

**Management Advisory Report:
Evaluation of Reduction in the Internal
Revenue Service's Compliance Activities**

May 2000

Reference Number: 2000-30-075

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 12, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report - Evaluation of Reduction in
the Internal Revenue Service's Compliance Activities

This report presents the results of our analysis of information pertaining to the continuing reductions in Compliance activities. This management advisory report is being provided for informational purposes to aid Internal Revenue Service (IRS) management in making decisions regarding the allocation of resources and the development of new management information systems.

In summary, our report states that, compared to Fiscal Year 1996, significantly fewer resources are now being applied to compliance activities, and compliance results have decreased greatly. Various stakeholders are concerned with these reductions. In addition, the IRS does not have an effective measurement system to determine the impact on voluntary compliance.

Since we are making no recommendations, a response to this report is not required. We previously shared a discussion draft of this report with the Chief Operations Officer for his comments. We are also providing the National Director for Legislative Affairs copies of the report for appropriate distribution within the IRS.

Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon Milbourn, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Executive Summary

The Internal Revenue Service (IRS) has been experiencing considerable changes in recent years. In 1997, the IRS was criticized at Senate hearings when taxpayers testified that they were harassed and mistreated. Subsequently, the IRS Restructuring and Reform Act of 1998 (RRA 98)¹ was passed to give taxpayers more rights and protection and to place greater emphasis on providing better service to taxpayers. In September 1998, the Commissioner announced a new mission statement to "Provide America's taxpayers top quality service. . . ." Over the past several years, the number of IRS employees has steadily decreased due to budget limitations. Correspondingly, the number of employees assigned to examine tax returns and collect delinquent taxes also decreased.

Our overall objective was to evaluate the reduction in compliance activities. We analyzed statistics regarding staff resources and related compliance results for Fiscal Years (FY) 1996 through 1999. We also determined what is being done to measure the impact of the reduced compliance activity and increased customer service activity.

Results

The number of district office employees examining tax returns and collecting taxes has decreased since FY 1996, causing decreases in related compliance results such as the number of returns examined and the number of delinquent accounts closed. IRS management and many stakeholders, including some members of the Congress, are concerned about the reduction in resources and the related decrease in business results. In addition, the IRS does not have a reliable method to measure voluntary compliance or the impact that increased customer service and decreased enforcement are having on voluntary compliance.

Fewer Resources Are Being Applied to Compliance Activities

The number of district office employees examining tax returns decreased 19 percent over the past 4 years, while the number of district employees collecting taxes and securing delinquent returns also decreased 19 percent. In the meantime, the number of tax returns filed increased by almost 5 percent. Many employees who normally examine tax returns or collect taxes were detailed to the Customer Service function to answer taxpayer questions and assist taxpayers in preparing their returns. Significant staff resources were also required during the last 2 years to implement the many provisions of the RRA 98.

¹ Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

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Compliance Results Have Decreased

The total amount collected by the IRS as a result of specific compliance activities decreased 13 percent during the past 4 years, while total accounts receivable owed to the IRS increased 19 percent. Because of limited resources, the IRS cannot work all of its collection cases; while awaiting assignment, these cases are held in an unassigned inventory. The dollar value of the delinquent accounts in this inventory increased 156 percent to \$7.6 billion during the past 4 years, and the inventory of investigations to secure unfiled returns increased almost 300 percent. At the same time, the number of enforcement actions such as federal tax liens, levies, and seizures decreased by 78 percent, 84 percent, and 98 percent, respectively.

The Examination function experienced similar decreases in accomplishments over the past 4 years. The number of returns examined by district office revenue agents and tax auditors in face-to-face audits decreased from 775,000 in FY 1996 to 392,000 in FY 1999 (a decline of 49 percent). The number of returns examined through correspondence decreased from 1,353,000 in FY 1996 to 829,000 in FY 1999 (a decline of 39 percent).

Various Stakeholders Are Concerned With the Reduction in Compliance Resources

Some members of the Congress, IRS management, and IRS employees are concerned with decreases in Collection and Examination activities. During a 1999 survey of employees and managers, 69 percent of Collection employees, 43 percent of Customer Service employees, and 62 percent of mid- and top-level management felt that "too little emphasis is placed on collecting revenue." The news media have had numerous stories presenting statistical information regarding the reductions in Examination coverage and Collection enforcement activity. Recognizing these concerns, the President's budget proposal for FY 2001 requests additional resources for compliance activities.

The Internal Revenue Service Does Not Have an Effective Measurement System to Determine Impact on Voluntary Compliance

In theory, the audit of tax returns and an effective collection process should encourage taxpayers to file their returns and pay the correct amount of tax. However, the IRS does not have a reliable system to measure this impact, nor does it have a method to determine whether improved customer service would, in fact, increase voluntary compliance. Without a measurement system, management will not know whether this strategy has been successful.

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Summary of Recommendations

This report is advisory in nature and is being provided for informational purposes to aid IRS management in making decisions regarding the allocation of compliance resources and the development of new management information systems. Consequently, we are not making any recommendations.

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Objective and Scope

The overall objective of the review was to evaluate the reduction in compliance activities.

Our overall objective was to evaluate the reduction in compliance activities. We analyzed various statistics regarding staff resources and related compliance results for Fiscal Years (FY) 1996¹ through 1999. We also determined what is being done to measure the impact of the reduced compliance activity and increased customer service activity.

All audit work was done using Internal Revenue Service (IRS) National Office information and contacts during the period October 1999 to March 2000. Our analyses were made using data available through normal management information reports. We did not conduct tests to verify the accuracy of the data in the reports.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The IRS brings in about 95 percent of the Federal Government's revenue, based primarily on voluntary compliance. The level of voluntary compliance is predicated on taxpayers believing that others are paying their fair share.

The IRS brings in about 95 percent of the Federal Government's revenue based on a tax system that relies primarily on voluntary compliance. Ninety-eight percent of the revenue is the result of taxpayers voluntarily filing tax returns and paying their tax liability without compliance contact by the IRS. In order for the voluntary system to work effectively, compliant taxpayers must believe that others are paying their fair share and that non-compliant people will be identified and required to pay the correct amount of taxes.

¹ We used 1996 as the base year because of difficulty in obtaining complete data for earlier years and because 1996 was the last complete fiscal year before the Senate hearings leading to the changes enacted by the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

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Audits are conducted, either face-to-face or through correspondence, to verify the accuracy of returns filed.

The IRS has two major compliance functions, the Examination Division and the Collection Division, that address non-compliance issues. The Examination function verifies whether taxpayers correctly determined their tax liability. IRS Service Centers conduct correspondence examinations of issues that can be verified through the mail. In district offices, tax auditors conduct face-to-face audits,² usually in the IRS office, and also conduct some correspondence audits. Revenue agents conduct face-to-face audits of more complex returns such as business taxpayers, partnerships, corporations, and specialty taxes such as excise tax returns.

Collecting unpaid accounts and securing unfiled returns are done through notices, telephone contacts, or direct field visits. Accounts that exceed workable inventory levels are placed in a holding file called the "Queue."

The collection process begins with notices sent to taxpayers who did not file a return or pay the tax liability. If the taxpayer does not make satisfactory payment arrangements or does not respond to the notices, the account is forwarded to the Automated Collection System (ACS) for a telephone contact or to a district Collection field office for a personal contact by a revenue officer. Computer programs score delinquent accounts for their collection potential. Accounts that are below predetermined scores for each district are placed in an automated holding file called the "Queue." Accounts that are not resolved through the ACS are transferred to the Queue or to the Collection Field function for further action by revenue officers.

In late 1997, the Congress criticized the IRS in hearings at which taxpayers testified they had been harassed and mistreated by the IRS. The Congress subsequently passed the RRA 98, which was intended to improve service to taxpayers and to give taxpayers more protection against overzealous IRS employees.

In September 1998, the Commissioner announced a new mission statement for the IRS: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

² The terms "audit" and "examination" are used synonymously as the verification of one or more issues on a tax return.

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applying the tax law with integrity and fairness to all.” To achieve this mission, the IRS established three strategic goals—service to each taxpayer, service to all taxpayers, and productivity through a quality work environment.

Results

Overall Government revenue has increased with the growing economy. However, IRS enforcement activity and revenue have declined, resulting in increasing accounts receivable and inventories of unresolved delinquencies.

Overall revenue taken in by the IRS has steadily increased with the growing economy from \$1.5 trillion in FY 1996 to \$1.9 trillion in FY 1999 (a 28 percent increase). However, enforcement activities have significantly declined during these 4 years, and Collection and Examination efforts and results in most areas have decreased. As a result, overall revenue collected from compliance activities decreased \$5 billion (13 percent) from FY 1996 to FY 1999, while gross accounts receivable increased \$41 billion (19 percent). The reductions have been caused primarily by:

- A decrease in staff levels due to budget constraints.
- A diversion of resources to improve levels of customer service during the filing seasons.
- Time needed to train employees and implement the many provisions of the RRA 98.
- An increase in time to resolve cases because of ever-changing and increasing complexities of tax laws.

Many stakeholders, including some members of the Congress, present and former IRS Commissioners, IRS managers and employees, tax practitioners, and news media, have expressed concerns about the decreasing IRS compliance activities.

At this time, the IRS does not have a reliable method to measure voluntary compliance or to determine the impact that increased customer service and decreased enforcement have on voluntary compliance.

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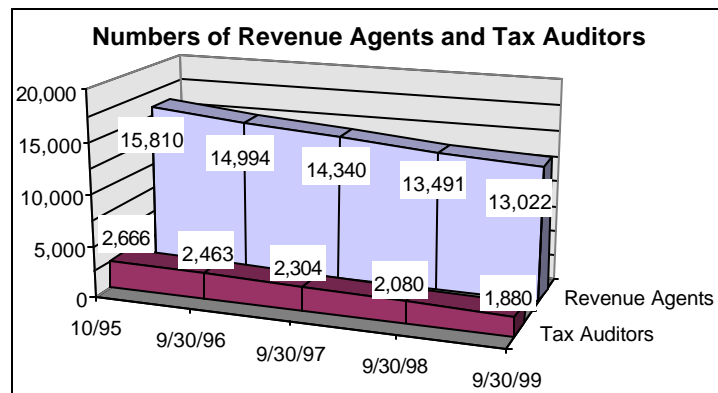
Fewer Resources Are Being Applied to Compliance Activities

The Number of Compliance Employees Has Declined

From the beginning of FY 1996 to the end of FY 1999, the number of IRS employees decreased from 114,000 to 98,000 (14 percent) while the number of tax returns filed grew by 5 percent.

As part of the continuing downsizing, the number of employees in the Examination and Collection functions decreased at a greater rate than the overall employee reduction. Examination staff available to audit returns decreased each of the last four years. As a result, there were 3,574 fewer revenue agents and tax auditors at the end of FY 1999 compared to the start of FY 1996.

The total number of revenue agents and tax auditors decreased 19 percent from the start of FY 1996 to the end of FY 1999. The number of revenue agents decreased 18 percent, and the number of tax auditors decreased 29 percent during this period.

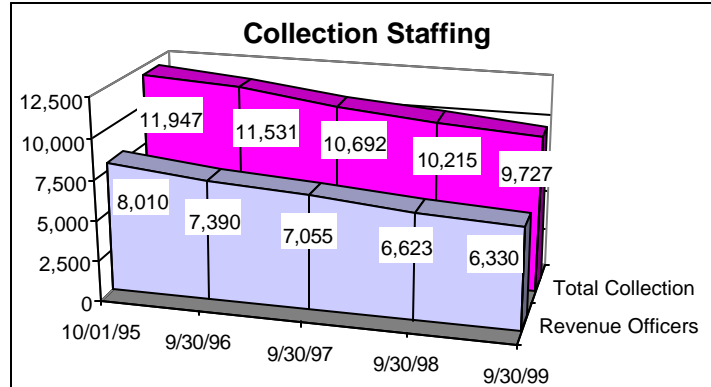


Source: Examination Division

Collection staff available to secure delinquent returns and collect delinquent accounts also decreased each of the last four years. At the end of FY 1999, there were 1,680 fewer revenue officers than at the start of FY 1996.

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The total Collection staff decreased 19 percent from the beginning of FY 1996 to the end of FY 1999, while the number of revenue officers decreased 21 percent during the same period.

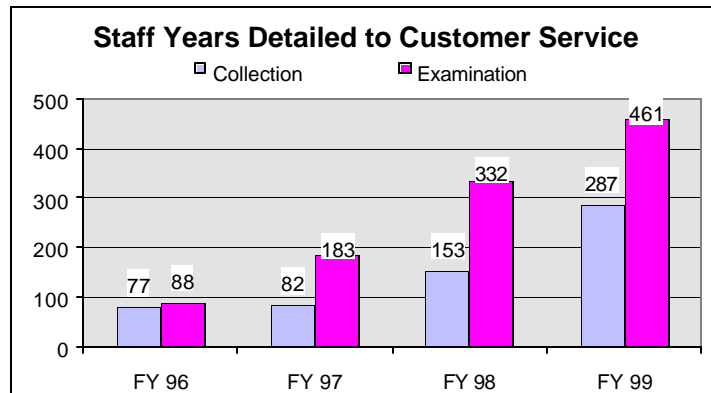


Source: Collection Division

More Compliance Employees Were Detailed to Assist Customer Service

As part of the IRS' efforts to provide better customer service, increasing numbers of employees have been detailed from the Collection and Examination functions to assist taxpayers during the filing seasons.

Compliance resources detailed to Customer Service increased from 165 staff years in FY 1996 to 748 staff years in FY 1999.

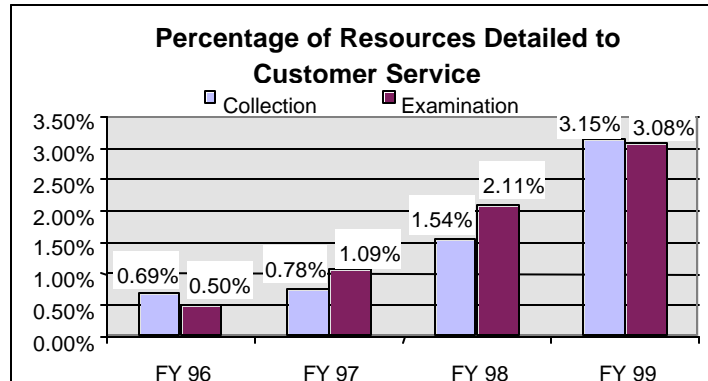


Source: Collection Reports 5000-23 and Examination Tables 37

Rather than collecting taxes and examining returns, these employees were answering taxpayer questions and helping taxpayers prepare their tax returns.

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The percent of total Collection and Examination resources detailed to Customer Service increased from 0.6 percent in FY 1996 to 3.1 percent in FY 1999.



Source: Collection Reports 5000-23 and Examination Tables 37

While the resources diverted to Customer Service amounted to only about three percent of the total Examination and Collection resources in FY 1999, those resources could have produced a significant amount of enforcement revenue. While the IRS does not have goals to collect a certain amount of dollars per employee, average revenue can be estimated using historical data. Based on this data, we estimate that approximately \$511 million in revenue was foregone by detailing the 748 staff years from Examination and Collection into Customer Service during FY 1999.

Significant Resources Were Needed to Implement the Internal Revenue Service Restructuring and Reform Act of 1998

The RRA 98 required many changes in IRS procedures; it created 71 new taxpayer rights issues requiring new procedures and increased time per case. It also set higher expectations for the way taxpayers would be served. Consequently, significant resources were needed to create and document the new procedures, create new forms, train affected employees, etc.

Overall training time for Collection and Examination employees increased from 3.7 to 7.6 percent of total time from FY 1996 to FY 1999.

Virtually all employees were required to receive varying amounts of training in the applicable subjects. Despite the decline in number of staff, the overall training time for Examination and Collection employees increased from 1,076 staff years in FY 1996 to 1,830 staff years in FY 1999. In addition, as with any new procedures, there is a “learning curve” period during which employees

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take longer to complete work while they become familiar with the new procedures.

The RRA 98 required the IRS to spend significant resources for issues that took less time in the past. For example, the RRA 98 expanded the rights for innocent spouses – those taxpayers who had no responsibility for the income and related taxes incurred by their spouses, even though the returns were filed jointly. This resulted in a significant increase in the number of innocent spouse cases for Examination. The due process in collection provisions of the RRA 98 also added to the time spent by Collection before enforcement actions can be taken.

The IRS estimates that 3,000 full time equivalents (FTE)³ were used in FY 1999 to implement RRA 98. The management information systems are capable of tracking the training time but did not track the other time spent to implement the RRA 98. Therefore, we cannot validate the IRS estimate.

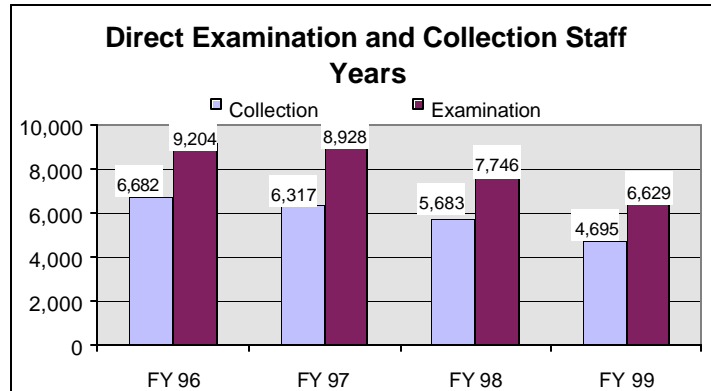
Time Spent Collecting Taxes and Examining Returns Decreased Significantly

Because of the reduced staffing and other factors cited on the preceding pages, the total direct time spent on case assignments by Collection and Examination employees dropped by 29 percent from FY 1996 to FY 1999.

³ A Full Time Equivalent (FTE) is the amount of time that 1 person would be paid in 1 year (usually 2,088 hours). Total hours worked divided by 2,088 results in the number of accountable FTEs. Therefore, three people working full time for four months would be one FTE, as would two people working half time for a full year. In this instance, 3,000 FTEs would be the equivalent of 12,000 employees working for about 3 months.

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Direct time spent by revenue officers collecting unpaid taxes and pursuing unfiled returns fell by 30 percent from FY 1996 to FY 1999. Direct time spent examining returns fell by 28 percent during this time.



Source: Collection Reports 5000-23 and Examination Tables 37

Time spent by revenue officers collecting unpaid accounts fell by 27 percent while time spent pursuing unfiled returns fell by 48 percent. The time spent by revenue agents and tax auditors examining returns fell by 28 percent.

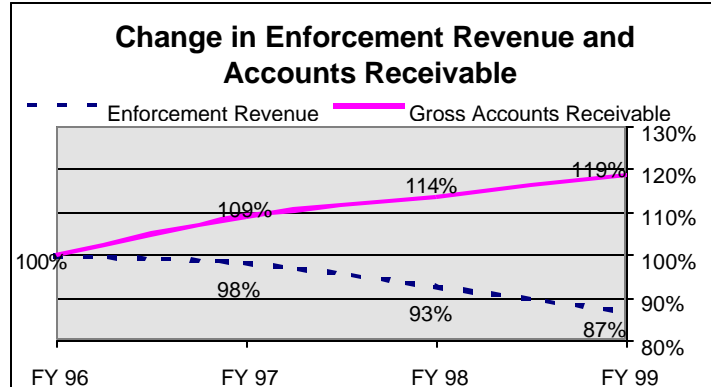
Compliance Results Have Decreased

The number of audits and the number of collection actions taken have decreased substantially in recent years. Consequently, the amount of revenue brought in by the compliance activities has been decreasing while the amount of outstanding liabilities⁴ has been increasing.

⁴ Gross accounts receivables include all unpaid assessments of tax, penalty, and interest recorded on taxpayers' accounts. These include: 1) taxes for which the IRS can support the receivable through taxpayer agreement or court ruling, 2) compliance assessments where neither the taxpayer nor a court has affirmed the receivable, and 3) write-offs which are not expected to ever be collected due to factors such as the taxpayer's death, bankruptcy, or insolvency.

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Overall enforcement revenue decreased \$5 billion (13 percent) from FY 1996 to FY 1999, while gross accounts receivable increased \$41 billion (19 percent).



Source: Enforcement Revenue Information System and Chief Financial Officer Financial Report

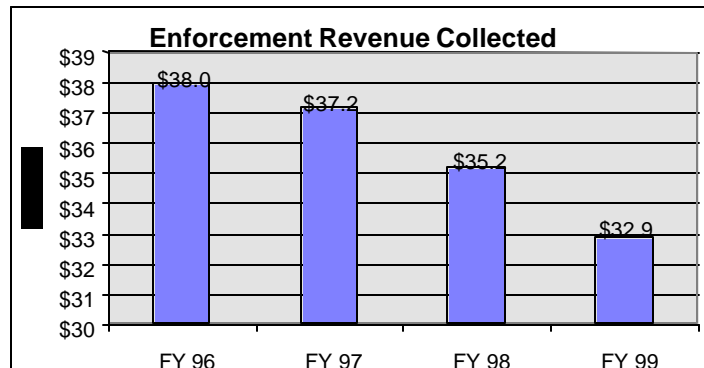
Enforcement revenue is any tax, penalty, or interest received from a taxpayer as a result of an IRS enforcement action (usually an audit or a collection action). While enforcement revenue is only a small part of the total revenue brought in by the IRS, it is a vital part of the strategy for achieving overall compliance.

The total amount of enforcement revenue collected decreased from \$38 billion in FY 1996 to \$32.9 billion in FY 1999. While the amount of the decrease in enforcement revenue is small compared to total tax revenue, it is equal to about 65 percent of the total FY 1999 IRS budget. (The total IRS budget during these years went from \$7.24 billion to \$7.82 billion.⁵ The portion of the IRS budget allocated to tax law enforcement was approximately \$3.1 billion in each of the last 2 years.)

⁵ This FY 1999 amount does not include the special Year 2000 (Y2K) emergency fund expenditures of \$0.5 billion.

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Overall enforcement revenue decreased from \$38 billion in FY 1996 to \$32.9 billion in FY 1999.



Source: Enforcement Revenue Information System

Collection Enforcement Actions and Results Have Decreased While Unresolved Delinquencies Have Increased

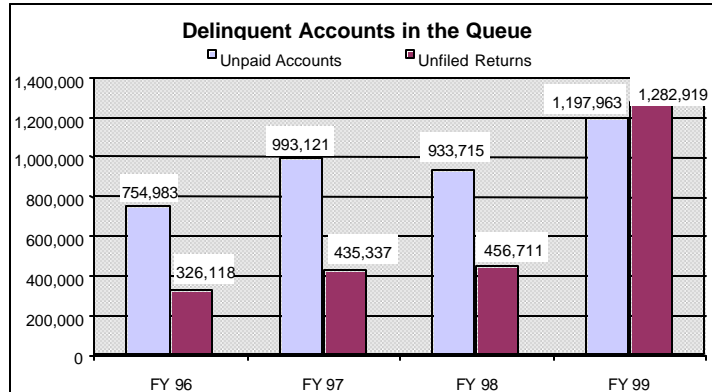
More Delinquent Accounts Are Staying in the Inactive Inventory

Since Collection does not have enough resources to work all delinquent cases received, an unassigned inventory called the "Queue" was established years ago to hold lower priority cases. Management can control the number of cases in active inventory by changing the Queue cutoff scores. Collection data shows that 26 of the 33 districts raised their Queue scores during FY 1999 to leave more cases in the Queue.

Since fewer cases are being worked, the volume of cases in the Queue has grown significantly, both in number of cases and dollar value of unpaid accounts. From September 1996 to September 1999, the number of unpaid accounts in the Queue grew by 59 percent while the value of those unpaid accounts rose 156 percent from \$2.96 billion in September 1996 to \$7.58 billion in September 1999. During this same time, the number of delinquent (unfiled) return cases in the Queue rose 293 percent, from approximately 326,000 cases in September 1996 to approximately 1.3 million cases in September 1999.

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The number of unpaid accounts in the Queue grew by 59 percent while the number of unfiled return investigations grew by 293 percent from FY 1996 to FY 1999.



Source: Collection Reports 5000-2 and 5000-4

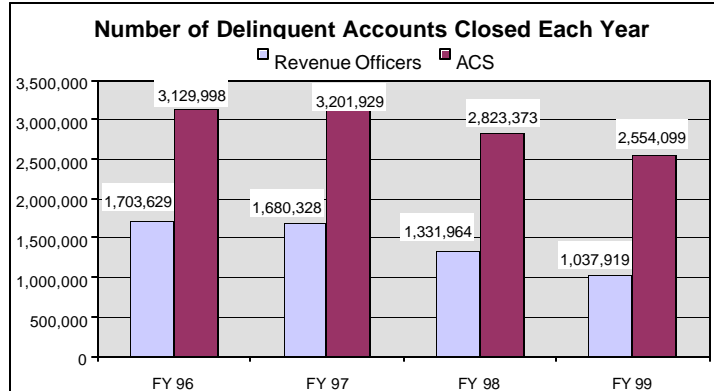
These increases to the Queue could have a significant impact on voluntary compliance. In many of these cases, the IRS sent taxpayers one or more notices and may have attempted telephone calls but then discontinued collection actions. Not following through could affect future filing and payment choices by these taxpayers as well as other people they know who filed and paid in the past.

Fewer Delinquent Accounts Are Being Closed

The numbers of delinquent accounts and delinquency investigations closed by revenue officers and the Automated Collection System (ACS) have decreased substantially since FY 1996. The number of accounts closed by revenue officers decreased 39 percent from 1.7 million in FY 1996 to just over 1 million in FY 1999. Accounts closed through the ACS declined 18 percent from 3.1 million in FY 1996 to 2.6 million in FY 1999.

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Revenue officers closed 39 percent fewer delinquent accounts in FY 1999 compared to FY 1996. The ACS closed 18 percent fewer accounts in FY 1999 compared to FY 1996.



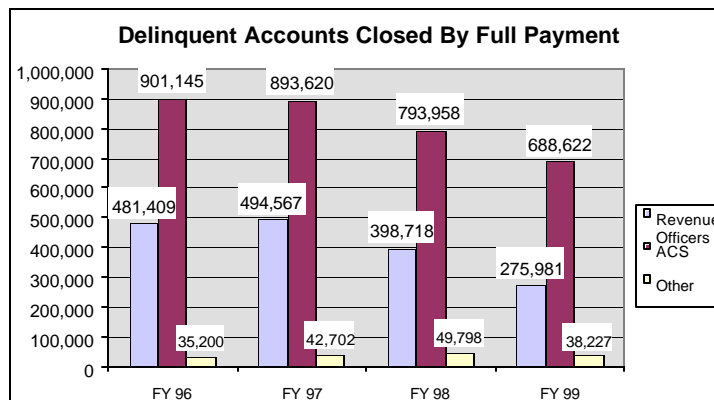
Source: Collection Reports 5000-2

Accounts can be closed in a variety of ways, such as:

- Full payment may be received.
- An Installment Agreement can be accepted for monthly payments.
- An Offer in Compromise can be accepted for payment of only a portion of the liability.
- A “currently not collectible” condition may be determined.

The number of accounts closed by full payment decreased from 1.4 million in FY 1996 to 1.0 million accounts in FY 1999.

The number of accounts closed by full payment decreased by 29 percent from FY 1996 to FY 1999.



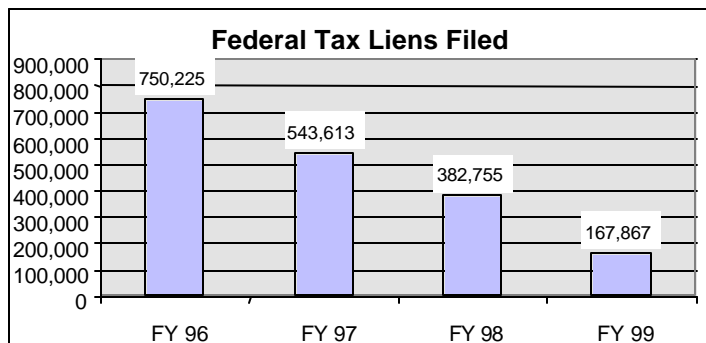
Source: Collection Reports 5000-2

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Collection Enforcement Actions Have Dropped Off Significantly

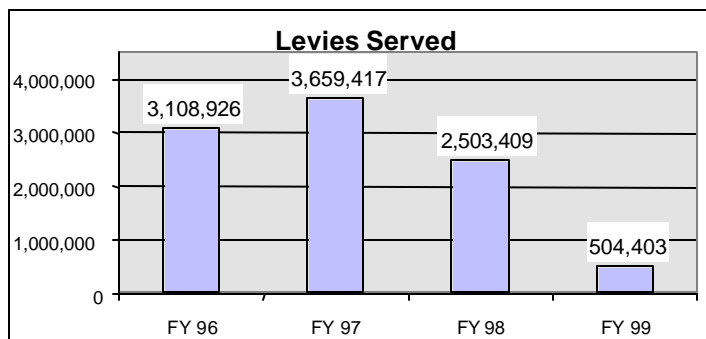
The numbers of enforcement actions (liens, levies, and seizures) to collect unpaid taxes have dropped off significantly since the Senate Finance Committee hearings in 1997 and even more dramatically since the January 1999 effective date of the RRA 98 sections pertaining to enforced collection actions. The RRA 98 requirements and the new IRS procedures to implement the RRA 98 are the primary causes for these reductions.

The number of liens filed to record the Government's interest in taxpayers' property declined 78 percent from FY 1996 to FY 1999.



Source: Collection Reports 5000-23

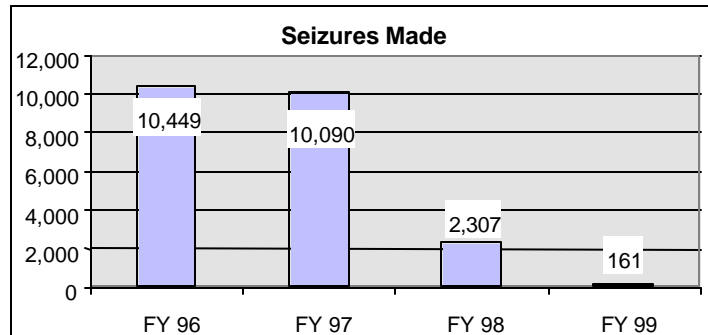
From FY 1996 to FY 1999, the number of levies on delinquent taxpayers' assets such as bank accounts, wages, and accounts receivable declined 84 percent.



Source: Collection Reports 5000-23

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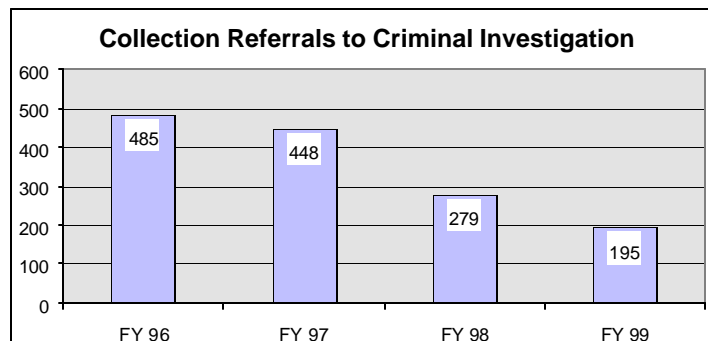
The number of seizures made of taxpayers' property for non-payment of taxes declined 98 percent from FY 1996 to FY 1999.



Source: Collection Reports 5000-23 and National Office Collection

Willful nonfiling of federal income tax returns can be a criminal offense. When Collection identifies situations that meet certain criteria, the case should be referred to the Criminal Investigation function. Certain other instances such as fraudulent Offers in Compromise or Bankruptcy filings can also be referred. The number of cases Collection referred to Criminal Investigation decreased 60 percent from FY 1996 to FY 1999.

The number of referrals from Collection to the Criminal Investigation Division decreased 60 percent from FY 1996 to FY 1999.



Source: National Office Criminal Investigation Division

Audits of Taxpayers Have Decreased

The number of tax returns examined each year has steadily decreased while the number of returns filed has grown. Therefore, a taxpayer's chance of being audited has decreased significantly.

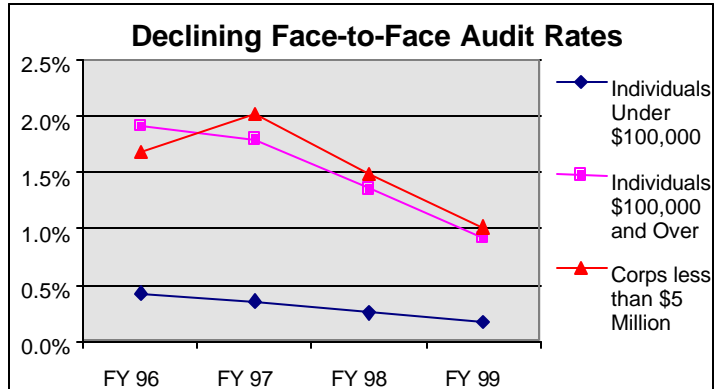
The number of tax returns filed has grown 5 percent from about 155 million in 1995 to 163 million in 1998. However, the number of returns examined by district office revenue agents and tax auditors in face-to-face audits decreased from 775,000 in FY 1996 to 392,000 in

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FY 1999 (a 49 percent decline). The number of returns with simpler issues examined through district or service center correspondence also decreased, from 1,353,000 in FY 1996 to 829,000 in FY 1999 (a 39 percent decline).

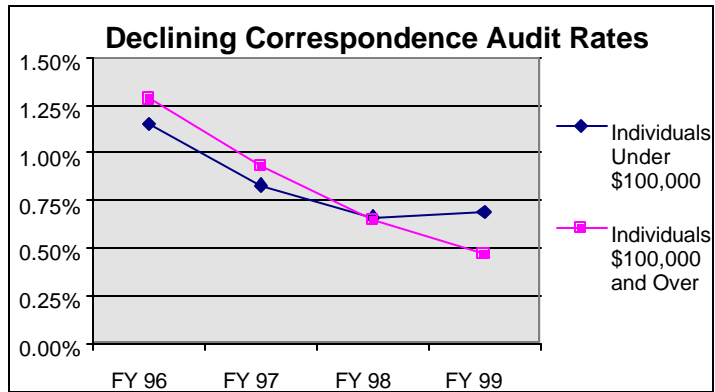
Audit Coverage as a Portion of Returns Filed

*The **face-to-face** audit rate for individuals⁶ making over \$100,000 adjusted gross income (AGI) was cut in half from 1 in 52 in 1996 to 1 in 108 in FY 1999. The rate for individuals making less than \$100,000 AGI went down from 1 in 233 in FY 1996 to 1 in 590 in FY 1999.*



Source: Examination Tables 37 and IRS Data Books Table 11

*The **correspondence** audit coverage for individuals making over \$100,000 AGI went down from 1 in 78 returns in FY 1996 to 1 in 212 in FY 1999. The rate for individuals making less than \$100,000 AGI went down from 1 in 87 in FY 1996 to 1 in 146 in FY 1999.*



Source: Examination Tables 37 and IRS Data Books Table 11

Total audit coverage (face-to-face and correspondence) for individuals making over \$100,000 AGI went down from 1 in 31 in FY 1996 to 1 in 72 in FY 1999. During this same 4-year period, the coverage for individuals making under \$100,000 AGI went down from 1 in 63 to

⁶ The category “individuals” includes taxpayers filing all types of Forms 1040, including those with Schedule C business income and Schedule F farm income.

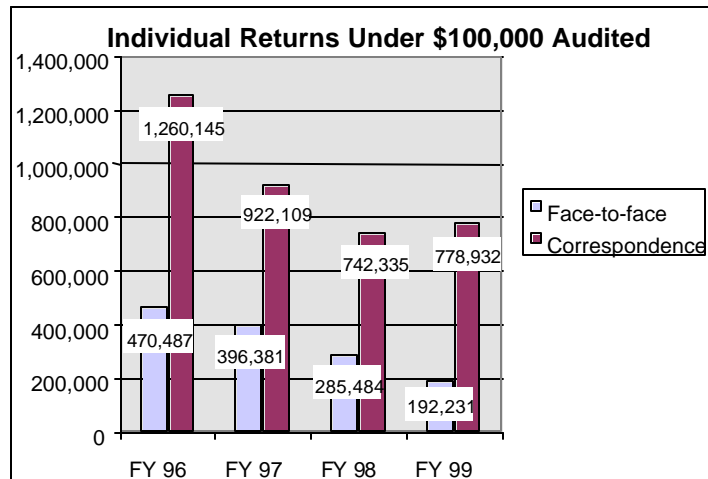
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1 in 117, and the coverage for small corporations (assets under \$5 million) dropped from 1 in 57 to 1 in 96.

Examination Coverage in Number of Returns Audited⁷

The number of individual returns with income under \$100,000 audited through correspondence fell by 38 percent while the number audited face-to-face fell by 59 percent from FY 1996 to FY 1999.

The IRS audited 760,000 fewer individual returns with income under \$100,000 in FY 1999 than in FY 1996.



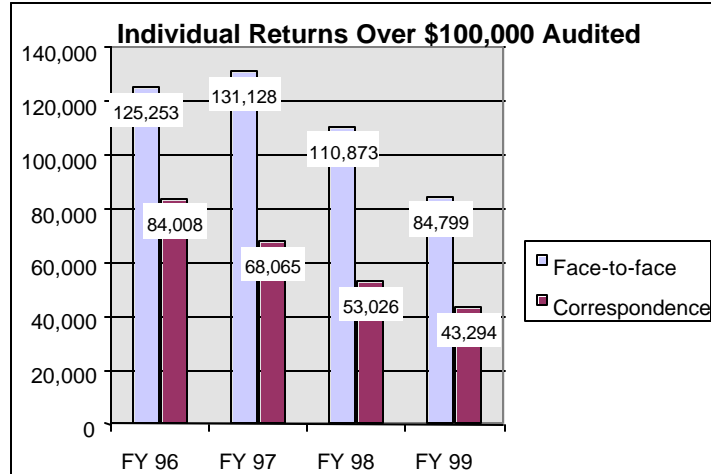
Source: Examination Tables 37 and IRS Data Books Table 11

Between FY 1996 and FY 1999, the number of individual returns with income of \$100,000 or more audited through correspondence fell by 48 percent while the number audited face-to-face fell by 32 percent.

⁷ The numbers in the three charts of individual and corporate returns audited do not include non-taxable returns such as partnerships and Sub-chapter S corporations. Adjustments on those returns would be carried onto the individual returns of the owners. These charts also do not include miscellaneous returns such as fiduciary, estate and gift, employment, and excise tax returns.

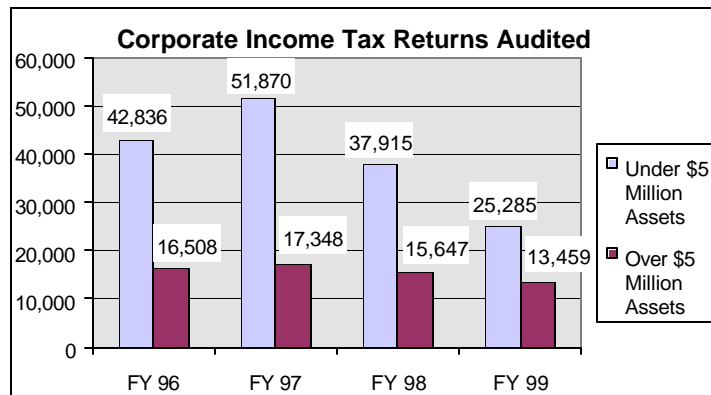
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The IRS audited 81,000 fewer individual returns with incomes over \$100,000 in FY 1999 than in FY 1996.



Source: Examination Tables 37 and IRS Data Books Table 11

The IRS audited 17,600 fewer small corporations and 3,000 fewer large corporations in FY 1999 than in FY 1996.



Source: Examination Tables 37 and IRS Data Books Table 11

The decreasing examination rates may encourage taxpayers to “play the audit lottery” if they feel their chances of being audited are so small. A September 1999 survey⁸ conducted by an independent survey firm commissioned by the IRS reported that seven percent of Americans said it is okay to cheat a little and three percent said it is acceptable to cheat “as much as possible.” While it is not feasible to examine up to 10 percent of returns filed, the current coverage is

⁸ Attitudes Toward Tax Evasion, prepared September 1999, for the IRS by Roper Starch Worldwide Inc., based on a nationwide telephone survey of 2,000 adult Americans.

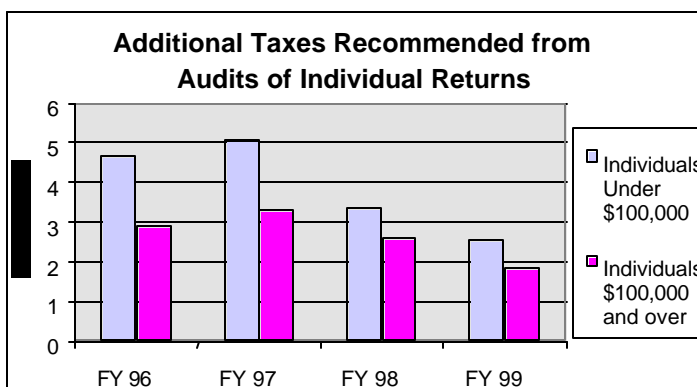
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a long way from even the 3 percent who said they would cheat as much as possible.

Results from Examinations Have Shown a Corresponding Decrease

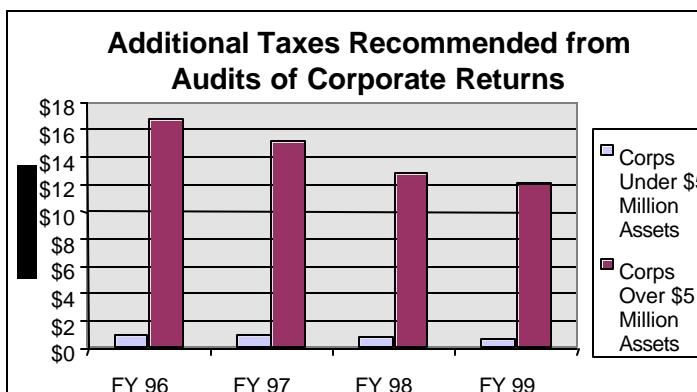
Because the number of audits has dropped off, the total dollars recommended for additional assessment from those audits has also decreased.

Additional taxes recommended on individual income tax audits fell from \$7.6 billion in FY 1996 to \$4.4 billion in FY 1999.



Source: Examination Tables 37 and IRS Data Books Table 11

Additional taxes recommended on corporate audits fell from \$17.8 billion in FY 1996 to \$12.7 billion in FY 1999.

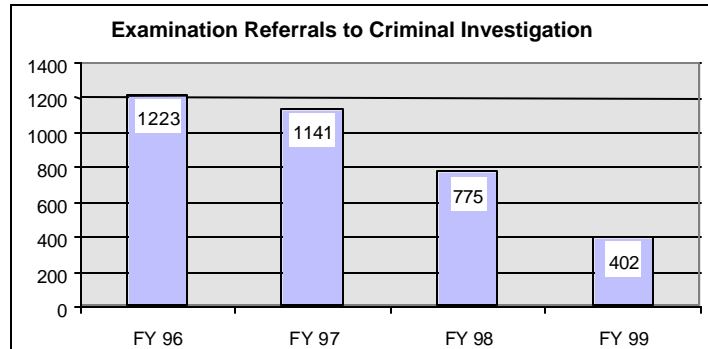


Source: Examination Tables 37 and IRS Data Books Table 11

Examination employees, like Collection employees, are required to refer cases to the Criminal Investigation function when potential fraud is present. Referrals for investigation of possible tax fraud have also dropped off significantly.

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The number of referrals from the Examination Division to the Criminal Investigation Division decreased 67 percent from FY 1996 to FY 1999.



Source: National Office Criminal Investigation Division

Various Stakeholders Are Concerned With the Reduction in Compliance Resources

In the past year, interest and concern about decreasing IRS compliance resources have been growing. Concerns have been expressed by various Congressmen, the present and former IRS Commissioners, IRS management officials and employees, tax practitioners, and numerous news media.

The IRS FY 2000 budget justification described the resource reductions and the expected impact on dollars collected and cases closed.

The IRS FY 2000 budget justification document to the Congress, dated February 1, 1999, described the reductions in Examination and Collection resources, the diversions of staff to implement the RRA 98 and support customer service, and the expected impact on dollars collected and cases closed. The justification stated that diversion of an estimated \$200 million in compliance resources for implementing the RRA 98 would be the beginning of a continuing curtailment of some compliance activities, primarily examination of tax returns and collection of delinquent accounts. That information included estimates that the resource diversions would result in \$436 million not collected and \$270 million less in recommended tax assessments.

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The Commissioner has testified repeatedly before various Congressional committees about the decreases in compliance activities.

Throughout 1999 and into 2000, the Commissioner testified before various Congressional committees about the status of RRA 98 implementation and the declining resources in compliance activities. Several Congressmen expressed concern about the reductions in compliance activities. In February 2000, the Commissioner presented proposals for budget increases in FY 2001. Those proposals included funding for additional employees in customer service and compliance activities to partially offset the shrinkage over the past several years.

The President's Federal Budget proposal for FY 2001 includes an increase for the IRS, with specific allocations for additional staffing in the Customer Service, Examination, and Collection functions.

Former IRS Commissioners have also been quoted in news articles about the need to maintain resources in compliance activities. One commented that the IRS is operating under the theory that if it is kind to people they will pay their taxes, but that is an unproven theory. He added that, in fact, it is almost certain that under a less-fearsome IRS, more taxpayers will file fraudulent returns. Another former Commissioner commented that the IRS is not really enforcing the tax laws and that, if tax revenues slip five percent because of weak enforcement, "there goes the budget surplus."

An April 1999 survey of IRS employees showed that many feel too little emphasis is being placed on collecting delinquent taxes.

In April 1999, the IRS surveyed about 8,000 employees and managers regarding the IRS' overall performance; equipment, tools, and technology; the status of modernization; and fairness, trust, and communications. Almost half of the responses (48 percent) said that too little emphasis was being placed on collecting tax revenue, including 62 percent of the mid/top-level managers and executives and 54 percent of the first-level managers. The majority of employees (56 percent) working in district offices also felt that too little emphasis was being placed on collecting tax revenue. This included 69 percent of Collection employees, 47 percent of Examination employees, and 43 percent of Customer Service employees.

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The IRS initiated several internal studies related to the decrease in compliance activities.

IRS management has initiated several studies about the decrease in compliance activities.

- The Office of Program Evaluation and Risk Analysis completed a study in February 2000 for the Chief Operations Officer and the RRA 98 Executive Steering Committee about the impact of the RRA 98 on enforcement.
- The Office of Program Evaluation and Risk Analysis is working jointly with the Compliance Research Division on a study of the tax gap.
- The Compliance Research Division has two separate studies on how to improve filing compliance and payment compliance.
- In April 1999, the Senior Council for Management Control⁹ considered this as an emerging issue for their oversight.

At tax practitioner meetings during the past year, various practitioners have also expressed the concern that sufficient resources need to be maintained to implement planned changes in the IRS.

Finally, during the latter part of 1999 and early 2000, the news media have carried many articles citing various statistics about the shrinking IRS. Many of these articles cited the reductions in staffing and in collection and examination activities and the potential negative impact this may have on overall compliance. While these news articles may be viewed as sounding the alarm by some, others may also view them as revealing IRS weaknesses and the opportunity to take advantage.

⁹ The Senior Council for Management Control has now evolved into the Financial and Management Controls Executive Steering Committee.

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The Internal Revenue Service Does Not Have an Effective Measurement System to Determine Impact on Voluntary Compliance

Not having an effective way to measure voluntary compliance has been an issue for many years since the TCMP was discontinued.

The IRS has been struggling for many years to develop an effective way to measure taxpayer compliance. One method the IRS used in the past was the Taxpayer Compliance Measurement Program (TCMP). The TCMP was a thorough audit of all items on a random statistical sample of tax returns. The results were tabulated to project overall compliance with tax laws and to refine computer selection criteria for objectively selecting returns for audit. However, the most recent TCMP was completed in 1992 based on returns filed for 1988. Therefore, there are no recent data to evaluate compliance levels, to develop formulas for objectively selecting returns for audits, or to allocate Examination resources. The IRS was scheduled to conduct another TCMP in 1994, but it was cancelled due to budget constraints and because it was thought to be too intrusive on taxpayers. Since that time, the IRS has not developed an alternative way to measure taxpayer compliance.

The GAO has reported many times over the years about the need for the IRS to measure compliance.

Numerous General Accounting Office (GAO) reports and testimonies have discussed the problems with the IRS not effectively measuring voluntary compliance. For example:

- In an April 1993 report,¹⁰ the GAO stated that the IRS' plan to downsize the TCMP would lessen the IRS' and the Congress' abilities to detect changes in the effectiveness of the voluntary tax system and may severely weaken the IRS' ability to measure its progress in achieving the goal of improved voluntary compliance.

¹⁰ *IRS' Plans to Measure Tax Compliance Can Be Improved* (GAO-GGD-93-52, April 5, 1993).

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- In an April 1996 report,¹¹ the GAO stated that because the planned 1994 TCMP was not done, the IRS needs to identify and implement alternative methods of measuring taxpayer compliance.
- In April 1999, the GAO testified¹² that the diversion of compliance resources to customer service initiatives and its effect on enforcement revenue is unknown since the IRS does not have a way to measure voluntary compliance.
- As recently as April 10, 2000, the GAO testified¹³ that the IRS does not have a measure for voluntary compliance but is working to develop one. The GAO added that regularly measuring progress in voluntary compliance is important to gauge whether the IRS is accomplishing a key aspect of its mission and that once it is developed, the IRS should be able to assess whether improved customer service contributes to an increase in voluntary compliance.

The IRS implemented a number of initiatives to promote customer service. Since the IRS does not have a reliable system to measure voluntary compliance, there is no way for it to determine whether improved customer service will, in fact, increase voluntary compliance.

Conclusion

Budgetary constraints and changing program emphases have resulted in significant decreases in IRS compliance activities. Although the dollars from enforcement revenue are not a large part of the total revenue, the

¹¹ *Alternative Strategies to Obtain Compliance Data* (GAO-GGD-96-89, April 26, 1996).

¹² *IRS' Fiscal Year 2000 Budget Request and 1999 Tax Filing Season* (GAO/T-GGD/AIMD-99-140, April 13, 1999).

¹³ *IRS Modernization - Business Practice, Performance Management, and Information Technology Challenges* (GAO/T-GGD/AIMD-00-144, April 10, 2000).

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billions of dollars involved are still significant amounts. In addition, this decrease could negatively affect future voluntary compliance levels.

Statistics show a return on investment of about five to one for resources provided to compliance activities. There is also an unquantified indirect impact on the voluntary compliance levels of other taxpayers. This makes a good business case for additional investment in compliance resources.

Providing better customer service and improved technology may improve compliance in some areas. However, there is no way to know how long that will take, and the IRS has no reliable way to measure it. The IRS needs to restore resources to work the cases identified as non-compliant or potentially non-compliant. Continuing decreases in enforcement activities, under the current tax system, may lead more taxpayers to stop voluntarily complying if they perceive that others are not paying their share.

Detailed Objective, Scope, and Methodology

The overall objective was to evaluate the reduction in compliance activities in light of current issues facing the Internal Revenue Service (IRS) (e.g., implementation of the IRS Restructuring and Reform Act of 1998 (RRA 98),¹ increased emphasis on customer service, reduction in compliance staffing levels, etc.). We focused on the management information that could be used to track the reduction in compliance activities for Fiscal Years (FY) 1996 through 1999 and what was being done to measure the impact of the reduced compliance activity and increased customer service activity.

- I. Determined resources available and applied to compliance and customer service activities for FYs 1996 through 1999. Allocated direct and indirect time as much as possible to evaluate the shifts from direct case time to customer service, the RRA 98, modernization efforts, or other identifiable uses.
 - A. Analyzed Collection Reports 5000-23 to determine total resources and distribution of time charged for each of the four fiscal years.
 - B. Analyzed Examination Tables 37 to determine resources applied to the various activities.
 - C. Discussed reports with Collection and Examination analysts to ensure we had the correct understanding of the sources and relationships of the data being used.

- II. Determined the amounts of overall revenue, dollars collected, and cases closed by various collection activities and examination results for FYs 1996 through 1999.
 - A. Analyzed Collection Reports 5000-2 and 5000-4 to determine total closures of delinquent accounts and delinquent returns and collections for each of the four fiscal years.
 - B. Analyzed Examination Tables 37 and IRS Data Books (Publication 55B) to determine closures and results for the various activities.
 - C. Obtained Criminal Investigation statistical information to determine the number of referrals received from Collection and Examination.

¹ The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

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- D. Discussed reports with Collection and Examination analysts to ensure we had the correct understanding of the sources and relationships of the data being used.

- III. Determined the changes in Collection enforcement statistics (seizures, levies, and liens). Analyzed Collection Reports 5000-23 to determine the number of each type of enforcement action in each of the four fiscal years.

- IV. Determined the changes in inventory levels and national cutoff scores for Collection programs.
 - A. Analyzed Collection Reports 5000-2 and 5000-4 to determine the number and dollar amount of accounts in the Queue² at the end of each of the last four fiscal years.
 - B. Analyzed the Queue cutoff scores for all districts for all four quarters of FY 1999. (Information for prior years was not available.)

- V. Analyzed the gross accounts receivable balances for FYs 1996 through 1999.

- VI. Analyzed the "Take Ten" Survey³ results of IRS employee attitudes to see how they related to the changing IRS emphasis. Determined what actions were planned as a result of this survey.

- VII. Analyzed the May 1999 poll conducted for IRS by Roper Starch Worldwide Inc. concerning taxpayers' attitudes about the IRS and tax cheating. Determined what actions were planned as a result of this survey.

- VIII. Determined the basis for the strategy change of shifting compliance (enforcement) resources to customer service activities.

- IX. Determined what the IRS was doing to monitor the reduction and diversion of compliance resources and the impact of it on voluntary compliance and overall Government tax revenue.
 - A. Reviewed the actions planned and taken on the relevant material weaknesses being addressed by the Senior Council for Management Controls.
 - B. Identified and reviewed any studies, position papers, strategy documents, briefings, etc., on this subject done by or for the:

² The Queue is an automated holding file for unpaid accounts and investigations of unfiled returns awaiting assignment.

³ The "Take Ten" Survey was a corporate climate survey of about 5,700 IRS employees conducted in Spring 1999 by Sirota Consulting.

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- Executive Steering Committee
 - Office of Program Evaluation and Risk Analysis
 - Collection Division
 - Examination Division
 - Chief Financial Officer's Financial Analysis Division, Office of Revenue Analysis
 - Compliance Research Division.
- C. Reviewed the IRS justifications submitted with the FY 2000 and FY 2001 budget requests.
- X. Determined what the IRS has done over the past several years to develop a method to measure voluntary compliance.
- A. Identified and reviewed prior General Accounting Office reports that addressed this issue.
 - B. Identified and reviewed studies by outside contractors that addressed this issue.
 - C. Discussed efforts by the Compliance Research Division to measure voluntary compliance.

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Appendix III

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