

**GAO**

Report to the Chairman, Subcommittee  
on Commerce, Consumer, and Monetary  
Affairs, Committee on Government  
Operations, House of Representatives

March 1991

**TAX  
ADMINISTRATION**

**IRS Does Not  
Investigate Most High-  
Income Nonfilers**



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United States  
General Accounting Office  
Washington, D.C. 20548

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**General Government Division**

B-241961

March 13, 1991

The Honorable Doug Barnard, Jr.  
Chairman, Subcommittee on Commerce,  
Consumer, and Monetary Affairs  
Committee on Government Operations  
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Internal Revenue Service's program for detecting and pursuing individuals who have an income of over \$100,000 and who fail to file required federal tax returns. It shows that the Service needs to improve this program to make sure that the nation's voluntary tax assessment system remains strong.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from the date of issuance. At that time we will send copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

Major contributors to this report are listed in appendix III. If you have any questions, please call me on (202) 272-7904.

Sincerely yours,

A handwritten signature in cursive script that reads 'Paul L. Posner'.

Paul L. Posner  
Associate Director  
Tax Policy and  
Administration Issues

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# Executive Summary

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## Purpose

The Internal Revenue Service (IRS) estimates that \$7 billion in 1987 federal taxes were not paid because people did not file required income tax returns. IRS identified over 4 million potential individual nonfilers in 1987, which was the most recent year being investigated when GAO did its review. This number represents a 24-percent increase in the number of potential nonfilers since 1985. The 1987 nonfilers included about 40,000 whose annual income exceeded \$100,000; these are high-income nonfilers.

The Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, expressed concern about IRS not pursuing high-income nonfilers. He asked GAO to determine whether IRS could investigate more of them and do so more effectively.

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## Background

IRS identifies potential nonfilers when a tax return cannot be found for income reported on information returns, such as wage statements (Form W-2). IRS assigns cases a priority—based on the estimated tax yield—that determines the degree of IRS scrutiny.

IRS uses three stages to investigate nonfilers. First, IRS sends as many as four notices that ask nonfilers to file a return. Second, IRS sends unresolved cases—depending on amounts and types of income—to either (1) an automated call site, where a tax examiner tries to obtain a tax return, or (2) the Substitute for Return program, where IRS estimates taxes owed, prepares a “substitute” return for the delinquent one, and recommends a tax assessment. In the third stage, cases unresolved at automated call sites are referred to an IRS district. In the Automated Collection System and the district offices, IRS may not pursue a case with a low priority. Rather, IRS may investigate other cases, such as those on delinquent taxes owed by businesses or individuals, that have higher priorities.

To determine whether changing IRS’ three-stage process would produce more returns and taxes, GAO randomly selected 1,200 of 3,600 high-income nonfiler cases at three IRS service centers. The 3,600 cases were those still unresolved after two notices were sent to a universe of about 12,000 cases. Of the 1,200 sample cases, GAO asked IRS to experiment by sending about

- 300 directly to District revenue officers,
- 300 to Automated Collection System sites, and

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- 300 to the Substitute for Returns program.

The final group of 300 was used as a control and investigated using the normal three-stage process.

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## Results in Brief

IRS does not fully investigate high-income nonfilers, which creates an ironic imbalance. Unlike lower income nonfilers in the Substitute for Returns program, high-income nonfilers who do not respond to IRS' notices are not investigated or assessed taxes. Even if high-income nonfilers eventually file tax returns, their returns receive less scrutiny than those who file returns on time.

GAO estimates that half of the high-income nonfilers at the three service centers were not investigated by district revenue officers or assessed a tax in earlier stages. Revenue officers did not pursue them because IRS understated the estimated yields from investigating them. Even if IRS correctly estimated these yields, it had too few revenue officers to investigate many more cases.

IRS could investigate more high-income nonfilers by using the Substitute for Returns program. GAO's test showed that this method produced more yield at the lowest cost and created a tax assessment that otherwise was unlikely. GAO believes an assessment, even if understated, is better than letting the nonfiler escape a revenue officer's scrutiny.

Although IRS checks returns filed on time for noncompliance, it does not have a systematic way to check for underreported income or overstated deductions on delinquent returns that high-income nonfilers eventually file. GAO found that none of these delinquent returns were computer matched with information returns, and few returns were referred to the Examination Division to be checked. However, nearly half of the delinquent returns that GAO asked IRS to check had evidence of noncompliance.

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## Principal Findings

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### IRS Understates the Priority of High-Income Cases

Two years after the deadline for filing returns, 47 percent of the 3,600 cases had not been investigated by revenue officers or otherwise assessed a tax.<sup>1</sup> Since IRS gave a high enough priority to only 2 percent of the cases, 45 percent will continue to escape revenue officers' scrutiny. This situation occurs partly because IRS' formula for ranking cases to be investigated by revenue officers understates the revenue potential of high-income cases. (See pp. 14 and 15.)

IRS based its formula for ranking cases on tax yields from 1984 nonfiler cases at all income levels, not just those over \$100,000. As a result, tax yields for lower income nonfilers pulled down the estimated yield for high-income nonfilers. GAO found that IRS' estimated yields for high-income cases were about one-third of the actual average yield—\$2,967 versus \$7,811. Had IRS separately estimated yields for high-income cases at the three service centers, revenue officers would have been assigned 831 more cases to investigate at 1989 staff levels, resulting in an additional \$10 million in taxes. (See pp. 15 and 16.)

To pursue more high-income cases, IRS would need additional staff. If IRS separately estimated yields for high-income cases and sent them directly to revenue officers, at 1989 staff levels, many cases would not be investigated because other Collection cases have higher estimated yields. (See pp. 16 and 17.)

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### The Substitute for Returns Program: A Viable Alternative

Given IRS' limited revenue officer staff, GAO tested the potential of referring high-income nonfiler cases to the Substitute for Returns program. By analyzing sample cases, GAO found that referring high-income cases to the program produced a higher yield-to-cost ratio than the current process—\$1,716:\$1 versus \$60:\$1. (See p. 17.)

IRS does not include high-income cases in the program because IRS said it believes its substitute return may understate taxes owed. The program uses information returns that may not show all the nonfiler's income. GAO believes, however, that the alternative is worse—high-income nonfilers escape any IRS tax assessment. Including them in the program

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<sup>1</sup>All numbers and percents cited are estimates based on sample results unless otherwise indicated.

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will help assure that more wealthy nonfilers pay their taxes. (See pp. 17 to 19.)

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### Delinquent Returns Receive Less Scrutiny Than Those Filed Timely

Nearly 12 years after GAO recommended that IRS check delinquent returns for unreported income, IRS still does not do so. Unlike returns filed on time, delinquent returns from high-income nonfilers are not computer matched for unreported income and are not generally selected for intensive examinations. Nor do IRS staff routinely review delinquent returns for noncompliance. (See pp. 21 and 22.)

GAO found that IRS needs to check such delinquent returns for noncompliance. Nearly half of the 178 delinquent returns GAO asked Examination officials to check had evidence of noncompliance—21 with unreported income and 60 with overstated deductions. However, Collection staff referred only four of these returns to Examination. Conversely, delinquent returns from lower income nonfilers in the Substitute for Returns program are reviewed for noncompliance. (See pp. 22 and 23.)

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### Recommendations

To improve IRS' pursuit of high-income nonfiler cases, GAO recommends that the Commissioner of Internal Revenue

- separately estimate tax yields for high-income nonfiler cases so more of these cases will be investigated by revenue officers,
- modify the Substitute for Return program to include high-income nonfiler cases that would otherwise escape IRS action, and
- develop a system to check delinquent returns from high-income nonfilers for noncompliance.

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### Agency Comments

In comments on a draft of this report, the Commissioner of Internal Revenue said that IRS could do more to resolve high-income nonfiler cases. He agreed to separately estimate tax yields and to check delinquent returns for noncompliance. Rather than include high-income cases in the Substitute for Return program, however, he plans to refer them to the Examination Division. GAO did not test this option but believes the concept may provide a workable alternative. (See app. III.)

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**Abbreviations**

ACS	Automated Collection System
IRS	Internal Revenue Service
RWMS	Resource and Workload Management System
SFR	Substitute for Return
TDI	Taxpayer Delinquency Investigation

# Introduction

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Our tax system relies on taxpayers to voluntarily assess their tax liability, file returns, and pay taxes on time. Without voluntary compliance, IRS cannot administer the nation's tax laws.

Section 6012 of the Internal Revenue Code requires individuals to file tax returns if they meet certain gross income criteria, regardless of whether they owe taxes. People who do not voluntarily file a return—nonfilers—diminish the public's respect for our tax system. Moreover, nonfiling is unfair to honest taxpayers who must bear a larger share of the tax burden.

Detecting and pursuing nonfilers is important. Unlike those who underreport income or overstate deductions and credits, the nonfiler does not come under the scrutiny of an IRS examiner. A filed return can be checked for errors, omissions, or fraud, but a nonfiler gives no such leads. This report examines IRS' efforts to identify and pursue individual nonfilers with income over \$100,000—high-income nonfilers.

In recent years, individuals have voluntarily filed over 100 million income tax returns annually. However, IRS annually identifies a few million individuals who may not have voluntarily filed required returns. IRS estimates that such individual nonfilers caused over \$7 billion in 1987 tax losses. This amount represents 11 percent of the estimated \$64 billion gap between income taxes owed and voluntarily paid by individuals for 1987.

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## Taxpayer Delinquency Investigation Program

IRS' Collection Division has principal responsibility for enforcing the highest degree of compliance with the filing requirements of the Internal Revenue Code. As part of its enforcement strategy, Collection also attempts to identify the reasons for nonfiling and ways to prevent it. One of Collection's key programs to obtain delinquent returns is the Taxpayer Delinquency Investigation (TDI) program, which covers both individual and business nonfilers. In addition, Collection staff pursue businesses and individuals who filed returns but owe additional taxes—accounts receivable—through the Taxpayer Delinquent Accounts program.

The TDI program identifies potential nonfiler cases by matching taxpayers' returns with information returns that show taxpayers' income. These information returns are submitted by employers and payers of income, such as banks paying interest. In 1989, payers submitted almost 1 billion information returns to report certain deductions and nearly

every category of income, including wages, interest, and dividends. When the match—done by IRS' Martinsburg Computing Center—shows income but no corresponding tax return, a potential nonfiler case is created. Similarly, when the match shows a filed return but not all of the income on the information return, a potential underreporter case is created.

For tax year 1987, such matching has identified about 24 million potential nonfiler and underreporter cases. IRS also identifies potential nonfiler cases by checking its master file for individuals who had filed returns but then stopped filing. IRS does not pursue all identified cases because some have little potential for tax assessments while others have incomplete information on the potential nonfilers.

Tax year 1985 is the most recent year for which IRS has nearly complete results from its efforts to pursue nonfilers. For that year, IRS identified 3.4 million potential nonfilers and spent about \$63 million to investigate them. The investigations resulted in obtaining 1.1 million delinquent returns and \$1.3 billion in additional tax assessments, interest, and penalties. For 1985, unlike 1987, IRS had not broken out the data by income ranges—that is, low, medium, and high income. Therefore, IRS cannot yet determine its success in obtaining returns from low-income or high-income nonfilers.

For tax year 1987, IRS identified about 4.2 million potential nonfilers. For the reasons discussed above, IRS either did not investigate or merely sent a reminder to file a return to about 2.4 million. The other 1.8 million cases were sent to IRS' service centers for investigation. Almost 40,000 of these 1987 nonfilers had high income—that is, over \$100,000—reported on information returns. For tax year 1988, IRS has identified 7 percent more potential nonfilers (about 4.5 million) and 18 percent more with high income (about 47,000) compared to 1987.

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## IRS Process for Investigating Individual Nonfiler Cases

The initial computer match between information returns and tax returns occurs in December of the year returns are due. IRS makes additional nonfiler computer matches in March and June of the following year to account for those who filed too late to be part of the earlier matches. For tax year 1987, the initial matches were made in December 1988, with the additional matches occurring in March and June 1989.

After identifying potential nonfilers, IRS attempts to obtain delinquent returns using a three-stage process. In the first stage, the appropriate IRS

service center sends as many as four computer generated delinquency notices to nonfilers. After each notice, the nonfiler has 6 to 8 weeks to either file a return or explain the reasons for not filing. Service centers began sending delinquency notices for tax year 1987 in June 1989. The final notices were mailed in December 1990.

In the second stage, nonfiler cases that are not resolved during the notice process are assigned to either the Substitute for Return (SFR) program or Automated Collection System (ACS) sites. This decision depends on the amount and type of income involved.

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## Substitute for Return Program

The SFR program is authorized under Section 6020 of the Internal Revenue Code. It authorizes the Secretary of the Treasury or his delegate to prepare tax returns for persons who file a false or fraudulent return or fail to file a return. The IRS-prepared return "substitutes" for the return that the taxpayer should have filed voluntarily.

In preparing a substitute return, IRS estimates the assessed tax by using its information on the nonfiler, including income shown on information returns. IRS assumes the nonfiler is single and uses the standard deduction. Then, over 2 years, IRS sends up to six notices to the nonfiler. The last two notices show estimated taxes, penalties, and interest owed. If the nonfiler fails to file, IRS assesses the taxes owed and begins efforts to collect them.

Nonfiler cases are eligible for SFR if (1) total income is under \$100,000; (2) less than 30 percent of total income is nonemployee compensation—or payments to self-employed individuals; and (3) total income is reported on fewer than 40 information returns. For tax year 1987, almost 1 million of the 1.8 million nonfilers investigated were included in the SFR program.

IRS excludes cases with more than \$100,000 in income from SFR because it believes that these cases may be too complex for IRS to prepare a substitute return. IRS excludes cases with over 30 percent nonemployee compensation or over 40 information returns because it believes these nonfilers may have much more income than shown on information returns. IRS is concerned that substitute returns may understate taxes owed.

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## Automated Collection System Sites

Also in the second stage, IRS refers cases not eligible for SFR, such as high-income nonfilers, to 1 of 21 ACS sites. Each site is a Collection office that attempts to resolve nonfiler cases through phone calls and correspondence. Before doing so, IRS computes a score of the estimated net tax yield, which is the tax owed less investigation costs, for each nonfiler case.<sup>1</sup> Net tax yield is Collection's measure for establishing priorities among its cases, including tax delinquent account cases for which IRS has already assessed a tax. IRS uses the estimated yield at ACS sites and district offices to determine investigative priorities.

For those nonfiler cases that have a high estimated net tax yield compared to other collection cases, ACS tax examiners attempt to identify the nonfiler's address and telephone number. If this information is obtained, the examiner attempts to contact the nonfiler by telephone or letter to secure all delinquent returns. Nonfiler cases that have a lower yield can remain inactive indefinitely in the ACS inventory. IRS did not have data to show the average age of nonfiler cases in the ACS inventory, but many have been unworked for a couple of years. For example, we found nonfiler cases that had been in this inventory since 1988.

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## District Revenue Officers

During the third stage, unresolved nonfiler cases from ACS are transferred to an automated inventory at the district office called the "queue" where—depending on the estimated net yield—they may be assigned to a revenue officer. If the case is investigated, a revenue officer contacts the person through telephone calls, letters, or visits to obtain the delinquent return. IRS did not have data to show the average age of cases in the queue. However, we found nonfiler cases in the queue from tax year 1980 that may never be investigated because of their low estimated yield.

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## Who Were the High-Income Nonfilers in 1987?

To determine their demographic characteristics, we analyzed 295 randomly selected cases on high-income nonfilers for tax year 1987 from a total of 3,651 cases at three IRS service centers. Using IRS' data, such as that from information returns, we estimate that

- their median income was \$134,000 and consisted primarily of wages,
- their average age was 46,
- 67 percent filed jointly, and

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<sup>1</sup>This score is called the Resource and Workload Management System (RWMS) score. IRS estimates it using the average yield of all closed cases. This report refers to the RWMS score as "net yield."

- 89 percent did not file a return for 2 or more years.

We also estimate that 34 percent were due refunds that averaged \$7,000. This percentage is lower than for people who filed timely 1987 returns—75 percent were due refunds. Appendix II has additional details on the characteristics of the high-income nonfilers.

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## Objectives, Scope, and Methodology

In a January 23, 1990, letter, the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, asked us to determine ways IRS could investigate more high-income nonfilers and do so more effectively. We also attempted to develop information to profile the characteristics of high-income nonfilers to see who made up this population.

To meet our objectives, we reviewed IRS procedures used at ACS sites, at district offices, and in the SFR program at service centers. We also discussed the policies, procedures, and priorities of the nonfiler program with officials at the IRS national office.

We also randomly selected a sample of tax year 1987 high-income nonfiler cases at three service centers and asked IRS to investigate them using different methods. We focused on tax year 1987 because, when we selected our sample, it was the most current year that IRS was investigating. We selected the three service centers on the basis of their geographic dispersion and the availability of our staff. IRS officials said the procedures to investigate nonfilers at these three service centers are typical of those at others. (See app. I for detailed information on sample selection and statistical analysis methods.)

For tax year 1987, IRS sent a total of 12,121 potential high-income nonfiler cases to its service centers in Austin, Texas; Cincinnati, Ohio; and Fresno, California. This number represents about 30 percent of the approximately 40,000 high-income nonfiler cases identified nationwide. Of the 12,121 cases, IRS resolved 8,470 (70 percent). IRS did not yet have data to specifically show how often it resolved the cases by obtaining a return in the notice stage or determining that no return delinquency existed. Such data will not be available until late 1991 or early 1992. The remaining 3,651 cases remained unresolved after IRS had mailed two delinquency notices to the nonfilers. We randomly selected 1,200 of these cases.

To test the effectiveness of different collection techniques, we randomly assigned the sample of 1,200 cases into four groups of about 300 each. We assigned one group each to ACS, the SFR program, and revenue officers for investigation. Cases in the three test groups were not sent a third or fourth delinquency notice. The remaining cases served as a control group and continued through IRS' three-stage process.

We developed a data collection instrument that IRS staff used to document their investigations of cases in the four groups. In estimating additional tax revenues, we considered net yield to be the taxes, penalties, and interest owed by the high-income nonfiler for tax year 1987 after subtracting withholding and estimated tax payments made before contact by IRS. The net yield, therefore, represents the increased revenues IRS could obtain from these nonfilers at the three service centers, less any IRS cost. We developed these costs by analyzing IRS' data, which we did not verify, on various Collection tasks. We also identified total revenues IRS obtained for other tax years by pursuing the 1987 cases. This total for all tax years is referred to as net balance due.

During our analysis, we noted that some delinquent returns that Collection staff obtained from high-income nonfilers appeared to underreport income or overstate deductions but were not referred to Examination to be checked for noncompliance. As a result, we asked Examination officials to review the returns received as of March 30, 1990, to determine whether Collection employees should have referred them to Examination. We verified the results of their reviews. We also followed up on our recommendation on this issue from our 1979 report on IRS' nonfiler program.<sup>2</sup>

To develop the profile of high-income nonfilers, we used IRS' data, which we did not verify, from information returns, nonfiler notices, and Master File transcripts for nonfilers in our control group. We also obtained data from any returns that high-income nonfilers eventually filed. We limited our analysis to the control group to reduce the time and effort needed by IRS staff to complete our data collection instrument.

Our audit work was done from October 1989 to September 1990 in accordance with generally accepted government auditing standards.

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<sup>2</sup>Who's Not Filing Income Tax Returns? IRS Needs Better Ways to Find Them and Collect Their Taxes (GGD-79-69, July 11, 1979).

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# Better Results Are Possible If IRS Changes Methods Used to Pursue High-Income Nonfilers

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IRS has an ironic imbalance in its nonfiler enforcement program. Unlike lower-income nonfilers in the SFR program, high-income nonfilers who do not respond to IRS actions are not assessed a tax. Instead, ACS employees pursue high-income cases and refer those unresolved to revenue officers. However, very few of these cases are likely to be investigated by revenue officers or assessed a tax, partly because IRS' formula for ranking cases to be investigated understates their estimated yields.

Even if the yields for the 1987 high-income cases had been correctly estimated, IRS staffing would have been insufficient to permit revenue officers to investigate many of the cases. IRS could give more scrutiny to high-income nonfiler cases by including them in the SFR program as is done for low-income nonfilers. This program would provide an assessment against nonfilers who would otherwise escape a revenue officer's scrutiny.

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## Understated Yields Result in Cases Not Being Worked by Revenue Officers

Two years after the April 1988 deadline for filing returns, 47 percent<sup>1</sup> of the 3,651 high-income nonfilers<sup>2</sup> had not been investigated by revenue officers or assessed a tax. Figure 2.1 shows the April 1990 status of all the cases and the likelihood that unresolved cases eventually will be investigated.

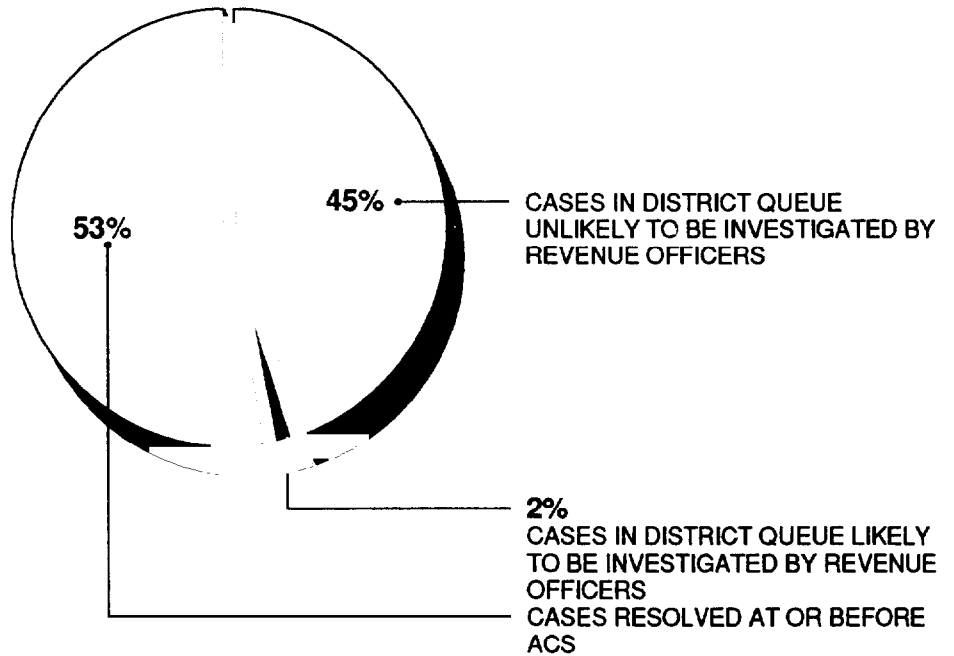
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<sup>1</sup>All numbers and percents cited in this chapter are estimates, unless otherwise indicated, based on our sample results.

<sup>2</sup>This number represents the universe of cases at the three service centers in which the high-income nonfilers did not respond to the first two notices.



Figure 2.1: Outcomes for the 3,651 High-  
Income Nonfiler Cases for Tax Year 1987,  
as of April 1990



Even with more time, only 2 percent of the cases that were in the district queue had high enough estimated net yields to be investigated by revenue officers. The other 45 percent had low yields, which means that these cases will remain in the queue indefinitely, thus escaping IRS scrutiny.

IRS' estimates of the net tax yields from investigating high-income nonfiler cases were significantly lower than actual yields. This difference occurred because IRS did not separately calculate yields for high-income cases. Rather, IRS estimated 1987 net yields using actual taxes assessed from investigations of all tax year 1984 nonfiler cases. By averaging yields from all cases, those with lower incomes reduced the estimated net yield—and investigative priority—for high-income cases. As a result, IRS' estimated yields for high-income nonfiler cases in our sample were about one-third of the actual yield—\$2,967 versus \$7,811.

Because 45 percent of 3,651 cases had priorities too low to be investigated by revenue officers, we wanted to determine whether revenue officers would have investigated more cases had IRS not underestimated the yields. To do this, we calculated yields from our sample cases and

compared the new yields to the minimum estimated yields necessary to trigger a revenue officer investigation in each district we reviewed. Districts adjust their minimum yields to fit their existing case workload and available revenue officers.

This comparison showed that an additional 831 (23 percent) of the 3,651 cases would have exceeded the minimum required for assignment to a revenue officer. These 831 cases represent almost \$10 million in additional taxes. Had more revenue officers been available in these districts, the minimum yields to trigger an investigation would have been lower. Thus, more than 831 high-income cases could have been assigned to revenue officers.

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## **IRS Should Consider Alternatives to Its Investigation Methods**

To test alternatives for investigating the 3,651 high-income nonfilers, we randomly assigned about 300 cases to each of three groups: (1) revenue officers, (2) ACS tax examiners, and (3) tax examiners at the SFR program. Another 300 cases were randomly assigned to a control group and were investigated using IRS' current three-stage method.

Each alternative approach resulted in a higher proportion of delinquent returns being obtained and in higher average yields than IRS' current approach. The most successful, however, varied depending on the criteria used to measure success. When the highest rate of obtaining delinquent returns is the primary measure, the revenue officers were the most successful. Conversely, when the highest yield or yield-to-cost ratio is used, the SFR program was the most successful.

It is important to recognize that IRS was able to investigate our sample cases, unlike the control group, free of resource constraints. Accordingly, the results from the test illustrate the potential benefits from pursuing these cases should IRS obtain sufficient resources. Table 2.1 outlines these results.

**Chapter 2**  
**Better Results Are Possible If IRS Changes**  
**Methods Used to Pursue High-**  
**Income Nonfilers**

**Table 2.1: Results From Three Alternative Methods for Investigating High-Income Nonfilers Compared to IRS' Current Method, Tax Year 1987**

<b>Collection method</b>	<b>Percent of returns obtained</b>	<b>Average<sup>a</sup> balance due</b>	<b>Average<sup>b</sup> cost</b>	<b>Balance due to cost ratio</b>
Revenue officers	64	\$10,953	\$152	\$72:1
ACS tax examiners	44	7,943	123	65:1
SFR examiners	40 <sup>c</sup>	12,010	7	1,716:1
Control group	35	4,753	79	60:1

<sup>a</sup>Average balance due is taxes, penalties, and interest owed for all delinquent tax years after subtracting withholding and estimated tax payments made before IRS contact. Collection costs have not been deducted from these estimates.

<sup>b</sup>Average cost is a GAO estimate, made using IRS data.

<sup>c</sup>In addition, IRS made assessments on another 55 percent of the substitute returns for those who did not submit a return. The other 5 percent either filed before notices were sent, were not required to file, or could not be located.

To obtain similar benefits from implementing the revenue officer approach nationwide, IRS would need more staff to investigate additional high-income cases. At 1989 staffing levels, many cases sent directly to revenue officers would not be investigated due to lower priorities than other collection cases.

## Advantages of Using SFR for High-Income Cases Seem to Outweigh the Disadvantages

Even if IRS investigates more high-income nonfiler cases by separately estimating their yield, the SFR program offers another way to pursue more high-income nonfilers. However, IRS excludes high-income nonfiler cases from SFR. If the SFR program were modified to include high-income cases, the advantages would seem to outweigh the disadvantages. These advantages follow:

- The balance due to cost ratio would far exceed that of the control group (\$1,716:\$1 versus \$60:\$1). This difference is largely due to lower costs in SFR. Preparing substitute returns takes far less time than pursuing nonfilers' returns.
- The average balance due would be nearly three times larger than that for the control group (\$12,010 versus \$4,753) and somewhat larger than that for cases assigned to revenue officers (\$12,010 versus \$10,953).
- The rate of obtaining delinquent returns would be slightly higher than for the control group (40 percent versus 35 percent).

By modifying the SFR program to include high-income cases, IRS also can avoid issuing refunds to high-income nonfilers for 1 tax year when they also have delinquent returns from other years. Section 6402 of the Internal Revenue Code authorizes IRS to offset refunds from 1 tax year

against assessments in other tax years. By preparing substitute returns, IRS can use the assessment from the substitute return to withhold the nonfilers' refunds until the return delinquency for other years is resolved. We believe that this action could encourage nonfilers in the SFR program to submit delinquent returns for all tax years in order to receive their refunds.

We found that IRS issued refunds to about 11 percent of the high-income nonfilers who were in our sample from the three service centers and who had not filed a tax return for other years. For example, a high-income nonfiler for tax year 1987 later filed delinquent 1987 and 1988 returns during November 1989 claiming total refunds of over \$7,800. This nonfiler then filed a delinquent return for tax year 1984 during January 1990, showing taxes owed of over \$7,000. As of April 1990, the nonfiler still owed this amount. Had IRS assessed the taxes owed for the delinquent 1984 return through SFR, IRS could have used this assessment to offset the taxpayer's 1987 and 1988 refunds.

Despite these advantages, the disadvantages of including high-income cases in SFR need to be carefully considered. These disadvantages follow:

- IRS' Accounts Receivable inventory may increase because some IRS assessments against people who cannot be located have little chance of being collected. Such an increase would artificially boost the size of this inventory, causing IRS to pursue unproductive assessments.
- A substitute return for high-income cases may underestimate the actual tax liability because some income may not be reported to IRS. High-income nonfilers may accept the substitute return rather than file a return on which they would owe more taxes.

In either case, the alternative is worse—allowing high-income cases to escape any IRS tax assessment. IRS had too few revenue officers to pursue nonfilers, or revenue officers pursued them but could not get a return. While using the SFR process may understate the nonfiler's tax liability, it would at least get an assessment on the books. Revenue officers could then attempt to collect the payment. They would be more likely to investigate because an assessment generally gives cases a higher priority than nonfiler cases without an assessment. In contrast, if the case remains indefinitely in the district queue, as many of these cases will, IRS will get no assessment.

Even if IRS discards the \$100,000 limitation for SFR cases, many high-income cases still will not be eligible for SFR. We estimate that 46 percent

of the high-income cases in our sample would continue to be excluded from the SFR program because they do not pass other restrictions—they have over 30 percent of total income in nonemployee compensation or 40 or more information returns. IRS excludes these cases from SFR because it is concerned that it may understate the tax liability by relying on the income shown on information returns. Modifying these criteria would allow more high-income cases into SFR and allow IRS to create an assessment that otherwise would not exist.

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## Conclusions

IRS has an ironic imbalance in its nonfiler program that allows wealthy nonfilers to avoid paying their fair share of taxes. High-income nonfilers who do not respond to IRS actions are not assessed a tax as are lower income nonfilers in the SFR program.

IRS could partially correct the imbalance by separately estimating net yields for high-income nonfilers. Doing so would result in revenue officers investigating more unresolved cases. Even so, most unresolved cases would not be investigated because IRS has too few revenue officers. The need to investigate more high-income nonfilers provides a strong argument for increasing IRS' revenue officer staffing.

Another way IRS could correct this imbalance is to modify the SFR program to include high-income nonfiler cases that were not resolved through the notice or ACS stages and will escape any further IRS actions. These include cases that revenue officers (1) will not investigate because of limited staff and (2) will investigate but for which they will not obtain a return.

We do not agree with IRS' reason for excluding complex high-income cases from SFR—fear of understating the tax liability. We believe any tax assessment, even if understated, is better than letting the nonfiler escape all IRS action. For this reason, those high-income nonfiler cases with 30 percent or more nonemployee compensation and 40 or more information returns and that would otherwise escape IRS action should also be sent to SFR. Doing so would allow IRS to resolve all high-income nonfiler cases that would otherwise remain unresolved.

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## Recommendations

We recommend that the Commissioner of Internal Revenue

- separately estimate net tax yields for high-income nonfiler cases in the formula for screening cases to be investigated by revenue officers and

- 
- modify the SFR program to include high-income nonfiler cases that would otherwise escape IRS action.

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## **IRS' Comments and Our Evaluation**

The Commissioner of Internal Revenue commented on a draft of our report in a February 1, 1991, letter (see app. III). He specifically agreed with our recommendation to develop separate estimates of net tax yields for high-income nonfiler cases and to refine the estimates as more recent data becomes available. We support these actions.

The Commissioner also commented on our recommendation to include in SFR all high-income nonfiler cases that would escape IRS actions. He said IRS could do more to resolve high-income nonfiler cases. Specifically, he said that such cases remaining unresolved after Collection's contacts will be referred to the Examination Division. He said Examination will first pursue these cases through correspondence or field examinations and then refer the case to SFR if this initial effort is unsuccessful. While our work shows that the SFR program is an effective way to pursue high-income nonfilers, we believe that these IRS actions, which were not part of our test, may also be effective.

# IRS Needs to Check Delinquent Returns From High-Income Nonfilers for Unreported Income and Overstated Deductions

Nearly 12 years after we reported the problem, delinquent returns from nonfilers still do not receive the same level of IRS scrutiny as returns from taxpayers who file on time. IRS checks returns filed on time for unreported income and overstated deductions through computer matching with information returns and through manual screening. However, delinquent returns from high-income nonfilers rarely receive these important checks.

Many delinquent returns that Collection staff obtained from high-income nonfilers had evidence of noncompliance but were not referred to Examination for review. Nearly half of the delinquent returns we asked Examination officials to check had sufficient evidence of unreported income or overstated deductions to justify referral, but only a few of these returns actually had been referred. Moreover, IRS did not computer match delinquent returns with information returns to check for unreported income.

## IRS Programs to Detect Noncompliance Do Not Apply to Delinquent Tax Returns

In our 1979 report on IRS' nonfiler program, we found, among other things, that IRS seldom checked delinquent returns it eventually obtained from nonfilers for unreported income.<sup>1</sup> In that report, we estimated that IRS did not detect \$14.8 million in delinquent nonfilers' unreported income with potential tax liabilities of \$2.2 million in the seven IRS districts reviewed. We recommended that IRS establish a system to check delinquent returns for unreported income.

Although IRS agreed to implement our 1979 recommendation, we found IRS still does not have a reliable system to check delinquent returns for noncompliance. Ironically, returns filed on time usually receive such checks. For example, as discussed in chapter 1, IRS identifies nonfilers and underreporters by matching tax returns with information returns in December of the year the tax return should have been filed. However, IRS does not repeat this computer match for delinquent returns that nonfilers later file as a result of IRS' efforts. By the time delinquent returns arrive, IRS' computer match is covering future tax years. Thus, these delinquent returns, unlike returns filed timely, miss this check for unreported income.

Collection employees also do not appear to screen delinquent returns for unreported income or overstated deductions. For example, by reviewing delinquent returns obtained by tax examiners at ACS or revenue officers

<sup>1</sup>Who's Not Filing Income Tax Returns? (GGD-79-69).

at district offices, we found that they had not reviewed and referred returns that had indications of unreported income or overstated deductions to Examination officials for more detailed checks. At the service centers, Collection branch officials said they may manually screen delinquent returns that pass through their branches for unreported income.

Collection employees do not screen delinquent returns for two reasons. First, IRS procedures do not require it. In fact, the procedures stipulate that Collection employees will not attempt to audit, examine, or verify the correctness of any return. Rather, Collection's main objective in the nonfiler program is to obtain returns. Second, these employees never get to see many delinquent returns. Service center officials estimated that 40 percent of the delinquent returns bypass the Collection branch because they arrive at service centers without an attached notice that indicates they are delinquent. As a result, they are not referred to the Collection branch.

After delinquent returns are processed through a service center, they are unlikely to be selected for an examination. Although the Examination Division electronically checks delinquent returns for examination potential, IRS officials said few would be selected for examination because returns filed for the current tax year receive greater attention. Further, although Examination staff review delinquent returns obtained through SFR for overstated deductions and unreported income, SFR excludes high-income nonfiler cases, as discussed in chapter 1.

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## **Checking Delinquent Returns for Noncompliance Could Be Productive**

Delinquent returns from high-income nonfilers that bypass the various checks for noncompliance still could be examined if Collection employees referred them to the Examination Division. However, we found that they rarely do refer them. While IRS procedures state that these returns may be referred, the procedures neither stress the importance of referrals nor provide criteria to decide which cases to refer. As a result, we found that Collection employees referred to Examination only 4 of the 178 delinquent returns that they obtained from the three service centers.

We asked Examination officials at the service center to review these 178 delinquent returns to get some idea of how many could have been referred because of evidence of unreported income or overstated deductions. These returns represent those obtained through our revenue



officer and ACS samples as of April 1990.<sup>2</sup> These Examination officials found evidence of noncompliance on 81 (46 percent) of the 178 returns. Of the 81 returns, 21 (12 percent) had evidence of unreported income and another 60 (34 percent) had evidence of overstated deductions.<sup>3</sup>

To uncover the apparent unreported income, these officials compared income reported on information returns to that reported on delinquent tax returns. For example, they found cases in which a high-income nonfiler had reported

- \$116,000 in wages on his delinquent tax return while information returns showed he received about \$128,000 in wages—an underreporting of about \$12,000 in income—and
- \$143,000 in income from medical payments on his delinquent tax return while information reports showed he received \$148,000—an underreporting of \$5,000 in income.

IRS also could detect potential unreported income if it computer matched delinquent returns from high-income nonfilers with their information returns.

The following examples illustrate what Examination can find if given the opportunity to review delinquent returns from high-income nonfilers for overstated deductions. Examination officials found delinquent returns with deductions of

- \$75,000 in mortgage interest, even though the reported income was \$101,000 and the information returns showed mortgage interest payments of \$58,000 and
- \$48,000 in reimbursed employee business expenses from the wage income reported on the delinquent return, even though the Form W-2 showed only \$5,000 in such expenses.

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## Conclusions

IRS does not check all delinquent returns from high-income nonfilers for unreported income or overstated deductions. By not checking delinquent returns, IRS may be giving nonfilers reason to believe that they can cheat

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<sup>2</sup>We did not ask Examination officials to do this check for SFR delinquent returns because they were going to have to do a similar check of these returns later.

<sup>3</sup>Examination officials did not estimate the actual amount of noncompliance and resulting tax losses on these 83 cases because they did not have the time, given their workload, to correspond with the nonfilers or examine their tax returns.

on their delinquent returns and not be caught. This is contrary to a sound enforcement strategy and only encourages further noncompliance.

We believe that people who do not comply with one tax law—the filing requirement—are quite likely not to comply with other tax laws. As a result, giving delinquent returns from high-income nonfilers less IRS scrutiny than returns filed on time is illogical. We believe high-income nonfilers should be subject to the same or a higher level of scrutiny as those who file on time.

Since nearly half of the delinquent returns from high-income nonfilers had evidence of noncompliance, we believe all of them should be referred to Examination for a screening for evidence of noncompliance. The recommendation in chapter 2 to allow high-income nonfiler cases to be sent to SFR will, if implemented, increase the number of delinquent returns that are checked. All delinquent returns obtained from SFR are sent to Examination for review. However, delinquent returns obtained through other means, such as revenue officers, also need to be checked.

We also believe that delinquent returns from high-income nonfilers should be computer matched to identify any discrepancies among income and certain deductions that the nonfiler reported. In fact, such matching could be done for all delinquent returns, not just those from high-income nonfilers.

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## **Recommendations**

We recommend that the Commissioner of Internal Revenue develop a system to ensure that delinquent returns from high-income nonfilers are checked for unreported income and overstated deductions. This check could be similar to that done during our review in which examiners at the service centers scanned the returns and also computer matched the returns with information returns.

One way to ensure delinquent returns do not bypass these checks would be for IRS to program its computer to identify a delinquent return when received from a high-income nonfiler. Then, IRS could send the delinquent return to Examination for an initial compliance check as is currently done for delinquent returns obtained from SFR. To ensure Examination's limited resources are used efficiently, in-depth examinations should be completed only on those delinquent returns for which strong evidence of noncompliance was found during the check.

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**Chapter 3**  
**IRS Needs to Check Delinquent Returns From**  
**High-Income Nonfilers for Unreported**  
**Income and Overstated Deductions**

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**IRS' Comments and**  
**Our Evaluation**

In a February 1, 1991, letter that commented on a draft of our report, the Commissioner of Internal Revenue agreed to develop this system. (See app. III.)

# Technical Appendix

The primary focus of our evaluation was an analysis of a randomly selected sample of high-income nonfiler cases. At each of three IRS Service Centers (Austin, Cincinnati, and Fresno), we selected a random sample of 400 nonfiler cases from the universe of cases that remained after IRS sent the nonfilers two delinquency notices. We selected this sample size to provide a confidence level of 95 percent with a precision of plus or minus 5 percent.

Once this overall sample was selected, we randomly assigned about 100 of the 400 cases from each Service Center into each of the following groups: (1) Revenue officers at the district office, (2) tax examiners at Automated Collection Sites, and (3) tax examiners in the Substitute for Return Program. The fourth group served as a control and was allowed to go through the normal three-stage process—notice, ACS, and revenue officers.

Our final sample size was 1,166 because some selected cases were eliminated from our sample for various reasons. For example, IRS lost three cases in one region. In another instance, because the truck carrying completed cases was in an accident, we were unable to reconstruct several cases that were destroyed. Also, six cases were erroneously included in our sample. Table I.1 outlines the overall population and our final samples for each Service Center.

**Table I.1: High Income Nonfiler Universe, Sample Population, and Sample Sizes by Service Center, 1987**

Service center	Universe after two notices	Sample population	Sample size
Austin	4,193	1,217	383
Cincinnati	2,434	717	389
Fresno	5,494	1,717	394
<b>Total</b>	<b>12,121</b>	<b>3,651</b>	<b>1,166</b>

We developed a data collection instrument that IRS used to record the outcome of these sample cases. IRS officials provided us with the completed data collection instrument and accompanying documentation, such as correspondence from the taxpayer, to support the conclusions reached by the employees working the cases. This documentation provided us with sufficient evidence to assess how well IRS followed up on our sample cases.

Statistical information and confidence intervals for issues we evaluated at the three service centers are shown in table I.2.

**Appendix I  
Technical Appendix**

**Table I.2: Estimates of Key Variables in Sample Cases**

Case characteristic	Estimate	95-percent confidence intervals	
		Lower	Upper
<b>Revenue officers</b>			
Return filed	64%	58%	70%
Taxpayer promised to file	9	5	12
Could not locate	10	6	13
Other	18	13	23
<b>ACS Sites</b>			
Return filed	44%	38%	51%
Taxpayer promised to file	6	3	8
Case sent to Queue	37	31	43
Could not locate	6	3	8
Other	7	4	11
<b>Substitute for Return</b>			
Return filed	40%	30%	50%
Substitute prepared	56	46	66
Other	4	1	8
<b>Control Group</b>			
Return filed	35%	29%	40%
Taxpayer did not respond	59	53	64
Other	7	4	9
Average RWMS <sup>a</sup> score	2,967	2,755	3,180
<b>Average assessment—1987</b>			
Control group	\$4,781	\$1,351	\$8,211
All others	\$7,890	\$5,759	\$10,022
Median Income (all)	\$133,729	<sup>b</sup>	<sup>b</sup>

<sup>a</sup>Resource and Workload Management System.

<sup>b</sup>These figures are not available.

# Profile Data for High-Income Nonfilers

**Table II.1: Estimated Income for 1987 High-Income Nonfilers**

Income	Percent of nonfilers <sup>a</sup>	Sampling error
\$100,000 to \$125,000	43	5.7
\$125,001 to \$150,000	19	4.5
\$150,001 to \$200,000	15	4.6
\$200,001 to \$300,000	13	3.8
Over \$300,000	11	3.3
<b>Total</b>	<b>100</b>	

<sup>a</sup>Does not equal 100 percent due to rounding.

**Table II.2: Type of Income That High-Income Nonfilers Received**

Type of income	Percent of nonfilers	Sampling error
Wages	66	5.5
Nonemployee compensation	60	7.6
Interest or dividends	80	4.7
Other types of income	56	5.7

**Table II.3: Predominant Type of Income for High-Income Nonfilers<sup>a</sup>**

Type of income	Percent of nonfilers	Sampling error
Wages	55	5.7
Nonemployee compensation	32	5.4
Interest and dividends	3	2.1
Other income	10	3.4
<b>Total</b>	<b>100</b>	

<sup>a</sup>We use "predominant" to mean the income represents more than 50 percent of total income as reported on information returns.

**Table II.4: Age of High-Income Nonfilers**

Age range	Percent of nonfilers	Sampling error
30 and below	7	2.9
31 to 40	21	4.8
41 to 50	38	5.6
51 to 60	22	4.8
Over 60	12	3.8
<b>Total</b>	<b>100</b>	

**Appendix II  
Profile Data for High-Income Nonfilers**

**Table II.5: Filing Status of High Income Nonfilers**

<b>Filing status</b>	<b>Percent of nonfilers</b>	<b>Sampling error</b>
Single	26	5.1
Married filing jointly	67	5.5
Married filing separately	1	<sup>a</sup>
Head of household	6	2.8
<b>Total</b>	<b>100</b>	

<sup>a</sup>Not statistically significant at the 95-percent confidence level.

**Table II.6: Results of Checking Delinquent Returns From High Income Nonfilers**

<b>Outcome</b>	<b>Percent of nonfilers<sup>a</sup></b>	<b>Sampling error</b>
Refund	34	4.4
Owed Taxes	56	4.6
No Refund Due or Tax Owed	10	2.8
<b>Total</b>	<b>100</b>	

<sup>a</sup>Does not equal 100 percent due to rounding.

# Comments From the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Mr. Richard L. Fogel  
Assistant Comptroller General  
U.S. General Accounting Office  
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: IRS Does Not Investigate Most High Income Nonfilers" and generally agree with the report's recommendations.

We agree that more can be done by the IRS to resolve high income nonfiler cases. Our FY 1991 compliance initiative puts significant emphasis on nonfiler issues. This initiative, now underway, will design a research and data collection methodology that will help us understand the characteristics of the nonfiler population and will assess both the short and long term impact of our efforts. In this regard, we appreciate the work being done by the General Accounting Office (GAO) in this area and will utilize their reviews, along with the findings from our own research efforts, to develop a comprehensive strategy to address nonfiler issues.

In response to GAO's specific recommendations, we plan to change our procedures so that all high income nonfiler cases that are unresolved after collection action will be referred to Examination. These cases will be reviewed for assignment to correspondence or field examination. We believe this process would be more effective in determining the correct amount of unreported income than our Substitute for Returns (SFR) program where we impute income based on income reported on wage and information returns. We plan to review the results of these changes in handling high income nonfilers and give consideration to including them in the Substitute for Returns program where appropriate.

We agree with GAO's recommendation to develop a system to assure that delinquent returns from high income nonfilers are checked for unreported income and overstated deductions. We will change our procedures to clearly state that all delinquent returns should be checked for both unreported income and apparent overstated deductions by Collection employees in service centers as well as district offices, and referred to Examination where appropriate.



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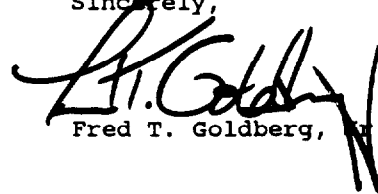
Mr. Richard L. Fogel

In addition, we agree with GAO's recommendation to review separate estimates of potential tax yields for high income nonfilers. We are continually revising our scoring methodology as new information becomes available.

Thank you for the opportunity to review this report. We hope you find these comments useful.

Best regards.

Sincerely,



Fred T. Goldberg, Jr.

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