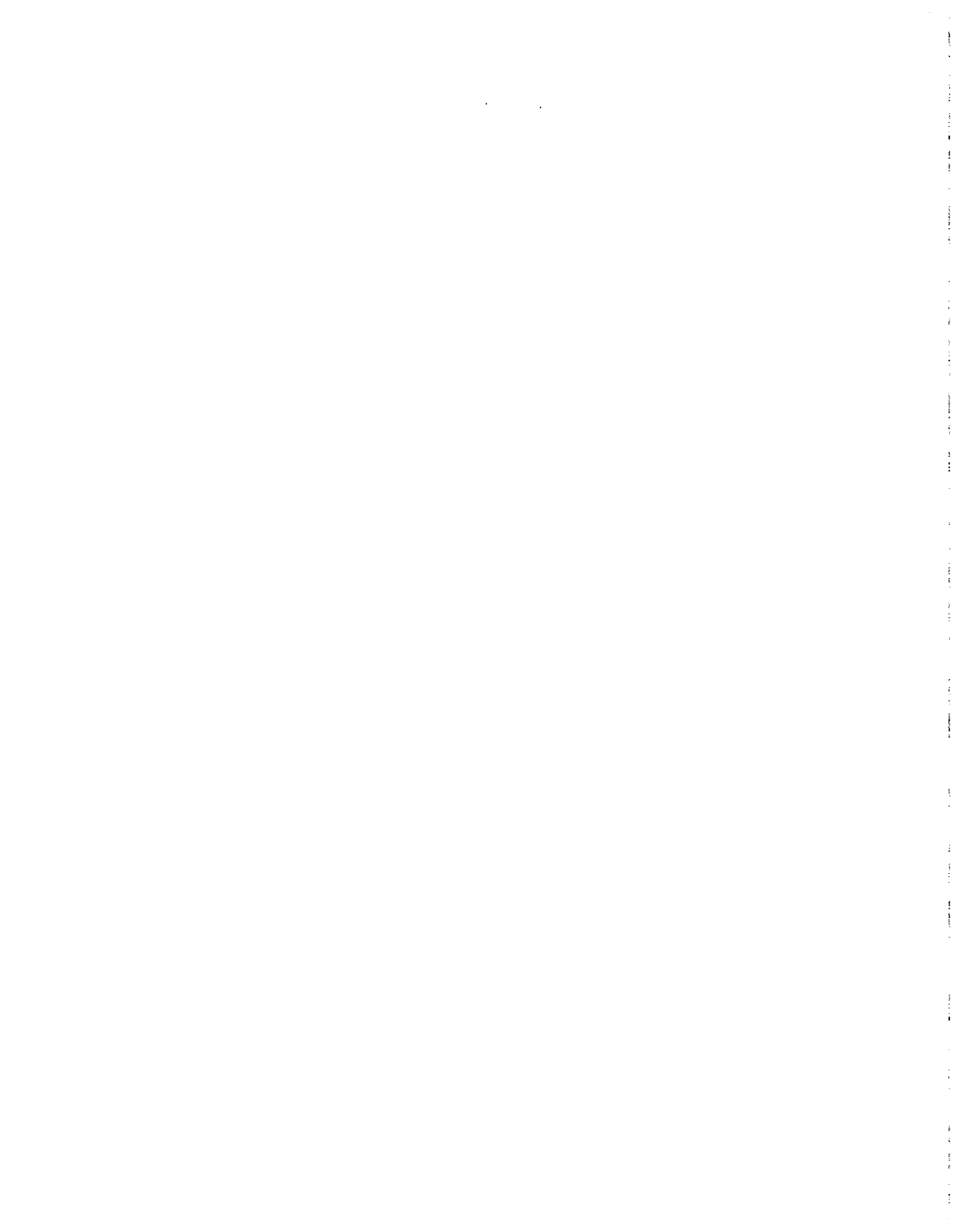
. To focus the TSM effort, IRS should direct its attention to a small number of projects that address critical gaps in mission performance and are part of the TSM vision. In light of the need to refocus TSM, IRS may not be in a position, in fiscal year 1996, to effectively use all of the funding for TSM that it has requested.

. IRS has taken several steps this year in an attempt to better control refund fraud. As one result of these changes, IRS is delaying the refunds of many taxpayers whose eligibility for the earned income credit (EIC) is problematic or who are not using valid Social Security Numbers. GAO believes that these actions, if effectively implemented, should help reduce refund fraud.

. Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all those eligible are receiving the credit. GAO has made several recommendations in the past that could help make the EIC less of a problem.

. Taxpayers continue to have problems reaching IRS by telephone. Of the 1,166 calls GAO made to IRS' toll-free assistance number, GAO reached an IRS assistor 13 percent of the time.

. IRS' budget includes a request for additional staff to answer the telephones. Although the requested increase would help, it will not make an appreciable difference in the large gap between the number of calls coming into IRS and the number it answers. More taxpayers might be able to get through to IRS if IRS adopted some of the practices used by other organizations that operate large telephone assistance programs.



Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in the Subcommittee's inquiry into the administration's fiscal year 1996 budget request for the Internal Revenue Service (IRS) and the status of the 1995 filing season.

Our statement addresses four main issues--the status of IRS' Tax Systems Modernization (TSM) program, IRS' efforts to control tax refund fraud, steps that might be taken to make the Earned Income Credit (EIC) easier to administer and less susceptible to fraud, and the ability of taxpayers to reach IRS by telephone. We also have some discussion of other issues related to IRS' budget request. Each issue is discussed in an appendix and summarized below.

BUDGET OVERVIEW

IRS' budget request is for about \$8.2 billion and staff of 114,885 full-time equivalents (FTEs), an increase of about \$739 million and 922 FTEs over IRS' expected fiscal year 1995 operating level. This overall increase is a net of various increases and decreases, including (1) increases to enable IRS to maintain current operations, (2) several reductions that represent IRS' share of the administration's initiatives to reduce the size and cost of government, and (3) increases to fund program changes.

Of the \$521.3 million in requested program changes, \$475.6 million is for automation projects, and the bulk of that (\$420.7 million) is for projects that IRS considers part of TSM. The other \$45.7 million is intended to help IRS deal with the two most predominant filing season issues so far this year and in the recent past--the need to better control refund fraud and the difficulties taxpayers experience in trying to reach IRS by telephone.

TSM

IRS is requesting \$1.03 billion in fiscal year 1996 for TSM development, an increase of 66 percent over IRS' proposed operating level for fiscal year 1995. IRS is also requesting \$61.2 million for the operation of completed TSM systems.

IRS initiated TSM in 1986 because its tax processing system, the same system still in use today, was outdated and in desperate need of repair. This processing system has remained virtually unchanged since it was automated in the early 1960s. For instance, most of the 200 million returns that IRS receives each year are still submitted in paper form, and only part of the information from these forms is keyed into computers. The processes that IRS employees use are paper-driven and labor-intensive, and employees must contend with taxpayer data that are sometimes difficult to access and that may be outdated and

incomplete. Taxpayers, too, are frustrated by often futile attempts to get information when they contact IRS.

TSM is intended to change all this by creating a new tax processing system that virtually eliminates the reliance on paper and that makes taxpayer information available to IRS employees wherever and whenever it is needed. IRS top management has provided a vision of this new workplace and has redefined the organization to be more responsive to taxpayers' needs and mission demands. In addition, IRS is planning to improve key business processes with a goal of achieving dramatic gains in service and productivity. However, after 8 years and an investment of almost \$2 billion in TSM systems, IRS has realized only marginal improvements in its operations.

Some initial systems have been completed with TSM funds, but most of these systems simply automate old processes without substantially improving service to taxpayers. We do not dispute the value such systems could add to the current environment. But we believe that focusing on progress in such systems as part of TSM shifts agency and oversight attention away from the critical path of actions necessary to achieve the ultimate TSM objectives.

IRS made some encouraging progress in the last year in correcting deficiencies in its management and technical infrastructure for TSM. However, we remain concerned that future systems development efforts are still at risk because of a number of factors. These factors include (1) the lack of sufficient technical and management expertise and skills to implement TSM; (2) continued development of systems for TSM without taking into account changes that could occur because of process improvements; and (3) the lack of system development priorities or fully established technical guidelines. Without addressing these factors, IRS risks continuing business as usual, and the opportunity to realize greater service improvements and cost reductions could be lost.

To focus the TSM effort, we believe that IRS should first direct its attention to a small number of projects that address critical gaps in mission performance and are part of the TSM vision. The mission-critical projects include those that would help create a paper-free environment and make taxpayer data uniformly available agencywide. IRS should then devote the full range of its available TSM resources (managerial, technical, financial) to successfully completing these projects within a short period--perhaps 12 to 18 months. By limiting its attention to a few critical projects, IRS could gain control over many of the TSM risks and could begin to move incrementally toward the TSM vision. In light of the need to refocus TSM, IRS may not be in a position, in fiscal year 1996, to effectively use all of the funding it has requested.

These issues are discussed more fully in appendix I.

REFUND FRAUD

As discussed in appendix II, IRS has taken several steps this year in an attempt to better control refund fraud and is asking for additional resources to do more in 1996. This emphasis is in response to serious concerns raised in several GAO reports¹ and congressional hearings and in reports by an IRS consultant and a task force established by the Secretary of the Treasury. These actions, if implemented effectively, could help reduce the number of fraudulent claims being submitted and help improve IRS' chances of detecting fraudulent claims that are submitted.

Some of IRS' new controls are directed at giving IRS more time to ensure the validity of the taxpayer and the claimed refund. As a result, IRS has already delayed the refunds of at least 1.5 million taxpayers and will delay the refunds of many more before the filing season is over. Those delays affect taxpayers who claim the EIC or who do not use valid Social Security Numbers (SSN).

If accounts in the news media are an indication, these delays have caused much confusion and anger among taxpayers and tax return preparers. IRS might have mitigated some confusion and anger if, as discussed in appendix II, it had done a better job of (1) giving taxpayers adequate advance notice of the potential delays to EIC-related refunds and (2) telling taxpayers whose refunds were being delayed because of an invalid SSN what they must do to correct the situation and get their refunds.

IRS is asking for an increase of \$28.3 million and 323 FTEs in fiscal year 1996 to combat refund fraud. An IRS official told us that the additional resources would be targeted toward prevention rather than detection. We agree with such a focus, because it is less costly and more efficient, in our opinion, to stop a fraudulent return from being filed than to identify and deal with the fraud after the return is filed.

Because most of the refund fraud cases IRS identifies involve the EIC, you asked for our views on what could be done to make the EIC easier to administer and less subject to fraud. Refundable credits, like the EIC, pose a challenge for tax administrators.

¹Tax Administration: IRS Can Improve Controls over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992); Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993); Tax Administration: Electronic Filing Fraud (GAO/T-GGD-94-89, Feb. 10, 1994); and Tax Administration: Continuing Problems Affect Otherwise Successful 1994 Filing Season (GAO/GGD-95-5, Oct. 7, 1994).

In addition to the concerns about fraud, there are equally important concerns that not all those eligible for the EIC are receiving it.

We have made several recommendations in the past that could help to make the EIC less of a problem for IRS and taxpayers. As discussed more fully in appendix III, those recommendations called for greater clarity in IRS' forms and instructions; eliminating differences between the definition of a qualifying child for EIC purposes and the definition of a dependent for purposes of claiming a dependency exemption; encouraging the advance payment option, whereby persons eligible for the EIC can choose to receive it in advance as part of their paycheck; and moving toward timely computer matching of employer wage information with tax return data.

TELEPHONE ASSISTANCE

An important indicator of filing season performance is how easily taxpayers who have questions or who want to order forms and publications are able to contact an IRS assistor on the telephone. In reports on past filing seasons, we discussed the inaccessibility of IRS' telephone service (i.e., the difficulty taxpayers had in reaching IRS by telephone).² To determine whether telephone service was again a problem during the early part of this filing season, we tested the accessibility of (1) the toll-free system that IRS tells taxpayers to call if they have questions about their account, the tax law, or IRS procedures and (2) the toll-free system IRS tells taxpayers to call if they want copies of tax forms and publications.

Results of both tests showed that accessibility is still a problem. Of the 1,166 calls we placed to the toll-free assistance number, we reached an IRS assistor 156 times--a 13 percent accessibility rate. We were more successful accessing IRS' forms ordering system, but even then we were able to reach an IRS assistor only 47 percent of the time. Our testing methodology and results are discussed in more detail in appendix IV.

IRS is asking for \$17.4 million and 239 FTEs in fiscal year 1996 to help it answer 1.3 million more telephone calls. Although these additional resources might help improve accessibility, it will not make an appreciable difference in the large and growing gap between the number of calls coming into IRS and the number it answers. We believe that more taxpayers could get through to an assistor if IRS adopted some of the basic management practices used by other organizations that operate large telephone

²See, for example, GAO/GGD-94-65 and GAO/GGD-95-5.

assistance programs. This is also discussed in more detail in appendix IV.

OTHER BUDGET ISSUES

In appendix V, we discuss three other issues related to IRS' fiscal year 1996 budget request:

-- IRS' operating plan for 1995 and its budget for 1996 both assume the receipt of at least \$92 million from new installment agreement user fees in both years. To the extent the user fees do not generate the expected revenues, activities included in IRS' appropriation for processing returns and assisting taxpayers will be underfunded.

-- A proposed change in legislative language restricting the use of money appropriated for tax law enforcement could have an adverse impact on IRS' continued implementation of its fiscal year 1995 compliance initiatives.

-- If the federal employee pay raise for 1996, including locality pay, exceeds the budgeted 2.4 percent, IRS will have a funding shortfall in fiscal year 1996--just as it has in fiscal year 1995.

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That concludes my summary statement. We welcome any questions that you may have.

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TAX SYSTEMS MODERNIZATION

IRS first articulated its plans for modernization in the mid-1980s and laid out a more specific vision in the early 1990s. IRS' vision calls for a work environment that is paper-free and where taxpayer information is readily available to IRS employees wherever and whenever it is needed. The focus of any TSM systems investment, then, should be on delivering the capabilities of this vision, such as paperless processing, rapid update of taxpayer accounts, and instant access to taxpayer data when responding to taxpayer inquiries.

IRS is funding 41 projects in fiscal year 1996 under the auspices of TSM. Thus, TSM has grown to more than double the 18 projects funded in fiscal year 1993. It is reasonable to expect that any project funded under TSM would be focused on providing essential TSM capabilities. Instead, some projects funded under TSM have focused on the current systems environment.

The systems that IRS has delivered to date under TSM, including the Electronic Filing System, the Automated Underreporter System, the Integrated Collection System, and Corporate Files On-Line (CFOL), have marginally improved IRS' current tax processing and compliance operations. However, they were not built to be an integrated part of the comprehensive TSM program and they have not delivered the large increases in capability and customer service that IRS hopes to have in the future.

For example, CFOL, which provides on-line access to taxpayer account information in the existing IRS master files, brings some marginal benefits to IRS. It speeds return processing by permitting electronic verification of taxpayers' names and addresses, and it gives telephone assistants access to taxpayer account information to help answer questions. However, CFOL's information comes from master files only and does not reflect taxpayer data that may be in other systems, such as the collection and examination systems. Thus, a telephone assistant may not have all relevant and current information when answering a taxpayer's questions. A future TSM module is to provide on-line access to complete taxpayer information.

The fiscal year 1996 budget request for TSM includes other systems that will enhance the current environment but not be an integral part of the future TSM program. These systems include the Examination Automated System, which automates the field examination processes; the Integrated Collection System, which automates the field collection process; the Corporate Systems Modernization and Transition, which replaces and upgrades the Martinsburg and Detroit mainframe computer systems; and the Service Center Recognition/Image Processing System, which

replaces the current optical character recognition of simple tax returns and documents. The examples cited account for \$156 million, or about 15 percent of the 1996 request for TSM development.

We believe that these systems should not be funded as part of TSM. We do not dispute the value these systems could add to the current environment, but as part of TSM, they shift agency and oversight attention away from the critical path of actions necessary to achieve the ultimate TSM objectives. Specifically, progress in the stand-alone, current-environment systems is not a barometer of progress in activities essential to achieving the TSM objectives.

TSM COSTS ARE UNCERTAIN

IRS has been unable to provide us and the Congress with reliable estimates of what the overall cost of TSM will be. As of October 1992, IRS was estimating that TSM would require about \$8.9 billion for systems development and a total of \$23 billion through 2008 for acquisition, operation, and maintenance. IRS' current estimate of TSM costs, as of February 1994, is \$9.4 billion for acquisition and \$22.3 billion in total. However, we had some concerns with the cost model that IRS used to develop the 1992 estimates and expressed these concerns to IRS in 1993. IRS' cost model has not been updated to address our concerns or changes in the TSM vision and scope. IRS intends to have a new cost model and revised estimates by September 1995. In the meantime, we continue to use IRS' estimates as an indication of the investment commitment that TSM entails. We would note, however, that all of these estimates include the variety of projects discussed above and many of them do not contribute to the central TSM vision.

TSM RISKS REMAIN HIGH

In the last year, IRS has made some progress in its management and planning of TSM. However, unmanaged risks continue to reduce IRS' chances for long-term success. These risks include

- IRS' lack of sufficient technical and management expertise and skills to implement TSM;
- the continued development of systems for TSM without taking into account changes that could occur because of process improvements; and
- IRS' lack of system development priorities or fully established technical guidelines.

Because of these and other risks, we have placed TSM on our list of high-risk government programs.

In May 1994, we issued a report that identified a number of practices that leading private and public organizations used to manage their information resources more strategically in order to improve performance and better meet customer needs.³ These practices included measuring the performance of key processes; focusing on process improvement; managing information systems projects as investments; and integrating the planning, budgeting, and evaluation processes. IRS has begun to study how it can use these practices to better manage its information resources and gain greater performance and service improvements.

However, IRS' current approach to TSM contrasts sharply with these practices. For instance, the successful organizations made sure that they had skilled and experienced technicians and managers to guide systems development efforts. According to the National Research Council (NRC), IRS needs to attract new skills to transform its software development staff from one of maintaining antiquated current systems to one that can design and build the modern, integrated systems that TSM requires.⁴ The NRC also noted that IRS needs to manage its contractors more aggressively to ensure timely production of high-quality software. In this regard, the NRC advised IRS to hire people experienced in managing software development contractors.

Successful organizations also analyzed their business processes and determined how they could be improved before undertaking related automation projects. IRS has taken an important step in this regard by initiating process improvement studies to streamline the tax return processing and customer service functions. However, IRS does not know how the results of these projects will be incorporated into the ongoing systems development efforts for these areas. As a result, IRS could end up with systems that do not meet the requirements of the streamlined or redesigned processes. In such a case, systems that have been developed may have to be retrofitted or scrapped.

³Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology (GAO/AIMD-94-115, May 1994).

⁴Continued Review of the Tax Systems Modernization of the Internal Revenue Service (Interim Report), Computer Science and Telecommunications Board, National Research Council. National Academy Press, Washington, D.C., 1994.

Successful organizations prioritized their development projects using an explicit set of criteria that assess the mission benefits, risks, and costs of each project. IRS has not set priorities for any of its development projects, instead it considers all projects to be equally important. Priorities are essential for allocating scarce resources, as well as to establish program and project contingencies. The NRC noted in its report that IRS was unable to respond quickly and effectively to the reduction in TSM funding for fiscal year 1995 because it lacked contingency plans.

Finally, successful organizations ensured that they had a technical framework of standards and guidelines in areas such as data management, telecommunications, and security, that enable project teams to build systems that connect together, operate smoothly, and exchange information. Guidelines are also important because systems developed without guidelines may have to be changed or redesigned later, usually at a higher cost. In the last year, IRS has described its technical approach to integrating its information systems and revised guidance to its TSM system developers that further defines the technical and functional design of TSM. For successful integration of all of the TSM systems, IRS must now establish management controls to ensure that all projects use these guidelines.

One long-standing critical gap in IRS' technical guidelines is security. Technical guidelines for security are particularly important because the TSM environment of on-line access will make taxpayer data even more susceptible to unauthorized access and disclosure. Last year, IRS received a draft security architecture from its Integration Support Contractor, but decided not to accept it and began an effort to develop its own security guidelines. To date, IRS has issued a security policy and a draft of high-level security requirements. IRS has also engaged another contractor to perform a data sensitivity analysis and identify which data elements should be given specific levels of security. IRS expects to issue initial security guidance to TSM project teams by April 1995.

The challenges of completing a complex modernization involving large integrated systems are great, and it is easy to lose sight of the ultimate goal. Therefore, it is important that IRS focus management attention and resources on those opportunities that can best improve mission performance. By working on a wide variety of TSM projects simultaneously, IRS has not had such a focus. As a result, while IRS has invested significant funds in modernization, it is still far from its vision for TSM.

REFUND FRAUD

Over the past few years, more attention has been focused on refund fraud. Fraudulent refund schemes are generally based on false claims of federal income tax withheld or refundable credits, such as the Earned Income Credit (EIC) or the Fuel Tax Credit. Perpetrators of schemes include individuals who make false claims using their true names and Social Security Numbers (SSN) and individuals who make false claims using (1) the names and SSNs of unsuspecting, legitimate taxpayers or (2) fictitious names and SSNs.

Although fraud affects all types of returns, much of the attention has been on electronic filing because the speed with which those returns are processed has made it more difficult for IRS to detect the fraud before the refund is issued. Also, although only about 12 percent of all individual income tax returns were filed electronically in 1994, about 43 percent of the returns IRS identified as fraudulent that year were filed electronically.

Table II.1 shows the growth in identified fraudulent returns and refunds since 1990. From 1990 through 1994, as indicated by the information in the table, \$102.6 million in identified fraudulent refunds were issued before IRS could stop them. Of that total, \$78.7 million (77 percent) related to electronic returns.

Table II.1: Number of Detected Fraudulent Returns and Deleted^a Fraudulent Refunds in Calendar Years 1990 Through 1994

Dollars in millions

Year	Paper			Electronic			Totals ^c		
	Returns	Refunds claimed	Refunds deleted	Returns	Refunds claimed	Refunds deleted	Returns	Refunds claimed	Refunds deleted
1990	5,302	\$15.9	\$14.8	411	\$1.2	\$0.5	5,713	\$17.1	\$15.3
1991	5,422	32.3	30.7	5,746	10.7	2.6	11,168	42.9	33.3
1992	12,244	33.2	30.9	12,725	33.6	22.5	24,969	66.8	53.4
1993	51,883	82.8	73.0	25,957	54.0	29.1	77,840	136.8	102.1
1994	44,137	90.7 ^b	81.5	33,644	69.8	35.9	77,781	160.5	117.4

^aA deleted fraudulent refund is one that IRS has detected and stopped before the refund is paid out.

^bThis figure excludes two returns claiming refunds totalling \$347 million.

^cTotals may not add due to rounding.

Source: IRS data.

Although the number of identified fraudulent returns is less than 1 percent of the total number of individual income tax returns filed in any year, we have been concerned about the growth in identified fraud and the uncertainty as to how much fraud is not being identified. Accordingly, we have made several recommendations directed at improving IRS' controls, some of which IRS has implemented, and have included filing fraud on our list of high risk government programs. Because the Subcommittee shared our concern, the Secretary of the Treasury established the Task Force on Tax Refund Fraud. On October 6, 1994, the Task Force testified before the Subcommittee and presented numerous recommendations of its own.

IRS HAS TAKEN STEPS IN 1995
TO DEAL WITH REFUND FRAUD

IRS has taken several steps in an attempt to reduce refund fraud in 1995. For example:

- To better protect against unscrupulous tax return preparers or transmitters participating in the electronic

filing program, IRS now requires new program applicants to provide fingerprints, that can be used to conduct criminal history checks, and to submit to a credit check.⁵ It is our understanding that IRS plans to decide, after this filing season, whether to extend this requirement to preparers and transmitters who are already in the program. Implementation of this requirement is consistent with a recommendation we made in 1992 that IRS check the background of electronic filing applicants.

-- To better ensure the appropriateness of refund claims, IRS has said that substantial efforts would be directed toward identifying claims with missing SSNs, invalid SSNs (ones that do not match Social Security records), and/or SSNs that were already used by another taxpayer. IRS has added controls that prevent returns with one or more of those conditions from being filed electronically. If a return with one of these conditions is filed on paper, IRS has said that it will delay any refund until the matter is resolved.

-- According to IRS, most of the refund fraud cases it has detected in the past involved the EIC. With that in mind, IRS is delaying refunds on many returns claiming the EIC to allow time to better assure their validity. This action is being taken on returns determined to be most problematical based on an IRS study last year. Because the delay only applies to that part of the refund attributable to the EIC, some taxpayers may receive two refund checks--one for the nonEIC part of their refund and a second, several weeks later, for the rest, assuming IRS determines that the EIC claim is valid. The notice IRS is sending filers to advise them of the delay says that the refund "may be sent to you within eight weeks". IRS has estimated that about 7 million filers will receive such a notice in 1995.

-- Recognizing that the ability of electronic filers to obtain quick loans in the amount of their refunds (known as refund anticipation loans) might increase the incentive to submit fraudulent electronic returns, IRS took steps to disassociate itself from those loans by no longer providing the direct deposit indicator. The indicator, which signaled that IRS would not be reducing the taxpayer's refund to pay another federal debt of the taxpayer, was being used by financial institutions as a basis for making the loans.

⁵The fingerprint requirement does not apply to Certified Public Accountants, attorneys, and enrolled agents.

These changes, if implemented effectively, could help reduce the number of fraudulent claims being submitted and help improve IRS' chances of detecting fraudulent claims that are submitted. Over the next several months, we will continue monitoring the implementation of these changes. We have two observations thus far about their potential effect on taxpayers.

First, IRS did not, in our opinion, provide taxpayers with adequate notice of the change involving EIC claims and the resulting delay in EIC refunds. We saw nothing in the Form 1040 tax package or in Publication 17 (Your Federal Income Tax) that explained that refunds involving the EIC could be delayed for several weeks. Both documents told potential electronic filers that "some refunds may be temporarily delayed as a result of compliance reviews" to ensure that the returns are accurate. Taxpayers who did not intend to file electronically--about 85 percent of the filers--were not even told that much. Also, by advising only potential electronic filers of possible "compliance checks", IRS may be giving the impression that electronically-filed returns are more subject to audit--not the kind of message that helps expand the use of electronic filing.

Second, some delayed refunds may not be resolved quickly and could cause additional taxpayer burden. When IRS identifies a return with an invalid primary SSN, it puts a hold on the refund and sends a notice (CP54B) to the taxpayer. That notice does not make it clear that the taxpayer's refund will not be released until the matter is resolved and, except in certain circumstances, does not require the taxpayer to send anything to IRS to help resolve the matter. This could result in additional correspondence with taxpayers and a further delay in issuing their refunds.

When we prepared this testimony, statistics were not available on the number of fraudulent refund returns identified this filing season. However, other indicators could be related to the new fraud control procedures.

-- IRS had received 24 percent fewer individual income tax returns electronically as of February 17, 1995 (6,720,000 compared to 8,872,000 during that same period in 1994).⁶

-- About 1.5 million taxpayers had been sent notices as of February 17, 1995, advising them that their refunds had been delayed as a result of IRS' fraud-related procedures.

-- At least 3 million reject notices sent out from the electronic filing system as of February 20, 1995, were for conditions that might indicate a questionable refund. Most of the notices related to some problem with the name and/or SSN of the taxpayer or a dependent. Because a return can be rejected for more than one reason, the number of reject notices may be greater than the number of returns rejected. We do not know how many returns were rejected nor how many of the rejected returns were corrected, resubmitted over the electronic filing system, and accepted.

Before the filing season began, many of IRS' 10 service centers expressed some concern about the impact of delayed refunds on their workloads. The only evidence of increased workloads we have seen to date is a 64 percent growth in the workload of the service centers' Error Resolution Units as of February 10, 1995, compared to last year. We do not know how much of the increase is due to IRS' new fraud procedures or whether that workload has become unmanageable. We will be following up on this issue during our continued monitoring of the filing season.

IRS' BUDGET REQUEST FOR 1996 INCLUDES
ADDITIONAL RESOURCES TO FIGHT REFUND FRAUD

The administration's fiscal year 1996 budget request for IRS asks for 323 FTEs and about \$28.3 million for a "cross-functional effort to combat tax refund fraud". IRS says that the additional resources will be used, among other things, to help it (1) detect and stop fraudulent refunds, (2) identify and refer for examination those EIC cases with audit potential, (3) handle the rapidly increasing inquiry calls associated with these cases, and (4) investigate and prosecute the most egregious cases.

⁶Some of the decrease in electronic filings has been offset by an increase in returns filed on paper and an increase in returns filed over the telephone as part of IRS' TeleFile program. In total, however, the number of individual income tax returns filed as of February 17 has declined, from 29,203,000 in 1994 to 28,019,000 this year.

IRS said in its budget estimates that, based on the results of past years' refund fraud efforts, the level of resources being requested should enable it to detect fraudulent refund claims amounting to \$474.3 million in fiscal year 1996. That estimate is significantly overstated. Using the average results per staff year that IRS achieved in 1993 and 1994, the expected results in 1996 would be about \$210.6 million.

However, an official in IRS' criminal investigations function told us that the ideal result would be for the amount of detected fraudulent refund claims to go down. He said that IRS hopes to achieve that goal by targeting additional resources on prevention rather than detection. We agree with that focus because it is less costly and more efficient, in our opinion, to stop a fraudulent return from being filed than it is to identify and deal with the fraud after the return is filed.

EIC CONTINUES TO CAUSE PROBLEMS FOR IRS AND TAXPAYERS

Even excluding the problems with fraud discussed in appendix II, the EIC continues to be a source of many taxpayer errors and additional IRS work.

In 1994, 14.8 million families received over \$15 billion in EIC benefits--an increase over the 14.1 million who received \$13 billion in 1993. IRS expects that about 6 million more persons will be eligible to receive the credit in 1995 due to provisions in the Omnibus Budget Reconciliation Act of 1993. Individuals without a qualifying child are now eligible for the credit if they (1) are at least 25 but less than 65 years old, (2) are not a dependent of another taxpayer, and (3) have earned income and adjusted gross income of \$9,000 or less.

This expansion has created additional work for IRS. During the processing of returns, IRS' computer system identifies taxpayers without qualifying children who appear to be eligible for the EIC but did not claim it. IRS suspends processing of those returns until they can be reviewed by a tax examiner. If an examiner determines from information on the return and by researching Social Security data (to determine the taxpayer's age) that the taxpayer is eligible for the EIC, IRS will calculate the amount and correct the taxpayer's return.

IRS told us that about one-half of the taxpayers whose returns had been suspended in the first few weeks of this filing season were determined to be entitled to the EIC. According to IRS data as of February 10, 1995, failure to claim the EIC has been the most frequent error made by taxpayers and preparers on this year's returns. The second most frequent error involves mistakes in calculating the EIC when it is claimed.

WHAT COULD BE DONE TO MAKE
THE EIC LESS OF A PROBLEM?

Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all those eligible for the EIC are receiving it. We have made several recommendations in the past that could help to make the EIC less of a problem for IRS and taxpayers.

In September 1993, we recommended that IRS take certain steps that we thought would make the EIC easier to administer⁷. Specifically, we recommended that IRS (1) modify the Forms 1040 and 1040A to collect the data now required by Schedule EIC, thus eliminating the need for taxpayers to complete and IRS to process a separate schedule, and (2) clarify taxpayer instructions on the need to provide complete information for determining EIC eligibility. IRS continues to require the Schedule EIC but has simplified it by moving EIC computations to a worksheet. IRS' Schedule EIC instructions, in our opinion, are still not clear.

IRS objected to modifying the Forms 1040 and 1040A and eliminating the Schedule EIC. It believed that such a change would confuse taxpayers because of differences between the definition of a qualifying child for purposes of claiming the EIC and the definition of a dependent for purposes of claiming a dependency exemption. A key difference in the two definitions is the requirement, for purposes of claiming a dependency exemption, that the taxpayer provide over 50 percent of a dependent's support (referred to as the "support test"). There is no support test in the definition of a qualifying child for EIC purposes. We addressed this problem in a March 1993 report, in which we analyzed four alternatives to simplify the laws on dependent exemptions, including two that would change the support test.⁸ On the basis of our analysis, we recommended that Congress consider enacting legislation that would substitute a residency test similar to that used in the EIC program for the dependent support test when the dependent lives with the taxpayer.

Persons eligible to receive the EIC can choose to receive it in a lump sum payment after filing a tax return or in advance as part of their paycheck. In February 1992, we reported that less than 1 percent of EIC recipients in 1989 took advantage of that second option.⁹ Although use of the advance payment option would help taxpayers benefit from the credit sooner, it could also create problems for IRS if persons receiving the advance payment later filed a tax return but did not report that they had received the credit in advance. Under IRS' returns processing procedures in place at the time we did our review, those persons could receive

⁷Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved (GAO/GGD-93-145, Sept. 24, 1993).

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

⁹Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, Feb. 19, 1992).

the credit again as a lump sum payment. We recommended that IRS take various steps to (1) better ensure that eligible taxpayers are aware of the advance payment option and (2) prevent those who take advantage of that option from receiving the credit a second time. When last we checked, IRS had taken steps to better publicize the availability of the advance payment option but had not revised its procedures to protect against duplicate payment of the EIC.

With respect to fraud on electronically filed returns, we recommended in December 1992 that IRS work toward electronically matching employer wage information with electronic return data¹⁰. That kind of match is currently beyond IRS' capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This is because of the time it takes to verify the information and correct any errors.¹¹ IRS has begun to test the possibility of getting partial year's wage information from the states and using that to verify that the taxpayer is employed and to have some information on the taxpayer's amount of earned income.

¹⁰Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

¹¹Under the Electronic Management System--one of many planned components of TSM--IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

TELEPHONE ACCESSIBILITY

An important indicator of filing season performance is how easily taxpayers who have questions or who want to order forms and publications are able to contact an IRS assistor on the telephone. In reports on past filing seasons, we discussed the difficulty taxpayers had in reaching IRS by telephone (i.e., "accessibility").¹² Although IRS answers millions of calls each year, even more calls go unanswered. Many taxpayers receive busy signals, face long on-hold times, or simply give up.

To determine whether accessibility was a problem during the early part of this filing season, we conducted two tests. One test was to determine the accessibility of the toll-free assistance for taxpayers who have questions about their account, the tax law, or IRS procedures. The second test was to determine the accessibility of the toll-free system that IRS tells taxpayers to call if they want copies of tax forms and publications. Results of both tests indicated that again this year taxpayers are having problems reaching IRS by telephone. We plan to repeat both tests later in the filing season.

To conduct the tests, we placed calls at various times during each work day from January 30 through February 10, 1995. We made our calls from seven metropolitan areas--Atlanta; Chicago; Cincinnati; Kansas City; New York; San Francisco; and Washington, DC. If we received a busy signal, we hung up, waited 1 minute, and then redialed. If after four redials (five calls in total) we had not reached IRS, we considered the attempt unsuccessful. If we reached IRS but were put on hold for more than 7 minutes, we abandoned the call.

DIFFICULTIES ENCOUNTERED IN TRYING
TO ACCESS TOLL-FREE TELEPHONE ASSISTANCE

In all, we made 344 attempts to contact IRS' toll-free telephone assistance this year. We succeeded in reaching IRS on the first try 79 times. In 20 cases, however, we abandoned the call after being on hold for more than 7 minutes. Thus, in only 59 (17 percent) of the 344 attempts were we successful in reaching an IRS assistor on the first try. In another 97 cases (28 percent), we successfully reached an assistor after one to four redials--an overall success rate of 45 percent. Our 344 attempts to reach an assistor required a total of 1,166 calls. Of those 1,166 calls, we reached an assistor 156 times--a 13-percent accessibility rate. IRS' own data show a nationwide accessibility rate of 12 percent during the same 2-week period.

¹²See, for example, GAO/GGD-94-65 and GAO/GGD-95-5.

In conducting our test, we did not ask questions of the assistors because it was not our intent to assess the accuracy of their assistance. IRS does its own test of accuracy, and we have assured ourselves in the past about the reliability of IRS' methodology. IRS' test data for 1995 showed an accuracy rate of about 86 percent as of February 11. That compares to a rate of about 89 percent for the same period in both 1994 and 1993.

LESS DIFFICULTY ENCOUNTERED IN TRYING
TO ACCESS TOLL-FREE FORM ORDERING SYSTEM,
BUT ACCESSIBILITY STILL LOW

One way taxpayers can obtain tax forms and publications is to place an order through IRS' telephone form ordering system. The order will then be filled by one of IRS' three forms distribution centers. As with the first test, our intent was to determine how easy it is to reach IRS over the telephone. We did not order any materials. We followed the same redialing and on-hold procedures as described in the toll-free telephone assistance test.

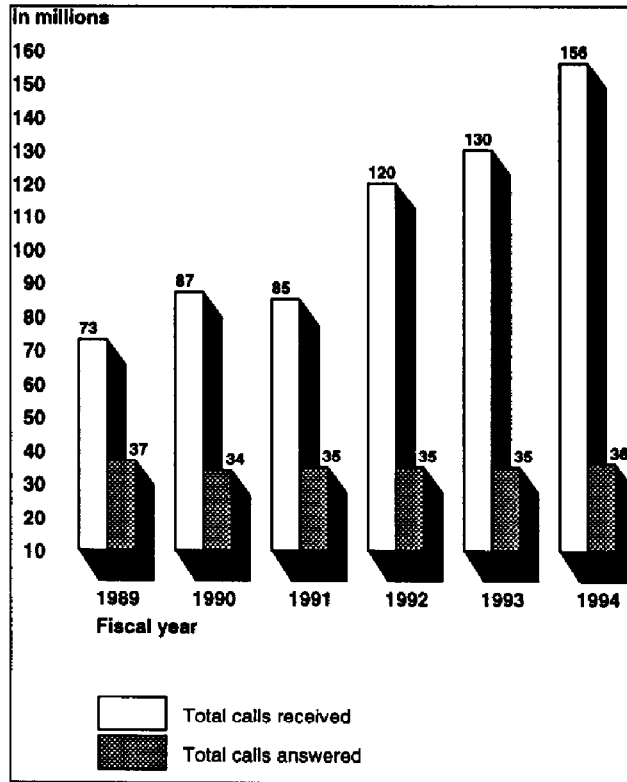
Of 240 attempts to contact the distribution centers, 137 (57 percent) were successful on the first try and 81 (34 percent) were successful after one to four redials--an overall success rate of 91 percent. Our 240 attempts to contact the distribution centers required a total of 465 calls. Of those 465 calls, we succeeded in reaching an IRS representative 218 times--a 47-percent accessibility rate.

We did not assess how well the distribution centers filled orders for tax forms and publications or whether IRS walk-in sites were adequately stocking these materials because (1) our checks in recent years showed that IRS was doing a good job in those areas, (2) IRS contracts for its own test of distribution center performance, and (3) our prior review of the contractor's methodology resulted in changes that have improved its reliability. The contractor's results as of January 27, 1995, showed that the distribution centers filled 96 percent of the test orders correctly.

IRS' REQUEST FOR ADDITIONAL RESOURCES
TO IMPROVE TELEPHONE SERVICE WILL NOT
APPRECIABLY INCREASE ACCESSIBILITY

The administration's fiscal year 1996 budget request includes an increase of 239 FTEs and \$17.4 million to enable IRS to answer 1.3 million additional telephone calls for assistance. Although the increase, if approved, will help, it will not make an appreciable difference in the large and growing gap between the number of calls coming into IRS (which we refer to as "received") and the number it answers, as shown in figure IV.1.

Figure IV.1: Comparison of Total Calls Received and Total Calls Answered for Fiscal Years 1989 Through 1994



Source: IRS data.

We believe that more taxpayers could get through to an assistor if IRS adopted some of the management practices used by other organizations that operate large telephone assistance programs. To maximize the number of calls answered, the four private companies we contacted and the Social Security Administration commonly established (1) challenging program goals for answering as many calls as possible based on customers' needs; (2) standards for the number of hours employees were expected to be on the telephones and the number of calls answered; (3) standard hours of operation, often extending beyond a 9-hour work day; (4) nationwide standards and uniform ways to measure operations and performance; and (5) nationwide call routing and easy access to customer information.

IRS has not used many of the management practices commonly used by the organizations we contacted. And, in cases where IRS did use a practice similar to those in the other organizations, it was not applied with the same emphasis on customers' needs. For

example, IRS has had specific goals for answering more calls for the past 2 years, but these goals are based on the resources IRS has available, not on taxpayers' demand for service. IRS officials believe the gap in the number of calls they are able to answer compared to the number of calls made by taxpayers is so great that it would be unrealistic for them to establish goals based on taxpayer demand.

IRS has, for the first time, provided access to its telephone assistors for 10 hours per work day during the 1995 filing season. This may allow more taxpayers to reach IRS, although there has been no increase in the number of assistors available. IRS has also been working to improve customer service by overcoming the lack of nationwide access to taxpayers' account information. This has been a major barrier to routing calls among IRS call sites. Specifically, in February 1995, IRS provided its assistors the ability to access taxpayers' accounts no matter where the taxpayers filed their returns. Thus, IRS can now route calls to any call site and an assistor will be able to retrieve any taxpayer's account, which should increase taxpayers' chances of being served. These are all positive steps, but it is too early to assess their impact on answering more calls.

Despite the progress made, IRS lacks the capability to centrally monitor and route nationwide call traffic on a real-time basis to available assistors anywhere in the country. IRS also still lacks some basic management practices for its telephone assistance program, including standards for the number of hours assistors should be on the telephone and for measuring performance. We believe that implementing these practices would, over time, allow IRS to answer more taxpayer calls with its existing level of resources, but it is unlikely that IRS would be able to answer all of the calls it receives.

OTHER ISSUES RELATED TO IRS' FISCAL YEAR 1996 BUDGET REQUEST

Beyond those issues discussed already, the most significant questions surrounding the fiscal year 1996 budget request are (1) will IRS receive the expected amount of installment agreement user fees? (2) will IRS successfully implement the fiscal year 1995 compliance initiatives? and (3) is the budgeted increase for a federal employee pay raise sufficient?

WILL IRS RECEIVE THE EXPECTED AMOUNT OF INSTALLMENT AGREEMENT USER FEES?

IRS' operating plan for fiscal year 1995 and its budget for fiscal year 1996 both assume the receipt of \$92 million from new installment agreement user fees. Installment agreements allow taxpayers to pay their tax liabilities on an agreed-upon schedule with IRS.

IRS' fiscal year 1995 budget request proposed two new user fees--one for providing a direct deposit indicator associated with the electronic filing program and another for setting up installment agreements. The proposed direct deposit indicator fee became moot when the Department of the Treasury announced in October 1994 that it would no longer provide that indicator. IRS expects to start charging for installment agreements in early to mid-March 1995. The fee is to be \$43 for each new installment agreement and \$24 for restructured agreements.

In our report on IRS' fiscal year 1995 budget request, we said that it is impossible to predict how taxpayers will react to a fee for installment agreements.¹³ For example, some taxpayers may be encouraged to pay their entire tax liability to forego incurring the fee. Others may be discouraged from entering into these agreements because of their cost. According to IRS officials, the \$92 million estimate is based on an assumption that IRS will receive about 2 million new installment agreements and 90,000 restructured agreements.

IRS' fiscal year 1995 appropriation act (P.L. 103-329) provided that the Secretary of the Treasury could spend user fee receipts to supplement appropriations made to IRS. Accordingly, IRS' fiscal year 1995 appropriation and fiscal year 1996 budget reflect lower amounts for tax return processing and taxpayer assistance than would have otherwise been the case if there were no user fee provision. If the demand for installment agreements falls short of what IRS expects in 1995 and/or 1996, activities

¹³Tax Administration: Analysis of IRS' Budget Request for Fiscal Year 1995 (GAO/GGD-94-129, Apr. 20, 1994).

that are included in IRS' appropriation for returns processing and taxpayer assistance would be underfunded.

WILL IRS SUCCESSFULLY IMPLEMENT THE
FISCAL YEAR 1995 COMPLIANCE INITIATIVES?

In every year but 1 from 1990 through 1994, Congress has funded compliance initiatives to provide IRS with additional staff with the intent of increasing compliance and producing more revenue. Yet, IRS' compliance staffing declined in that period. For fiscal year 1995, Congress provided IRS with \$405 million for more compliance initiatives and restricted IRS' ability to use the compliance funds for other purposes. The fiscal year 1995 appropriation act also said that no funds could be transferred from IRS' Tax Law Enforcement appropriation. These restrictions were imposed because IRS had not fully implemented past initiatives and had used initiative funds to cover budget shortfalls in base operations. In recent testimony before the House Appropriations Subcommittee on Treasury, Postal Service, and General Government, we said that these restrictions increased the prospects that IRS would implement the fiscal year 1995 compliance initiatives.

IRS' fiscal year 1996 budget does not include any funding for new initiatives or additional funding for the fiscal year 1995 initiatives. It does, however, show an annualization of the 1995 initiative for an additional 546 FTEs. According to IRS officials, funds that were used for support costs associated with hiring the new employees in fiscal year 1995, but not needed for that purpose in fiscal year 1996, will be used instead to "buy" additional FTEs for 1996.

The fiscal year 1996 budget also requests a change to the restriction that was imposed in the 1995 appropriation act on the use of compliance initiative funds. In lieu of the language that prohibits any transfer of funds from the Tax Law Enforcement appropriation, IRS is proposing language that would allow funds to be transferred if IRS obtains the advance approval of the House and Senate Appropriations Committees. We believe that the restriction imposed in the fiscal year 1995 appropriations act should be retained to better ensure that IRS uses the compliance initiative funds as Congress intended and to protect against erosion of IRS' enforcement base as occurred in prior years.

IS THE BUDGETED INCREASE FOR A FEDERAL
EMPLOYEE PAY RAISE SUFFICIENT?

The President's fiscal year 1996 budget provides for a 2.4 percent federal employee pay raise. For IRS that percentage increase equates to \$92 million. It is uncertain whether this

amount will be sufficient to cover an across-the-board pay increase and locality pay. IRS' fiscal year 1995 budget provided for a 1.6 percent federal pay raise that was not adequate to cover locality pay. As a result, according to IRS budget officials, IRS needed to absorb an additional \$50.7 million for locality pay. If Congress authorizes locality pay for fiscal year 1996 to the levels outlined in the Federal Employees Pay Comparability Act, IRS may need to absorb an additional 2.4 percent average pay increase--\$92 million more than the amount provided for in the fiscal year 1996 budget.

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