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COMPLIANCE AND COLLECTION

Challenges for IRS in Reversing Trends and Implementing New Initiatives

Statement of Michael Brostek, Director
Strategic Issues

GAO-03-732T

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Highlights

Highlights of GAO-03-732T, a testimony before the Subcommittee on Transportation, Treasury, and Independent Agencies, Committee on Appropriations, House of Representatives

COMPLIANCE AND COLLECTION

Challenges for IRS in Reversing Trends and Implementing New Initiatives

Why GAO Did This Study

Taxpayers' willingness to voluntarily comply with tax laws depends in part on their confidence that friends, neighbors, and business competitors are paying their fair share of taxes. The Internal Revenue Service's (IRS) programs to ensure compliance and to collect delinquent taxes are viewed by many as critical for maintaining the public's confidence in our tax system.

The Subcommittee asked GAO to present information on trends in IRS's compliance and collection programs and to discuss issues related to IRS's efforts to increase staffing for these programs. GAO was also asked to discuss IRS's plans to launch new initiatives to reduce noncompliance with the Earned Income Tax Credit (EIC) and to use private collection agencies to assist in collecting delinquent taxes.

What GAO Recommends

GAO is not making any recommendations. GAO is currently working with members of Congress to define the scope of work they would like GAO to do to assess IRS's proposed initiative to address EIC noncompliance.

www.gao.gov/cgi-bin/getrpt?GAO-03-732T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

From fiscal years 1993 through 2002, IRS's four major compliance programs for individual taxpayers had mixed trends in the portion of taxpayers they contacted with two declining, one increasing, and one staying relatively the same. Among the programs, IRS's often-cited audit rate declined about 38 percent. From fiscal years 1996 through 2001, IRS's collection program experienced almost universal declines in workload coverage, cases closed, direct staff time used, productivity, and dollars of unpaid taxes collected. Many parties have expressed concern about the compliance—especially audit—and collections trends for their potential to undermine taxpayers' motivation to fulfill their tax obligations.

Since 2001 IRS has sought more resources including increased staffing for compliance and collections. Despite receiving requested budget increases, staffing levels in key occupations were lower in 2002 than in 2000. These declines occurred for reasons such as unbudgeted expenses consuming budget increases and other operational workload increases. Based on past experience and uncertainty regarding some expected internal savings, fiscal year 2004 anticipated staff increases might not fully materialize.

IRS's 2004 budget proposes a substantial initiative to address known sources of EIC noncompliance. IRS intends to ramp up the initiative rapidly with planning and implementation proceeding simultaneously. If it is to succeed, the initiative will require careful planning and close management attention.

IRS also proposes to use private collection agencies to assist in collecting certain delinquent tax debt. IRS is seeking authority to retain some tax receipts in a revolving fund to pay the private collectors. A pilot effort to use private collectors in 1996 was unsuccessful, in part because IRS was unable to identify and channel appropriate collection cases to the private collectors. Key implementation details for this proposal must be worked out and it too will require careful planning and close management attention.

Proposed EIC Initiative Caseloads by Fiscal Year and Initiative Type, 2004-08

Thousands of filers

		Fiscal year				
Initiative		**2004**	**2005**	**2006**	**2007**	**2008**
Qualifying child	Relationship certification	45[a]	2,000	1,500	800	100
	Residency certification	[a]	0	1,000	1,000	1,000
Filing status		5	450	450	450	450
Income reporting[b]		175	470	470	470	470

Source: IRS.

Note: Projections are based on receiving an initiative-specific annual appropriation of $100 million.

[a]In 2004, a total of 45,000 claimants will be asked to certify both their relationship and their residency.

[b]Also known as the "underreporter" initiative.

Mr. Chairman and Members of the Subcommittee:

I am pleased to participate in the Subcommittee's hearing today focusing on compliance issues and initiatives in the Internal Revenue Service's (IRS) fiscal year 2004 budget request. Specifically, my statement today will cover recent trends in IRS's compliance and collection programs, IRS's staffing for these programs, and its initiatives to expand compliance efforts for the Earned Income Credit (EIC) and to use private collection agencies to assist in the collection of delinquent tax debt.

From fiscal years 1993 through 2002, IRS's compliance programs for individual taxpayers—audits, document matching, nonfiler identification, and math error corrections—had mixed trends in the rate at which they contact potentially noncompliant taxpayers with two declining, one increasing, and one staying relatively the same.[1] Among the four programs, IRS's often-cited audit rate declined approximately 38 percent comparing 1993 to 2002. In the collection area, comparing fiscal years 1996 to 2001 IRS's collection program experienced almost universal declines in workload coverage, cases closed, direct staff time used, productivity, and dollars of unpaid taxes collected.[2] Many parties have expressed concern about the compliance program--especially audit—and collection program trends for their potential to undermine taxpayers' motivation to fulfill their tax obligations.

Concerned about these trends, IRS has sought additional resources, including increased staffing levels for compliance and collection since fiscal year 2001. However, despite receiving requested budget increases, staffing levels in key occupations were lower in 2002 than in 2000. Reasons for this decline include unbudgeted expenses consuming budget increases and workload increases in other essential operations. The 2004 budget again proposes funding increases in part to augment staffing for compliance and collection activities. Also, as it did last year, IRS projects that savings from more efficient operations will enable it to shift more staffing into these activities in 2004. Current savings projections since the budget was prepared, as well as the past history of unrealized staffing

[1] IRS and others sometimes refer to the four programs as enforcement programs.

[2] The collection of delinquent taxes is also considered to be a compliance program by IRS. For purposes of this testimony, it is discussed separately.

increases, raise questions about whether IRS will realize the full staffing increases it expects.

In the compliance area, IRS's 2004 budget proposes a new initiative to address noncompliance in the EIC. The EIC initiative is a substantial new effort to target known sources of EIC noncompliance that IRS intends to ramp up rapidly. Planning and implementation for this initiative will proceed simultaneously. The success of the initiative will depend on careful planning and close management attention as IRS's implementation progresses.

In the collection area, IRS has proposed using private collection agencies to assist it with a portion of the collection activities for some delinquent tax debt. IRS is requesting authority to retain some tax collection receipts in a revolving fund that would be used to pay the private collectors. A pilot effort to use private debt collectors in 1996 was unsuccessful, in part because IRS was unable to identify and channel appropriate collection cases to the private debt collectors. Various key details for implementing this proposal must be worked out and it, like the EIC initiative, will require careful planning and close management attention if Congress authorizes the effort.

Our assessment of IRS compliance and collection trends, and budget issues is based on recently issued GAO products. We updated certain trends for IRS's fiscal year 2002 operations by analyzing IRS management reports. We also used data reported by the Treasury Inspector General for Tax Administration. To assess the status of IRS's EIC initiative and plans to use the assistance of private collection agencies, we interviewed IRS officials and reviewed documents prepared to justify both initiatives.

I will now discuss these issues in more detail, turning first to trends in IRS's compliance and collection programs.

Trends in Compliance and Collection Programs Have Triggered Concern

In recent years, steep declines have occurred in some of IRS's compliance programs for individual taxpayers, as have broad declines in its efforts to collect delinquent taxes. These trends have triggered concerns that taxpayers' motivation to voluntarily comply with their tax obligations could be adversely affected.

Compliance Trends Are Mixed; the Often Cited Audit Rate Has Declined Steeply

Taxpayers' willingness to voluntarily comply with the tax laws depends in part on their confidence that their friends, neighbors, and business competitors are paying their fair share of taxes. IRS's compliance programs, including audits, document matching, and other efforts, are viewed by many as critical to maintaining the public's confidence in our tax system.

Looking across all four of IRS's major enforcement programs between fiscal years 1993 and 2002 reveals a somewhat mixed picture, as shown in figure 1. The four programs and their trends are as follows:

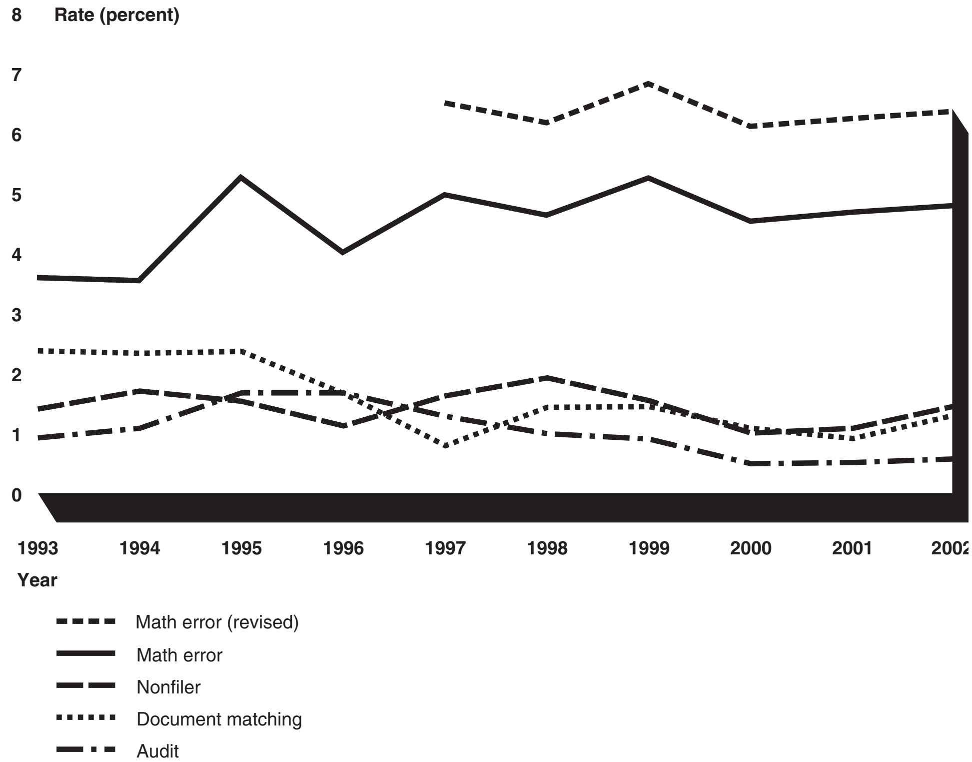
- The math error program that identifies obvious errors such as mathematical errors, omitted data, or other inconsistencies on the filed tax return. Using only the math error count, which is consistent throughout the 10 years, the math error contact rate rose 33 percent (from 3.59 to 4.79 percent).

- The document matching program that identifies unreported income using information returns filed by third parties such as employers and banks. Document matching rates went up and down at various times but ended 45 percent lower (from 2.37 percent to 1.30 percent) in 2002 compared to 1993.

- The nonfiler program that identifies potential nonfilers of tax returns by using information return and historical filing data. The nonfiler rates also went up and down but ended in 2002 about where they were in 1993.

- The audit program that checks compliance in reporting income, deductions, credits and other issues on tax returns through correspondence or in face-to-face meetings with an IRS auditor. Comparing 1993 to 2002, the audit contact rate dropped 38 percent (from 0.92 to 0.57 percent) even though it rose significantly between 1993 and 1995.

Figure 1: IRS Compliance Contact Rates, Fiscal Years 1993-2002

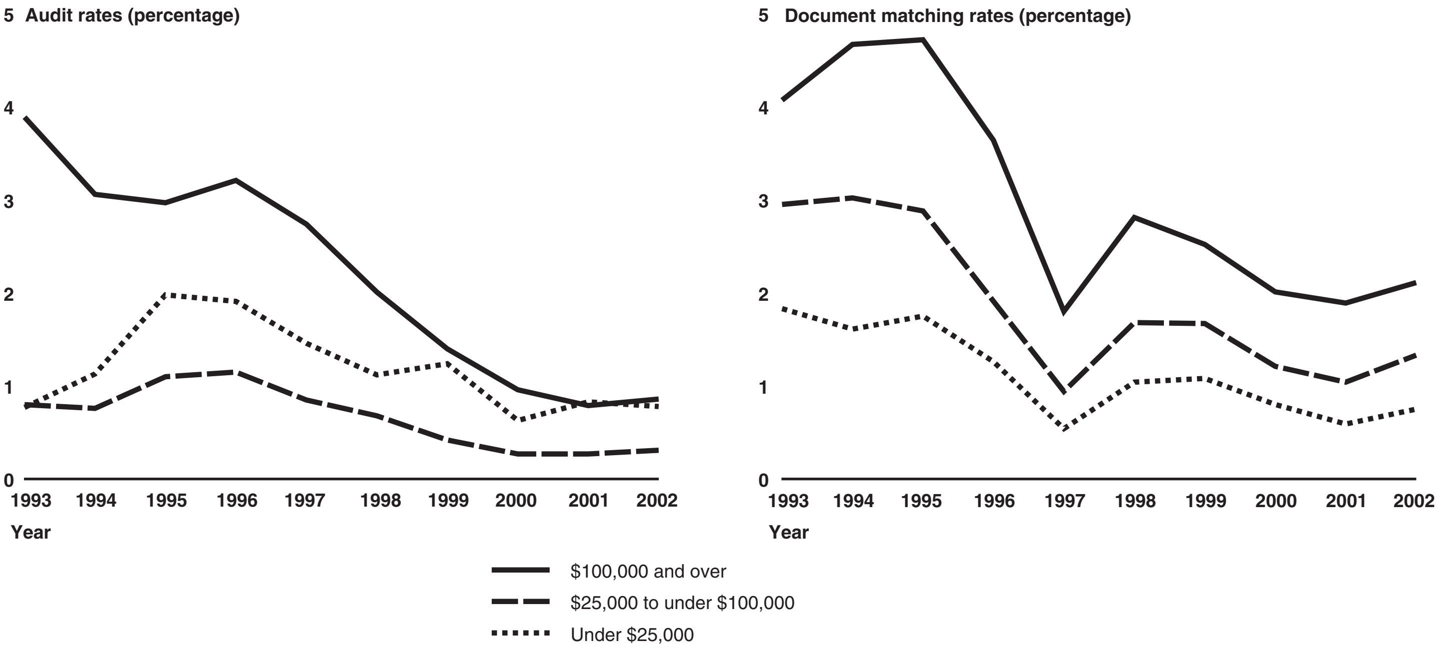


Source: GAO analysis of IRS data.

Note: The revised math error contact rate includes roughly 2 million contacts that IRS had been making but had not been reporting as math errors for fiscal years 1997 through 2002. IRS had not collected data on these math errors prior to fiscal year 1997.

Figure 2 shows compliance program trends based on income ranges. Although audit rates for individual taxpayers in higher and middle-income ranges rose slightly in 2002, overall they were significantly lower in 2002 than in 1993, while the rate for the lowest income range was virtually the same in 2002 as in 1993. The audit contact rates for the highest and lowest income individuals essentially converged at around .8 percent in fiscal years 2001 and 2002. Most of the audits of the lowest income individuals dealt with EIC claims. Document matching contact for all three income ranges rose somewhat between 2001 and 2002. However, rates for all three income ranges ended significantly lower in 2002 than 1993 following similar patterns of change over the years. Data on contact rates by income level were not available for the math error and nonfiler programs.

Figure 2: IRS Individual Audit and Document Matching Contact Rates by Income Level, Fiscal Years 1993-2002



Source: GAO analysis of IRS data.

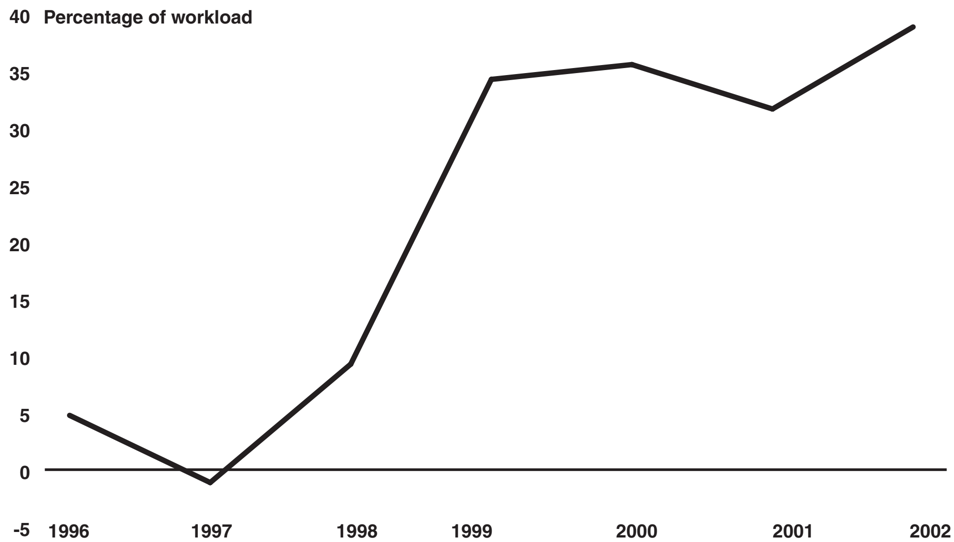
Collection Trends Have Declined

As we reported in May 2002, between fiscal years 1996 and 2001 trends in the collection of delinquent taxes showed almost universal declines in collection program performance, in terms of coverage of workload, cases closed, direct staff time used, productivity, and dollar of unpaid taxes collected.[3] Although IRS's workload generally declined for two of those indicators, workload and cases closed, the collection work it completed declined more rapidly creating an increasing gap as show in figure 3.[4] During that 6-year period, the gap between the new collection workload and collection cases closed grew at an average annual rate of about 31 percent.

[3] U.S. General Accounting Office, *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002).

[4] Workload is the number of delinquent accounts assigned to field and telephone collection. Work completed is the number of delinquent accounts worked to closure, excluding accounts for which collection work has been deferred.

Figure 3: Percentage Gap between Collection Workload and Work Completed, Fiscal Years 1996-2002



Source: GAO analysis of IRS data.

The increasing gap between collection workload and collection work completed led IRS in March 1999 to start deferring collection action on billions of dollars in delinquencies. IRS's inventory of delinquent accounts was growing and aging and the gap between its workload and capacity to complete work was increasing. Officials recognized that they could not work all collection cases, and they believed that they needed to be able to deal with taxpayers more quickly, particularly taxpayers who were still in business and owed employment taxes.[5]

By the end of fiscal year 2002, after the deferral policy had been in place for about 3 and one-half years, IRS had deferred taking collection action on about $15 billion in unpaid taxes, interest, and penalties. IRS' deferral of collection action has declined somewhat since the deferral policy was adopted. Although the rate has declined from 45 percent in 2000 to about

[5] IRS considers employment tax compliance to be among the most challenging issues for small business, since delinquent tax can rapidly compound beyond the employer's ability to pay. See U.S. General Accounting Office, *Tax Administration: IRS's Efforts to Improve Compliance with Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

32 percent in 2002, IRS is still deferring collection action on about one out of three collection cases.

Concerns Regarding the Compliance and Collection Trends

Many parties have expressed concern about these trends in IRS's compliance and collection programs. Since the mid-1990s, we have issued six reports on IRS compliance and collection trends in response to congressional concerns.[6] During annual oversight hearings on IRS, Congress often raises questions about the declining audit rate and possible effects on compliance. In recent years, congressional concerns as well as IRS's requests have resulted in efforts to augment IRS's staffing levels.

In fact, the former IRS Commissioner's report to the IRS Oversight Board during September 2002 made what was perhaps the most explicit case for additional staffing to address IRS's compliance and collection performance. Although the Commissioner recognized that IRS needed to improve the productive use of its current resources, he cited a need for an annual 2 percent staffing increase on top of planned productivity increases over 5 years to help reverse the trends. In terms of the collection of tax debts, the IRS Commissioner estimated that an almost 60 percent gap exists between IRS's collection workload and the work it has completed. Closing this gap, according to the Commissioner, would require 5,450 new full-time staff.[7] IRS also has been looking for ways to free resources for compliance programs by boosting productivity or reducing workload in other areas.

[6] U.S. General Accounting Office, *Tax Administration: Audit Trends and Results for Individual Taxpayers*, GAO/GGD-96-91 (Washington, D.C.: Apr. 26, 1996); *Tax Administration: IRS' Audit and Criminal Enforcement Rates for Individual Taxpayers Across the Country*, GAO/GGD-99-19 (Washington, D.C.: Dec. 23, 1998); *IRS Audit Rates: Rate of Individual Taxpayers Has Declined With the Effect on Compliance Unknown*, GAO-01-484 (Washington, D.C.: Apr. 25, 2001); *Tax Administration: Use of Nonaudit Contacts*, GAO/GGD-00-7 (Washington, D.C.: Mar. 16, 2001); *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002); and *Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts*, GAO-03-378 (Washington, D.C.: Jan. 31, 2003).

[7] Internal Revenue Service, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System*, September 2002.

In our recent Performance and Accountability Series report on the Treasury Department, we cite the collection of unpaid taxes as one of the management challenges facing IRS.[8] In that report, we state that IRS is in various stages of planning and implementing management improvements, including reengineering compliance and collection practices. However, as of September 30, 2002, IRS's inventory of known unpaid taxes totaled $249 billion, of which $112 billion has some collection potential, and is at risk.[9]

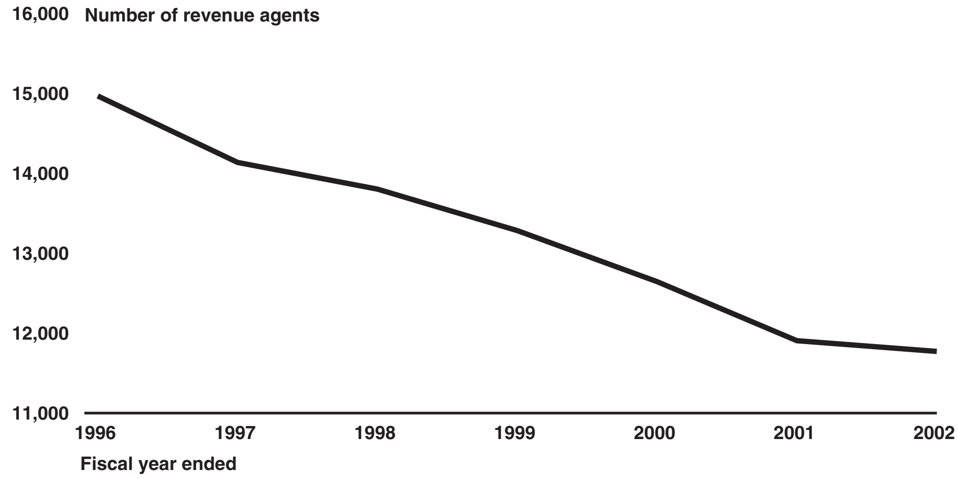
Increasing Compliance and Collection Staffing Has Been and Remains an IRS Priority, but Declines Have Continued

Since 2001, IRS's budget requests have made increasing its compliance and collection staff one of several key priorities. For example, in its 2001 budget request IRS asked for funding for the Staffing Tax Administration for Balance and Equity initiative, which was designed to provide additional staff for examination, collection, and other enforcement activities. However, as shown in figures 4 and 5, staffing in two key compliance and collection occupations were lower in 2002 than in 2000. This continues a general trend of declining staffing in these occupations for a number of years.

[8] U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of the Treasury,* GAO-03-109 (Washington, D.C.: January 2003).

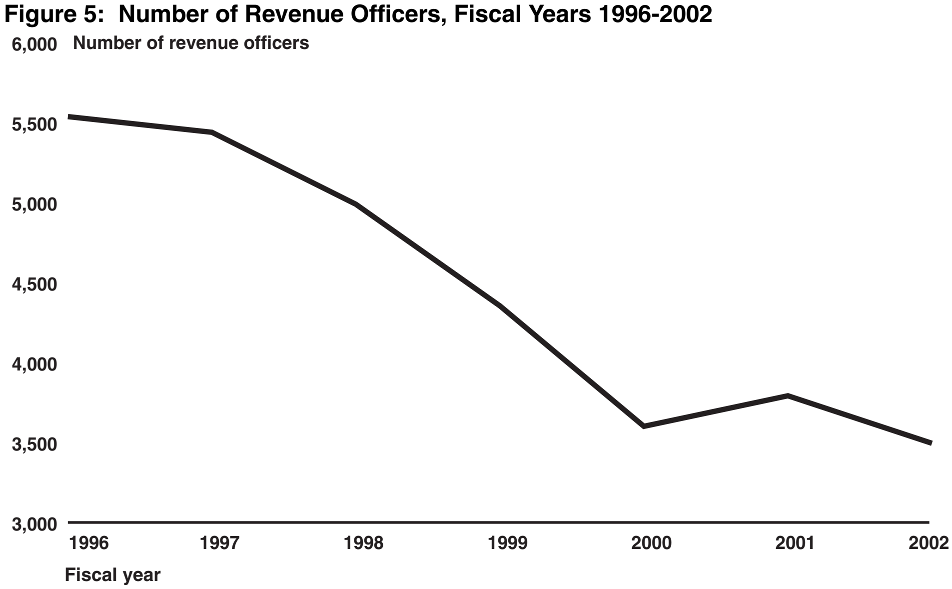
[9] Known unpaid taxes consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable with a taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments in which neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which are unpaid assessments for which IRS does not expect collections due to such factors as the taxpayer's death, bankruptcy, or insolvency. The $112 billion only includes the first two categories.

Figure 4: Number of Revenue Agents, Fiscal Years 1996-2002



Source: Treasury Inspector General for Tax Administration.

Figure 5: Number of Revenue Officers, Fiscal Years 1996-2002



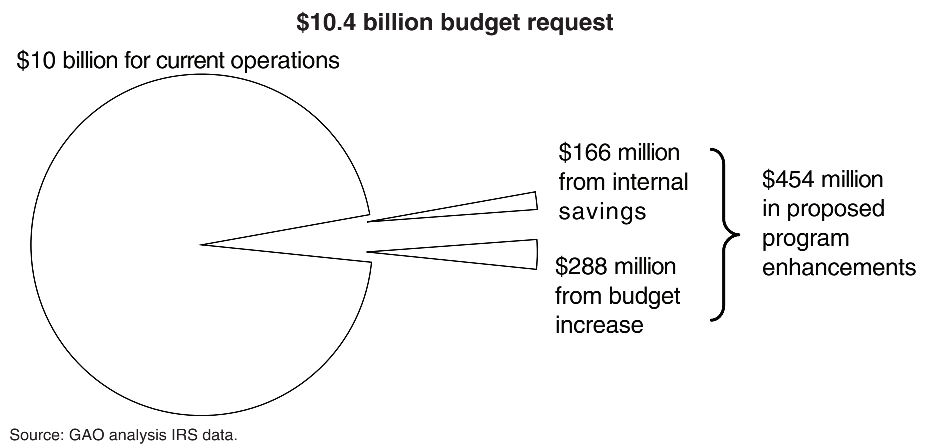
Source: Treasury Inspector General for Tax Administration.

The declines in compliance and collection staffing occurred for several reasons, including increased workload and unbudgeted costs. In September 2002, the Commissioner attributed the decline in compliance staffing to increases in workload in other essential operations, such as processing returns, issuing refunds, and answering taxpayer mail. In the most recently completed fiscal year, 2002, IRS faced unbudgeted cost increases, such as rent and pay increases, of about $106 million. As a result, IRS had to delay hiring revenue agents and officers. IRS noted in its 2002 budget request that any major negative changes in the agency's financial posture, such as unbudgeted salary increases, will have a negative effect on staffing levels.

Fully Realizing a Fiscal Year 2004 Staffing Increase May Be Challenging

For fiscal year 2004, IRS is requesting $10.4 billion, an increase of 5.3 percent over fiscal year 2003 requested levels, and 100,043 full-time equivalents (FTE). Also, IRS's 2004 budget request is its second in a row to propose increased spending for higher priority areas that would be funded, in part, with internal savings redirected from other areas. Specifically, IRS proposes to devote an additional $454 million and 3,033 more FTEs to enhance programs, including compliance and some customer service areas. As shown in figure 6, $166 million of the enhancements would be funded from internal savings with the remainder funded from the budget increase.

Figure 6: IRS's Proposed Funding for Program Enhancements



Source: GAO analysis IRS data.

We commend IRS for identifying savings to be reinvested in operations to improve IRS performance. This approach implements a key principle of IRS's long-term modernization effort. Under this approach, the reengineering of IRS's work processes, much of which depends on investments in computer modernization, would automate or eliminate work, improve productivity, and free staff time that could then be redirected to higher priority customer service and compliance activities.

Some caution is appropriate, however, in considering whether the additional FTEs will be realized. In addition to the potential that some cost increases may not be funded as in prior years, revised projections developed since the 2004 budget request was prepared raise questions about IRS's ability to achieve all the savings projected and shift resources to compliance as planned.

IRS has revised the savings associated with several reengineering efforts identified in the 2004 budget request. Revisions this far in advance of the start of the fiscal year are not a surprise. They do indicate some uncertainty associated with the budget request's savings projections.

For example, most significant reengineering efforts planned for fiscal year 2004, in terms of FTEs and dollars to be saved, will not achieve all of their projected savings because the efforts were based on assumptions that will not be realized, according to IRS data and officials. IRS's effort to improve the efficiency of compliance support activities, the single most significant effort, depended partially on IRS implementing individual compliance savings projects in 2003. This effort was projected to save 394 FTEs and almost $26 million. However, due in part to delays until 2004 to allow for additional testing, this effort is now expected to save about 30 percent of the original projections through the end of fiscal year 2004. IRS now projects that the seven most significant efforts will save 1,073 FTEs and $60.5 million, down from original projections of 1,356 FTEs and $77.7 million.

Reengineering efforts may not achieve all of their savings goals, in part, because of the long time lag between when IRS begins developing its budget request and when the fiscal year begins. As with most other federal agencies, IRS usually begins formulating its budget request about 18 months before the start of the fiscal year and about 10 months before the President submits his budget to Congress. With planning beginning so far ahead of the budget's actual execution, inevitable intervening events, such as delays in implementing computer systems, make the assumptions upon which projections are based no longer realistic.

In addition to lower current estimates of the potential savings from the seven most significant reengineering estimates, some of the other reengineering efforts listed in the 2004 budget request are not well defined.

This raises questions about whether they will achieve their savings goals. For example, IRS still is reviewing its procedures to identify ways to make tax return processing more efficient. Although IRS projected this effort to save 203 FTEs and $6.9 million, it has not yet identified the operational areas that will be reengineered. IRS officials said that the projected savings are based on a 2 percent efficiency increase, but they are currently determining how to achieve that goal.

According to IRS budget officials, IRS uses its budget formulation process to establish productivity goals, although the responsible business units may not know specifically how savings will be achieved. Officials said that this approach encourages innovation in meeting performance goals while identifying ways to save FTEs and budget dollars.

EIC Initiative Is a Substantial and Challenging Strategy to Target Known Compliance Problems

IRS's 2004 budget submission requests $100 million and 650 FTEs for a new initiative to improve compliance in one area in which noncompliance is known to be a concern: EIC. Although Treasury and IRS have made progress in defining the scope and nature of the initiative, many details about its implementation are still to be settled as planning for and implementation of the initiative proceed simultaneously. IRS hopes that this effort will reduce EIC noncompliance without unnecessarily burdening or discouraging those who are eligible for and claim EIC. Given its scope, potential effects on EIC claimants, and planned rapid expansion, the success of the initiative will depend on careful planning and close management attention as IRS implements the initiative.

Begun in 1975, the EIC is a refundable tax credit available to certain low-income, working taxpayers. Two stated long-term objectives of Congress have been: 1) to offset the impact of Social Security taxes on low-income individuals; and 2) to encourage these same individuals to seek employment, rather than depend on welfare benefits. Researchers have reported that the EIC has been a generally successful incentive-based antipoverty program, as was intended by Congress.[10] For tax year 2001, about $31 billion was paid to about 19 million EIC claimants.

[10] The Council of Economic Advisers, *Good News for Low Income Families: Expansions in the Earned Income Tax Credit and the Minimum Wage*, December, 1998. Congressional Research Service, *The Earned Income Tax Credit (EITC): An Overview*, Updated report, March 19, 2003.

However, in addition to its successes, the EIC program has historically experienced high rates of noncompliance—including both overclaims and underclaims of benefits. For over a decade we have reported on IRS's efforts to reduce EIC noncompliance. Due to persistently high noncompliance rates, we have identified the EIC program as a high-risk area for IRS since 1995.[11] An IRS study of 1985 tax returns estimated that the EIC overclaim in that year rate was 39.1 percent. The results of subsequent EIC compliance studies conducted by IRS are shown in table 1.

Table 1: EIC Overclaim Rates for Selected Years

	Overclaim rate estimates	
Tax year	**Lower-bound**	**Upper-bound**
1994	--	23.5
1997	23.8	25.6
1999	27.0	31.7

Source: IRS reports.

Notes: All overclaim rates were adjusted by IRS to reflect dollars recovered from ineligible recipients. For 1994 only a single estimate was available. In 1997 and 1999, because not all individuals responded to the audit contacts, IRS used certain assumptions to estimate an overclaim rate range. The lower bound assumes that the overclaim rate for the nonrespondents is the same as for the respondents, while the upper bound assumes that all non-respondents are overclaims.

In 1997, Congress instructed IRS to improve EIC compliance through expanded customer service and outreach, strengthened compliance, and enhanced research efforts. For these efforts Congress authorized a 5-year, EIC-specific appropriation of $716 million. Although the 5-year period elapsed in fiscal year 2002, Congress appropriated $145 million specifically for EIC compliance for fiscal year 2003. For fiscal year 2004, IRS is requesting $153 million for this appropriation; the $100 million request for the new EIC initiative is separate.

Early in 2002, when the results of IRS's most recent study of EIC compliance for tax year 1999 were released, the Assistant Secretary of the Treasury and the IRS Commissioner established a joint task force to seek new approaches to reduce EIC noncompliance. The task force sought to

[11] Prior to 2001, EIC was part of a broader IRS Tax Filing Fraud high-risk area. Beginning in 2001, the focus of that designation was narrowed to EIC specifically. See U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: January 2001).

develop an approach to validate EIC claimants' eligibility before refunds are made, while minimizing claimants' burden and any impact on EIC's relatively high participation rate. Through this initiative, administration of the EIC program would become more like that of a social service program such as Food Stamps or Social Security Disability, where proof of eligibility is required prior to receipt of any benefit.

Based on its various studies of EIC noncompliance, IRS determined that three specific areas account for a substantial portion of EIC noncompliance. These three areas—qualifying child eligibility, improper filing status, and income misreporting (also called "underreporter")—account for nearly 70 percent of all EIC refund errors, according to IRS. The joint Treasury/IRS task force designed an initiative that would address each of these sources of EIC noncompliance.

Filers that improperly claim qualified children represent the single largest area of EIC overclaims, on a dollar basis. Under the proposed initiative, IRS will attempt to verify all taxpayers' claims for EIC-qualifying children under two criteria: a residency and a relationship certification. IRS plans to use third-party databases and other means to verify qualifying children for an estimated 80 percent of EIC claimants. All other EIC claimants will be asked to provide additional eligibility documentation prior to the filing season. Those who do not respond and/or are unable to document their eligibility will have the EIC portion of their returns frozen. If taxpayers do not provide documentation before the filing season, IRS plans to require them to provide it during or after the filing season. When and if they document their eligibility, the EIC portion of their returns will be released.

Initially, beginning in the summer of 2003, IRS intends to select 45,000 EIC claimants whose qualifying child residency or relationship requirements could not be verified from available databases. IRS plans under its initiative to contact these taxpayers and give them the opportunity to provide verifying documentation for the child (or children) that is (are) claimed to qualify for the EIC. The two components of establishing qualifying child eligibility—the claimant's relationship to the child, and residency with the claimant for more than 6 months—will be treated somewhat differently. Taxpayers who establish their qualifying child relationship will not have to do so in future years but all taxpayers will have to show annually that the children lived with them for the required time. IRS expects to expand the program in July 2004 by starting to contact approximately 2 million taxpayers; in another planned expansion in July 2005, IRS would contact 2.5 million taxpayers.[12]

The other two parts of this initiative will cover an additional 180,000 high-risk filers for tax year 2003—5,000 to verify their filing status and 175,000 to verify their income. Criteria for selecting the 5,000 cases in the filing status category have not yet been determined. They will be drawn from tax year 2003 cases. For the 175,000-case income verification initiative, IRS will use document matching to identify EIC filers who have a history of misreporting income in order to increase (or receive) the EIC.[13] Based on that history, these taxpayers' returns are to be flagged when their 2003 EIC claims are filed. Any EIC refund portion of each return is then to be frozen until IRS can verify the taxpayers' income through document matching or audit procedures in the fall of 2003. These filers will be identified out of tax year 2002 and 2003 cases. Table 2 shows IRS's projections for future casework in all three initiative areas.

[12] According to IRS, planned expansions are estimates that depend on its assessments of its capacity to handle and the results the proposed 45,000 filer initiative.

[13] IRS's automated underreporter system will be an important part of the income verification initiative.

Table 2: Proposed EIC Initiative Caseloads by Fiscal Year and Initiative Type, 2004-08

Thousands of filers

Initiative		Fiscal Year 2004	2005	2006	2007	2008
Qualifying child	Relationship certification	45[a]	2,000	1,500	800	100
	Residency certification	[a]	0	1,000	1,000	1,000
Filing status		5	450	450	450	450
Income reporting[b]		175	470	470	470	470

Source: IRS documents.

Note: Projections are based on receiving an initiative-specific annual appropriation of $100 million and estimates of how many cases IRS can adequately work.

[a]In 2004, a total of 45,000 claimants will be asked to certify both their relationship and their residency.

[b]Also known as the "underreporter" initiative.

Although the Treasury/IRS task force and now IRS have made progress in defining the scope and nature of this initiative, many details about its implementation are still to be settled. IRS expects to learn lessons from initial sample cases it will work in 2003 that will be incorporated into planned expansions of the effort later in 2003 and in 2004. IRS officials said that estimates of the number of new employees that will be needed and their training requirements are evolving. For example, although IRS's 2004 budget submission identifies 650 FTEs for this initiative, current plans are for a much lower staffing level at this point. In addition, cost and FTE estimates are based on historical data that may not be directly comparable to the staffing and technological demands of the initiative. Based on these estimates, of the $100 million 2004 request, IRS has proposed budgeting just under $55 million for direct casework in the three compliance areas. The remaining $45 million is allocated to technology improvements and management, development, and implementation costs related to the three targeted compliance areas.

Fundamental to the precertification of qualifying children is the development of clear forms that identify the specific types of documentation IRS will accept to substantiate that a qualifying child meets the relationship and residency tests for EIC. IRS is currently working with others, like the Taxpayer Advocate, to develop these new forms, which are to be used beginning this summer.

Recently, concerns have been expressed about IRS's intention to request marriage certificates as proof of relationship to the qualifying child. We have not looked at this specific issue. However, our 2002 report noted that EIC forms and instructions that IRS used for similar attempts to determine qualifying child eligibility could be confusing to taxpayers and required documents that EIC claimants had difficulty obtaining.[14] When taxpayers have been disallowed the EIC through an IRS audit, they are required to substantiate their qualification for the EIC—that is, "recertify"—before they can receive the credit again. As part of this process, IRS's forms indicated that EIC claimants could, for example, use medical records to prove a child's residency with them. However, EIC claimants faced difficulty in providing such records. Low-income working families are less likely to have stable relationships with medical service providers and their children are less likely to have routine medical care.

IRS officials said that they plan to pretest the proposed precertification forms both to determine whether they are clear and understandable to EIC claimants but also to determine whether the claimants can provide the required information. This is a critical step in implementing the initiative. We recently reported that IRS seldom tests the new and revised individual tax forms and instructions.[15]

Ensuring consistent interpretation of documentation gathered in the new initiative will also be important. In our 2002 report, we noted that IRS examiners did not consistently assess documentation for qualifying children. For example, we asked 21 examiners to examine five EIC scenarios. The 21 examiners did not agree for any of the scenarios, and, in some cases, the examiners reached widely varying judgments about whether the evidence was sufficient to support an EIC claim.[16] In order to better ensure consistent and accurate decisions based on documentation submitted, we recommended that IRS provide training to its examiners.

[14] U.S. General Accounting Office, *Earned Income Credit: Opportunities to Make Recertification Less Confusing and More Consistent*, GAO-02-449 (Washington, D.C.: Apr. 25, 2002).

[15] U.S. General Accounting Office, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

[16] GAO-02-449.

Administering the EIC is not an easy task for IRS. IRS has to balance its efforts to help ensure that all qualified persons claim the credit with its efforts to protect the integrity of tax system and guard against fraud and other forms of noncompliance associated with EIC. This initiative is a substantial undertaking with a relatively aggressive implementation schedule. Although it appears to be targeted to address known compliance issues, its success will depend on careful planning and close management attention. Any one of many challenges could put the initiative at risk. These include whether, for instance, the proposed new forms will result in evidence that IRS can use to verify relationship and residency requirements. Further, IRS must determine whether lessons from the first attempts to verify the eligibility of relatively small numbers of EIC claimants can be learned and incorporated before the substantial expansion of the initiative in fiscal years 2004 and 2005.

Challenges Must Be Met if IRS Is to Successfully Use Private Collection Agencies

IRS's 2004 budget requests $2 million and legislative authorization for use of private collection agencies (PCA)[17] to assist IRS in collecting certain types of delinquent tax debt. IRS proposes to fund continuing use of PCAs from a to-be-established revolving fund that would receive a portion of taxes collected through use of PCAs.

As with its EIC initiative, IRS has defined the parameters for its use of PCAs, but many key details for implementing the initiative remain to be resolved. These implementation details, such as identifying delinquent debt cases suitable for PCAs to pursue and protecting taxpayer rights, will be critical if the initiative is to succeed. If the PCA initiative is authorized, IRS will need to put focused management attention on planning and monitoring the implementation of the PCA initiative to ensure proper handling of these issues.

As previously noted, IRS's inventory of delinquent debt is growing and aging, with the gap between its workload and capacity to complete work increasing. As a consequence, IRS has been deferring about one in three new delinquency cases without pursuing any collection action. This practice is contrary to the experience of Treasury and IRS, which indicates that referring eligible debts for collection as early as possible greatly enhances the success of collection efforts. The former IRS Commissioner

[17] IRS is calling this initiative "Collection Contract Support."

estimated in 2002 that it would take 5,450 FTEs and $296.4 million for IRS to bridge the gap between its workload and capacity to complete the collection casework.

To help bridge this gap, Treasury has proposed an initiative to reach taxpayers to obtain payment on delinquent debt through the assistance of PCAs. Under this initiative, IRS would give PCAs specific, limited information on outstanding tax liabilities, such as types of tax, amount of the outstanding liabilities, tax years affected, and prior payments. Based on the information provided by the IRS, PCAs would then be permitted to locate and contact taxpayers, requesting payment of liabilities (i.e., tax, interest, or penalty) in full or in installments (within 3 years, as specified by IRS). If a taxpayer's last known address is incorrect, the PCAs would search public records for the correct address. PCAs are not to be permitted to contact third parties to locate taxpayers. PCAs would not be allowed to accept payments; all payments must be made to IRS. PCAs would generally have 12 to 24 months to attempt collection. Afterwards, uncollected accounts are to be redistributed to other PCAs for additional collection efforts. Because PCAs would have no enforcement power, the initiative would allow the IRS to focus its own enforcement resources on more complex cases and issues.

Other procedural conditions under the proposal include requiring PCAs to inform taxpayers of the availability of assistance from the Taxpayer Advocate. Furthermore, PCAs would not be permitted to take any enforcement action against a taxpayer, such as seizing assets to satisfy the debt. To ensure that taxpayer rights and privacy would be safeguarded, PCAs would be governed by the same rules by which IRS is governed.

Initially, IRS plans to stagger implementation of the initiative. For the first 6 months, IRS will place collection cases with no more than five PCAs, with a total volume estimate not to exceed 50,000 cases per month for the first 3 months. IRS will contract with additional PCAs at a 6-month interval with an anticipated rate of 2.6 million total cases annually by the time all agencies have been operational for 1 full year. Assigned case inventory rates will depend on a number of factors, including PCA performance, ability to manage new inventory, quality control, volume of cases referred to IRS for review, and readiness of IRS to supply cases. Based on this implementation framework, Treasury has projected revenue estimates of $46 million in 2004, and $476 million from 2004 through 2008.

In order to implement the PCA initiative, IRS must ensure that it will have the capacity to fulfill its responsibilities under the proposed contracts and to oversee the PCAs. Further, it must make some difficult design decisions. One significant capacity issue concerns whether IRS will be able to identify those delinquent debts with the highest probability of resolution through PCA contacts. Earlier pilot efforts to study use of PCAs in 1996 and 1997 were hindered, in part, because IRS was unable to do this. For example, we reported that the numbers and types of collection cases sent to PCAs during those pilots were significantly different from those anticipated in the pilot program's original design. This resulted in substantially fewer collection cases than PCAs could productively work to make the effort cost-effective. IRS realizes that identifying appropriate cases for referral to PCAs is a key issue. While IRS proposes using "case selection analytics" to identify appropriate cases, the analytical model has not been developed.

Another IRS capacity issue relates to the cases that PCAs, for several reasons, will refer back to IRS. For instance, under the proposed arrangement, if a taxpayer was unable to fully pay the delinquent debt, the case would be referred back to IRS. Some cases would then go to a different PCA; therefore, the success of that PCA's efforts in these cases would depend on how well IRS reprocesses the cases. Until some experience is gained under the proposed program, it will be difficult to reliably estimate the number of cases that will be referred back to IRS and the number of resources it will need to devote to the cases.

Other IRS capacity issues concern, for instance, how many resources it will take to administer the contracts and to oversee the PCAs' performance. IRS expects to have up to 12 contractors, 2 of which would be small businesses, and proposed procedures call for on-site visits and some direct observation of PCAs' collection efforts. IRS would also need to ensure PCAs' performance, such as having adequate procedures to safeguard taxpayer information before and after the contracts are awarded, and that it and the PCAs have secure computer systems to manage the work flow.

How the PCAs will be compensated is a key design decision that must be finalized. On the one hand, IRS needs to provide the PCAs an incentive to be efficient in collecting the delinquent debts and on the other hand, it must ensure that the incentive does not lead to inappropriate performance pressure on PCA staff. IRS intends to make part of PCAs' compensation dependent on other factors, such as quality of service, taxpayer satisfaction, and case resolution, in addition to collection results. Both the law and IRS policy prohibit IRS managers from using records of tax enforcement results, such as dollars collected and taxes assessed, to evaluate employee performance or set production goals. IRS and Treasury report that existing taxpayer protections would be fully preserved under the PCA initiative. Specifically, as with IRS employees, PCA employees could not be evaluated based on tax enforcement results. IRS is considering using a "balanced scorecard" to measure contractors' performance, but has not proposed specifically how this compensation balance will be struck.

Finally, although the revolving fund mechanism presents potential advantages to IRS in better ensuring that it can pursue delinquent tax debts, IRS has not done a cost analysis on implementing the PCA initiative versus expanding the use of traditional IRS collection activities. We have not seen any plans to do so in the future. Some IRS officials believe that because IRS telephone collection staff have a broader scope of authority (e.g., the ability to levy a bank account to satisfy the debt) and greater experience with collecting delinquent taxes, IRS telephone staff are likely to be more effective and cost-efficient than PCAs. PCAs, however, may have advantages that IRS lacks. A number of factors would need to be considered in doing a cost analysis, and a comparison may not be possible without having some experience in using PCAs to collect this type of debt.

Concluding Observations

Although IRS has received increases in its budgets since fiscal year 2001 in part to increase staffing to enhance in its compliance and collection programs, IRS has been unable to achieve the desired staffing levels. Based on past experience and uncertainty regarding some expected internal savings that would enable IRS to reallocate staff to these programs, fiscal year 2004 staff increases might not fully materialize. Today's hearing provides a useful venue for the Subcommittee to explore these funding issues and how IRS should prioritize its efforts.

IRS has defined the scope and nature of its proposed new initiatives to address known sources of EIC noncompliance and to use private collection agencies to assist in collecting certain delinquent taxes. However, in both cases IRS faces significant challenges in moving forward to successfully implement the proposals. In commenting on a GAO report on IRS's National Research Program—IRS's ongoing effort to measure the level of taxpayers' compliance while minimizing the burden on taxpayers selected for the study—the former Commissioner said that IRS would not compromise the quality of the program in order to meet the program's target date. We believe this is a sound standard for these efforts as well.

Careful planning for and testing of key implementation steps can help ensure the initiatives' success.

This completes my prepared statement. I would be pleased to respond to any questions.

Contact and Acknowledgments

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