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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS

ON

[IRS' EFFORTS TO IDENTIFY AND PURSUE
INCOME TAX NONFILERS AND UNDERREPORTERS]

Mr. Chairman and Members of the Subcommittee:

We are pleased to assist the Subcommittee as it begins its inquiry into the so called "subterranean economy" and what can be done about it to ensure the continued soundness of our voluntary tax assessment system. Our testimony focuses on assessing the adequacy of IRS' tools for dealing with the problem.

The subterranean economy can be defined as the aggregate of unrecorded cash activity and that activity which escapes economic measurement and tax assessment. This includes the actual exchange of goods or services for cash or for the value of other goods or services--that is, bartering. From a broader standpoint, the subterranean economy can affect measures of economic activity, unemployment, and average earnings because transactions are not recorded or otherwise accounted for. Obviously, such activity adversely impacts our tax system in that income earned is not reported and thus not taxed.

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The extent and makeup of the subterranean economy are unknown. Various estimates of either all or part of the subterranean economy have been made but no agreement has been reached as to its size. However, IRS has an effort underway directed toward estimating the extent of nonfiling and underreporting--the two key parts of the subterranean economy. We do know, on the basis of our own work, that the nonfiler portion of the subterranean economy in 1972 involved about 5 million nonfilers who received about \$30 billion in taxable income and owed about \$2 billion in Federal income taxes. While these figures alone are disturbing, the extent of underreporting may be as great a problem. Thus, a fundamental question is, how does IRS identify and pursue nonfilers and underreporters?

IRS' MAJOR TOOLS FOR ENFORCING COMPLIANCE

The Service has four basic tools to detect nonfiling and underreporting:

- collections,
- document matching,
- audits, and
- criminal investigations.

The extent to which IRS uses each of these tools against nonfilers and underreporters varies and depends on whether their failure to file or report all their income is detectable through documentation or a "paper trail."

Some unreported income is detectable through information provided to IRS by sources other than the taxpayer in question, such as that reported as alimony by another party, or salaries or wages reported by an employer on a W-2 form. Similarly, unreported income could be detected through the audit of taxpayer documents. Effective use of document matching and audits can help assure such income is attributed to the correct taxpayer.

Conversely, unreported income secured through "cash" or otherwise unrecorded transactions leaves no paper trail and thus can only be detected, if at all, through a full-fledged investigation of the taxpayer. Examples of such income would be that obtained through organized crime activity, or simply doing skilled work for remuneration in cash and not reporting it.

Our work indicates that while IRS has tools in place to deal with both components of the subterranean economy, it has paid substantially more attention to determining whether the amounts reported by taxpayers who do file reflect their true tax liability. Given the apparent size of the subterranean economy, IRS may need to reassess its strategy for ensuring taxpayer compliance, including the extent to which it uses and allocates resources to the various tools and compliance areas.

It is, therefore, appropriate to discuss how IRS is currently using the tools it has to combat the nonfiling and underreporting problem.

COLLECTIONS

The results of our work on the nonfiler portion of the subterranean economy showed that IRS needs to use its collection resources more effectively to better deal with the nonfiler problem. The Collection Division is the key IRS unit responsible for ensuring that taxpayers file their returns.

Until our work, IRS did not have an estimate on how many nonfilers there were or the consequences of nonfiling on the voluntary tax assessment system. We estimated that of the 68 million individual taxpayers required to file in 1972, about 5 million with tax liabilities of about \$2 billion, did not. IRS was able to catch about 600,000, or 12 percent, of the 5 million nonfilers. IRS said it did not pursue the remaining nonfilers because of limited resources.

Because of the size of the nonfiler population, IRS needs to get a clearer picture of the size and characteristics of the nonfiler population. This is needed information for determining where best to concentrate your efforts.

For instance, we found that while nonfilers generally are similar to those who file, the following occupations have the highest nonfiling rates

- laborers (about 17 percent),
- service workers (about 16 percent),
- craftsmen (about 13 percent), and
- clerical workers (about 13 percent).

We also found some weaknesses in the Taxpayer Delinquency Investigation Program resulting from

- inadequate criteria for selecting potential nonfilers to investigate,
- restrictive investigative policies and procedures applied to those selected, and
- inadequate practices in managing nonfiler cases.

IRS selects potential nonfilers for investigation generally on the basis of whether a person's income, as shown by certain data in its files, indicates a predetermined tax liability. Selection is not based on whether a person is technically required to file. In fact, IRS' data sources do not always show the requirement to file. As a result, many people who are not required to file are selected for investigation, while many who may be required to file are not selected.

There is a better way for IRS to select potential nonfilers for investigation. We developed a model that assured, with about 83 percent certainty, that individuals selected for investigation are indeed required or not required to file returns. We recommended that IRS create a similar model for nationwide use. The Service agreed to do so.

Since IRS selects more people than it can thoroughly investigate with its limited resources, its investigative policies and procedures intentionally limit the extent to which they are pursued. Moreover, IRS procedures do not ensure that nonfilers, once caught, will file all their delinquent tax returns; nor do the procedures require that delinquent returns be checked to identify unreported income.

We reviewed 962 randomly selected cases in 7 district offices from IRS' Taxpayer Delinquency Investigation Program for tax year 1975. About 46 percent of the cases were closed successfully because (1) IRS secured delinquent returns, (2) the individuals were not required to file, or (3) the individual had filed previously. Generally the unsuccessful closures were due to IRS' decision not to investigate the taxpayers sufficiently to locate them or verify whether they were required to file.

At our request, IRS investigated more thoroughly 389 of the unsuccessful closures. Investigating such cases increased costs, but revenues to the Government outweighed costs 3 to 1. We estimate that IRS did not investigate thoroughly 56,000 nonfiler cases in the 7 districts for tax year 1975. As a result, IRS did not

--secure about 25,000 delinquent returns involving \$15.8 million in taxes owed and \$7.7 million in refunds, or

--uncover about \$14.8 million in unreported income with potential tax liabilities of \$2.2 million.

In our July 11th report to the Congress, we made several recommendations to IRS for improving its efforts to identify and pursue nonfilers. IRS said it would implement our recommendations to the extent practical. It stated, however, that its present nonfiler program is cost beneficial and that due to limited resources, it can thoroughly investigate only the more productive nonfiler cases.

IRS' nonfiler program is productive in terms of taxes, penalties, and interest assessed against those caught. However, IRS selects many persons who are not required to file and does not secure returns from many because it fails to investigate them thoroughly. Furthermore, many persons from whom IRS secured returns had already shown some intent to file before IRS investigated them as nonfilers. Thus, IRS needs to better select for investigation only those people who are most likely required to file and thoroughly investigate those persons.

IRS stated that the amount of enforcement resources it allocates to detecting nonfilers must be weighed against and balanced with its declining audit coverage and its increasing accounts receivable inventory.

Although additional resources may be needed to fully implement our recommendations, we are not suggesting IRS divert resources from other important enforcement programs. However, we believe the Congress should, on the basis of cost estimates provided by IRS, determine whether IRS' nonfiler efforts are being funded at a level sufficient to cope with the magnitude of the problem.

Document Matching

The document matching program is IRS' most powerful tool to detect, on a mass scale, individuals who do not report all their income.

In document matching, payers are required to submit to IRS information on the type and amount of income paid to taxpayers. IRS can use its computers to match this information with income reported on the taxpayer's return. About 55 percent of the income information documents in tax year 1977 came to IRS on computer tapes. A significant number, however, arrive in paper form. The more computerized the information is, the easier it is for IRS to use it.

While various matching efforts were conducted earlier, the program--as it exists now--started with tax year 1974 when IRS processed about 40 percent of the domestic information documents it received from payers. IRS expects to process about 80 percent of the 1978 documents. About one half of this increase results

largely from the new Combined Annual Wage Reporting System under which the Social Security Administration will convert millions of wage documents to magnetic tape.

Our ongoing work in the document matching area is directed at evaluating its effectiveness in detecting individuals who underreport their income. While we are still in the preliminary stage, we have identified some potential problem areas.

First, there are indications that payers are not submitting all the documents they should. It is difficult to estimate the extent of this problem, however, because IRS has no system to keep track of the payers and the documents required to be submitted by them.

Second, many information documents submitted to IRS are not used, thereby allowing taxpayers who underreport their income to go undetected. For tax year 1977, for example, IRS received 505 million information documents of which 271 million were processed.

Third, much income is not reported but could be. For example, interest on marketable U.S. public debt obligations is not subject to information document reporting--IRS is pushing to include this income in the program.

Fourth, there is a lack of management information on the document matching program. More information is needed to really evaluate its effectiveness in detecting underreporters, make

adjustments to the program, and determine more accurately its costs and benefits.

Not all the above problems can be readily corrected. But, IRS is working on them.

Audits

IRS considers the audit to be its most significant enforcement effort. Because audits are directed at persons who file returns, they can be expected to impact much more on underreporters than nonfilers. We are not convinced, however, that IRS audits are as effective as they might be in detecting underreporters. We have three concerns:

- IRS has inadequate data on the underreporting problem and on the amount of unreported income detected by its audits.
- IRS' process for selecting returns for audit is more deduction-oriented than income-oriented.
- IRS' annual examination plan may not allow enough time for examiners to do the type of audit work necessary to identify unreported income.

Criminal Investigations

The Criminal Investigation Division also plays a vital role in detecting underreporters and nonfilers who are engaging in purposeful tax evasion--often without leaving a "paper" trail.

Each year, the Criminal Investigation Division, through its 2,800 special agents, conducts about 9,000 detailed investigations. For the most part, those investigations are directed at some form of underreporting or nonfiling. Over half the Division's workload is generated by referrals from the Examination and Collection Divisions. As such, the Criminal Investigation Division's efforts are dependent on the ability of others to identify nonfilers and underreporters and to develop sufficient information to convince the Criminal Investigation Division that a detailed investigation is warranted.

The Criminal Investigation Division also generates its own cases through information gathering efforts. These efforts enable IRS to get at pockets of noncompliance that might otherwise go untouched and, as such, are one of the Service's most important tools for detecting the more complex schemes involving underreporters or nonfilers. Basically, information gathering activities differ from other IRS activities in that they are not constrained to evaluations of information in IRS' possession. Special agents can make inquiries of Federal, State, and local agencies, develop and use informants, and conduct surveillances. These activities often lead to detailed investigations involving the issuance of summonses and analyses of complex financial transactions. Investigations, in turn, can lead to convictions; and IRS believes that the publicity resulting from those convictions acts as a deterrent to other would-be violators.

It is important to note also that although the Criminal Investigation Division's activities constitute an important part of IRS' overall compliance effort, they directly affect few taxpayers. During fiscal year 1978, for example, only 1,414 individuals were convicted of tax fraud.

IRS COMPLIANCE STRATEGY

IRS thus has a broad range of enforcement tools available to combat the subterranean economy. But, are all these tools effectively combined in a compliance strategy which maximizes voluntary compliance among all taxpayer groups? Assuming the subterranean economy is significant, IRS may have to completely re-think its current compliance strategy.

Historically, IRS has allocated the greatest share of its compliance resources to the audit program. IRS believes examining returns stimulates voluntary compliance more so than investigating taxpayers, matching documents, closing delinquent accounts, or conducting other compliance-related activities. For example, in its financial plan for fiscal year 1979, IRS allocated about \$713 million, or 61 percent, of the total \$1.2 billion in compliance resources to the audit program. Of the remainder, IRS allocated \$275 million (24 percent) to collections, \$128 million (11 percent) to criminal investigations, and \$51 million (4 percent) to document matching. IRS allocated

the other \$1 billion of the \$2.2 billion appropriation to activities not directly related to compliance.

We have underway a study directed at evaluating the basis IRS uses to allocate resources to its compliance functions. Although our work is still in its early stages, it appears that the audit, collection, document matching, criminal investigation, and related programs are not a part of a systematic and well-integrated approach to the noncompliance problem. Each compliance group establishes its own objectives, approach, and plans, which are perhaps most beneficial to their own interests but not necessarily the most beneficial to the overall compliance mission. There is little, if any, consideration given to comparing the impact of each compliance function and reallocating resources among them.

Long-range strategic planning is limited primarily to the examination program. There is no overall compliance plan, and planning for the collection, criminal investigation, and document matching programs consist mainly of developing annual operational plans.

At a minimum, IRS should be more consistent in defining the target groups, determining the approach and level of compliance effort devoted to each group, and measuring the program impact for each group. For example, it may be more cost beneficial to put additional compliance resources into the document matching

program as opposed to the audit or collection programs. But, unless IRS looks at all three programs within the context of how they together foster increased compliance among targeted groups of taxpayers, it cannot effectively make such a decision. We have seen little to indicate that IRS approaches resource allocation in this way.

This concludes our prepared statement. We would be pleased to respond to questions.