

TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES ONE HUNDRED FOURTH CONGRESS FIRST SESSION

—————
JULY 18, 1995
—————

Serial 104-30
—————

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

20-681 CC

WASHINGTON : 1996

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-052358-3

COMMITTEE ON WAYS AND MEANS

BILL ARCHER, Texas, *Chairman*

PHILIP M. CRANE, Illinois
BILL THOMAS, California
E. CLAY SHAW, JR., Florida
NANCY L. JOHNSON, Connecticut
JIM BUNNING, Kentucky
AMO HOUGHTON, New York
WALLY HERGER, California
JIM McCRERY, Louisiana
MEL HANCOCK, Missouri
DAVE CAMP, Michigan
JIM RAMSTAD, Minnesota
DICK ZIMMER, New Jersey
JIM NUSSLE, Iowa
SAM JOHNSON, Texas
JENNIFER DUNN, Washington
MAC COLLINS, Georgia
ROB PORTMAN, Ohio
GREG LAUGHLIN, Texas
PHILIP S. ENGLISH, Pennsylvania
JOHN ENSIGN, Nevada
JON CHRISTENSEN, Nebraska

SAM M. GIBBONS, Florida
CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
ANDY JACOBS, JR., Indiana
HAROLD E. FORD, Tennessee
ROBERT T. MATSUI, California
BARBARA B. KENNELLY, Connecticut
WILLIAM J. COYNE, Pennsylvania
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM McDERMOTT, Washington
GERALD D. KLECZKA, Wisconsin
JOHN LEWIS, Georgia
L.F. PAYNE, Virginia
RICHARD E. NEAL, Massachusetts

PHILLIP D. MOSELEY, *Chief of Staff*
JANICE MAYS, *Minority Chief Counsel*

SUBCOMMITTEE ON OVERSIGHT

NANCY L. JOHNSON, Connecticut, *Chairman*

WALLY HERGER, California
MEL HANCOCK, Missouri
SAM JOHNSON, Texas
ROB PORTMAN, Ohio
JIM RAMSTAD, Minnesota
DICK ZIMMER, New Jersey
GREG LAUGHLIN, Texas

ROBERT T. MATSUI, California
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM McDERMOTT, Washington

CONTENTS

Advisory of July 10, 1995, announcing the hearing	Page 2
---	-----------

WITNESSES

Internal Revenue Service, Phil Brand, Chief Compliance Officer	5
U.S. General Accounting Office, Jennie S. Stathis, Director, Tax Policy and Administration Issues, General Accounting Division	12

American Bar Foundation, Chicago, Ill., Kent W. Smith	128
Feinstein, Jonathan S., Yale School of Management, New Haven, Conn	123
Gibbs, Lawrence B., Miller & Chevalier	71
Goldberg, Fred T., Jr., Skadden, Arps, Slate, Meagher & Flom	59
Long, Susan B., Syracuse University, Syracuse, N.Y	116
National Association of Enrolled Agents, Joseph F. Lane	90
National Taxpayers Union Foundation, David L. Keating	96
Scheuren, Frederick (Fritz), George Washington University, Washington, D.C	111
Smith, Verenda, Alexandria, Va	88
Sparrow, Malcolm K., Harvard University, Cambridge, Mass	75

SUBMISSIONS FOR THE RECORD

U.S. Department of the Treasury, Eric J. Toder, Deputy Assistant Secretary, statement	139
Joint Committee on Taxation, Kenneth J. Kies, Chief of Staff, letter	141

American Institute of Certified Public Accountants, Deborah Walker, letter	143
Pilla, Daniel J., St. Paul, Minn., statement	145

TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

TUESDAY, JULY 18, 1995

**HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
*Washington, D.C.***

The subcommittee met, pursuant to notice, at 10 a.m., in room B-318, Rayburn House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The advisory announcing the hearing follows:]

(1)

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
July 10, 1995
OV-10

CONTACT: (202) 225-7601

Johnson Announces Oversight Hearing on the Internal Revenue Service's Taxpayer Compliance Measurement Program

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing to examine the Internal Revenue Service's (IRS) plans to implement a study of 1994 income tax returns through its Taxpayer Compliance Measurement Program (TCMP). **The hearing will take place on Tuesday, July 18, 1995, in room B-318 of the Rayburn House Office Building, beginning at 10:00 a.m.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

Sound tax policy and administrative decisions depend on comprehensive, reliable, and timely information on the level of taxpayer compliance with existing tax laws. For 30 years, the TCMP has been the IRS's primary program for gathering such information. The IRS collects TCMP data by auditing a random sample of taxpayers' returns in which every line on the return is examined.

In addition to measuring compliance levels, the data is used for estimating the tax gap (i.e., the difference between the amount of income tax owed and the amount voluntarily paid), developing formulas for objectively selecting returns for audit, allocating the IRS's audit resources, analyzing specific compliance issues, and developing legislative proposals designed to improve taxpayer compliance. Congress and federal and state agencies also use TCMP data for policy analysis, revenue estimating, and research.

Beginning in November, the IRS plans to conduct TCMP audits of approximately 150,000 tax returns filed by individuals, small corporations, partnerships and S corporations for tax year 1994. Compliance characteristics will be analyzed and measured within three groupings of individual taxpayers and within 24 industry categories at both the national and smaller geographic levels.

Some believe that TCMP studies are too costly, too time consuming and too burdensome for the taxpayers involved. The IRS must use extensive resources to audit the tax returns selected for analysis. The length of time it takes to plan, implement, analyze and report on TCMP surveys results in a lack of timeliness in the availability of the information gathered. In addition, the burden placed on taxpayers who are the subject of these special audits is substantial. The need to present documentation on every item on a return is laborious and the necessity of discussing issues the taxpayer did not report or claim can be confusing. For those who hire a professional to assist them, there can be a substantial dollar cost involved. And finally, the audits are seen as unfair for those who have fully complied with the tax laws and would not otherwise be the subject of an audit.

(MORE)

WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

SCOPE OF THE HEARING:

The purpose of the hearing is to assess the value of the TCMP program to effective tax administration and policy analysis, and to determine if there are less burdensome alternatives available to the IRS to achieve the program's primary goals. Testimony will be received on the uses of the data, its timeliness, its availability for policy analysis, and relevancy to fundamental tax reform. Testimony will also be gathered on the design, sample size, cost and implementation schedule for the current TCMP survey, as well as the IRS's readiness to meet that schedule. Of particular concern is the burden TCMP audits place on taxpayers and whether taxpayers whose returns are selected for analysis should be compensated for the costs they incur as a result of the audit.

In announcing the hearing, Chairman Johnson described the hearing as especially relevant because Congress has not yet received reports on the findings of overall compliance from the 1985, 1987 and 1988 TCMP surveys. "If this Subcommittee is to conduct effective oversight of the IRS, it must have access to the information that will allow it to evaluate the Service's allocation of its enforcement resources. The Committee on Ways and Means should have the most up-to-date compliance data available as it reviews the effectiveness of current law and proposals for legislative changes."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business on Wednesday, August 2, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. Good morning, the hearing will be convened. I welcome you to our hearing on the Taxpayer Compliance Measurement Program.

For 30 years, TCMP, the Taxpayer Compliance Measurement Program, has been the Internal Revenue Service's primary program for gathering information on taxpayer compliance with existing tax law. The Service has used this information primarily to improve its selection of cases to be audited and on occasion to seek legislation to address specific problems. Tax policy and administration depend on comprehensive, reliable, and timely information on taxpayer compliance with existing tax law.

The IRS is now prepared to initiate a new taxpayer compliance program, the biggest one yet. Its purpose is to gather information, not only for audit selection but for better use of all of its resources, including taxpayer assistance and education. Today we look forward to testimony that will describe the comprehensiveness and reliability of the information that will be gathered.

But timeliness is an issue for which this subcommittee finds testimony unnecessary. The TCMP studies have been carried out in 1985 on individual and S corporation returns, and in 1988 on corporations, exempt organizations, delinquent returns, and again on individual returns. Seven years later, this subcommittee has yet to receive reports analyzing these findings.

There has to be some agreement on the timely delivery of information to the Ways and Means Committee so that it may be used by those who legislate tax policy and to the subcommittee so that it can perform adequate oversight of the IRS.

We would also look forward to hearing comments from the witnesses on the imposition of a requirement that the IRS report to Congress a comprehensive analysis of its findings in a timely manner, and further that the data be made more easily available to independent researchers in order to achieve greater and more independent analysis of the data.

TCMP studies have been described by some as too costly, too time consuming, and too burdensome. Certainly, the requirement that taxpayers document every item on their return is burdensome. I have been told that taxpayers are even required to provide their marriage certificates to prove they are married. If the information gathered through the TCMP is necessary to the development of good tax policy and good tax administration, it is appropriate to ask if there are more efficient and less burdensome means of gathering that information.

TCMP audits are costly to taxpayers whether it is the cost of the taxpayer's own time or whether that of a hired tax professional. In addition, the audits seem as unfair for those whose returns show no indication of a need for an audit. We have to ask ourselves, is it fair for government to place a burden and expense on innocent people in order to better identify those who may not be so innocent?

Should taxpayers be compensated for their participation? If so, how would that best be accomplished?

I welcome the witnesses today and thank you for your willingness to testify on these issues. Let us start with Phil Brand, the Chief Compliance Officer of the IRS.

Mr. Brand.

**STATEMENT OF PHIL BRAND, CHIEF COMPLIANCE OFFICER,
INTERNAL REVENUE SERVICE**

Mr. BRAND. Madam Chairman and distinguished members of the subcommittee, I appreciate the opportunity to appear before the subcommittee to discuss IRS' Taxpayer Compliance Measurement Program in general; as well as our planned TCMP survey of the 1994 tax returns. I have a written statement I request to be entered into the record which I will now summarize.

Chairman JOHNSON. Without objection, Mr. Brand.

Mr. BRAND. The first TCMP surveys were conducted in 1963 and 1964. One of these first surveys involved the examination of 1963 individual forms 1040 tax returns. Data from this survey was used to develop the sophisticated computerized system to select individual and small corporate returns for examination. This system is still in use today. It is called discriminant function or DIF.

DIF benefits taxpayers by significantly reducing the examinations resulting in no change to the tax liability purported by the taxpayer. In fiscal year 1969, prior to the use of DIF, 46 percent of the examinations that we conducted resulted in no change to the tax reported by the taxpayer. In 1994, only 15 percent of returns selected for examination using DIF resulted in no change to tax returns.

This means that a significant number of taxpayers, who have correctly and accurately filed their returns, are not burdened with examinations.

Over the past 30 years, IRS has conducted 25 TCMP surveys of various types of returns. In all these surveys we have focused on specific segments of the taxpaying population—individuals, corporations, partnerships and S corporations—one segment at a time over a 7- to 8-year time period. These surveys were designed to provide statistically valid data on compliance levels by return type and by reported income and asset level at the national and regional level.

Since the data from these surveys is 7 to 14 years old, the IRS is selecting returns for examination and allocating resources based on data that is not current. New data that is statistically valid by market segment and geographical area is critical to enable us to focus our compliance efforts on the most noncompliant taxpayers.

The plan survey for 1994 tax returns will, for the first time, combine the four major return types—individuals, corporations, partnerships, and S corporations. In addition, for the first time, it will also include foreign-controlled corporations giving us much needed data on FCCs. We will randomly select and examine approximately 153,000 returns.

The 1994 TCMP is an integral part of the IRS' new approach to identify and address noncompliance. This approach involves analyzing data by market segments and geographical area, identifying compliance issues, causes for noncompliance, and recommending solutions to address the noncompliance.

Through analysis of TCMP data by market segment and geographical area, the IRS will use education, outreach, and focused enforcement activities in a way that maximizes our impact. In addition, the data will provide better information on noncompliance that can be corrected through legislation.

The 153,000 sample size represents a filing population of over 123.9 million returns—only about one-tenth of 1 percent of that total filing population. Most of the examination work will occur in fiscal years 1996 and 1997. Thus, we estimate that approximately 23.5 percent of our total revenue agent and tax auditor staffing will be devoted to TCMP examinations. In fiscal year 1997, this will decrease to 16.4 percent with a further decline in fiscal year 1998 to 7 percent of the total revenue agent and tax auditor staffing.

Although this TCMP survey does require a fair amount of examination resources, the GAO has stated that the concern that TCMP is too costly has little merit. The most effective allocation of enforcement resources and additional recommended tax law changes that data from TCMP will provide should generate millions more in revenue than the cost of the TCMP survey.

TCMP audits carefully review all aspects of the tax return and the extent to which it reflects the taxpayer's true tax situation. However, our examiners do have flexibility as to the depth that this review must take and small dollar amounts are not assessed. Thus, we balance the need for accurate data with the burden this places on the taxpayer.

The IRS has considered alternative ways to capture the data that we need to administer the system, including gathering enforcement data from operational programs, conducting numerous specific studies, and conducting opinion surveys. While these alternatives would provide some measure of compliance, there are a number of shortcomings to such data.

The alternatives we have investigated and tried have not proven up to the task of supporting accurate, verifiable compliance measures. The IRS uses TCMP data to develop DIF formulas to identify and select returns for examination that have the highest potential for tax change, to identify emerging noncompliance trends, to identify compliance problems which can be corrected through legislative change, to assign resources to areas with the highest noncompliance, and to develop tax gap estimates.

Earlier in my testimony, I shared with this subcommittee the impact that TCMP has had on reducing returns that are examined and result in no change to the reported tax liability. In my written testimony I discuss three examples of how TCMP results have uncovered compliance problems which were addressed through legislative change. These examples involved a problem with the number of dependents being claimed, the overstating of child care credits, and taxpayers not fully reporting their State tax refunds. In all three examples, the legislative changes resulted in substantial additional tax revenues.

TCMP data is also used by other agencies and the executive and legislative branches of government to adjust national income and products accounts, and to estimate potential revenue gains from tax proposals intended or expected to affect noncompliance. In ad-

dition, States use relevant portions of our data files for studies of compliance with their income tax laws.

In conclusion, our goal is to improve our detection of noncompliance, to more effectively assign our resources to the areas with the highest noncompliance, and to identify compliance problems which can be corrected through legislative change. To achieve this goal, the IRS needs data that is statistically valid within market segments and on a geographical basis. The best method we have identified to date for securing this data is TCMP.

The IRS is on target to implement the upcoming survey on time. I assure you we will meet the challenges of conducting the examinations in a timely manner and with the least possible burden to taxpayers.

Madam Chairman, this concludes my prepared remarks. I will be happy to answer any questions you or the other members may have.

[The prepared statement follows:]

**STATEMENT OF PHIL BRAND
CHIEF COMPLIANCE OFFICER
INTERNAL REVENUE SERVICE**

JULY 18, 1995

Madame Chairman and Distinguished Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee today to discuss IRS' Taxpayer Compliance Measurement Program (TCMP) in general, as well as our planned TCMP survey of 1994 tax returns.

Background

For over 30 years, the IRS has relied upon the information obtained from TCMP to collect the proper amount of tax dollars due and owing. Statistically valid data on compliance behavior enables the IRS to focus its compliance efforts on the most noncompliant taxpayers. TCMP is the primary data source for determining, measuring, and tracking taxpayer compliance levels. Thus, TCMP is one of IRS' most important tools to improve compliance.

To determine compliance levels across a filing population, TCMP selects and examines a randomly selected sample of tax returns. TCMP audits are designed to review all aspects of the return and, thus, to determine whether the return reflects the taxpayer's true tax situation. From these audits, detailed data on taxpayers' reporting behaviors is captured and analyzed. From this data analysis, we can determine the extent to which taxpayers correctly report their federal income tax liability.

The first TCMP surveys were conducted in 1963 and 1964. One of these first surveys involved the examination of 1963 individual (Form 1040) tax returns. Data from this survey was used to develop a sophisticated, computerized system to select individual and small business returns for examination. This system, still in use today, is called Discriminant Function (DIF). DIF has significantly improved our ability to identify and select the returns for audit with the highest potential for change. DIF benefits taxpayers by significantly reducing the number of examinations resulting in no change to the tax liability reported by the taxpayer. In FY 1969 (prior to IRS' use of DIF), 46 percent of the examinations resulted in no change to the tax reported by the taxpayer. In FY 1973 (after implementing DIF), examinations that resulted in no change to the tax return had dropped to 30 percent. In FY 1994, only 19 percent of returns selected for examination using DIF resulted in no change to the tax return. This means that a significant number of taxpayers who have correctly and accurately filed their returns are not burdened with an examination.

Over the past 30 years, the IRS has conducted 25 TCMP surveys of various types of returns. In all of these surveys, we have focused on specific segments of the taxpaying population -- individuals, corporations, partnerships, and S corporations -- one segment at a time. Four separate surveys of these four types of returns were conducted over a 7-8 year time period. The most recent surveys conducted of each of the types of tax returns and the sample size of each survey follows:

·	Individuals (Form 1040)	1988 returns	55,000 returns
·	Corporations (Form 1120)	1987 returns	19,000 returns
·	S Corporations (Form 1120S)	1984 returns	10,000 returns
·	Partnerships (Form 1065)	1981 returns	<u>27,000 returns</u>
	Total Sample Size		<u>111,000 returns</u>

These surveys were designed to provide statistically valid data on compliance levels by return type (Form 1040, 1120, etc.) and by reported income/asset levels at the national and regional level. Since the data from these surveys is 7-14 years old, the IRS is selecting returns for examination and allocating resources based on data that is not current. For this reason, the planned survey of 1994 tax returns is an IRS priority.

Planned Survey of 1994 Tax Returns

The planned survey of 1994 tax returns will, for the first time, combine the four major return types -- individuals, corporations, partnerships, and S corporations. In addition, for the first time, it will also include Foreign Controlled Corporations (FCCs); giving us much needed data on FCCs. We will randomly select and examine approximately 153,000 returns. These returns will be examined over a 30-month period beginning in October 1995 and ending in March 1998. Data analysis from this TCMP will provide better DIF formulas to select 1999 returns for examination.

The 1994 TCMP is an integral part of the IRS' new approach to identifying and addressing noncompliance. This approach involves analyzing data by market segments and geographic area; identifying compliance issues and causes of the noncompliance; and recommending solutions to address the noncompliance. Through analysis of TCMP data by market segment and geographic area, the IRS will use education, outreach and focused enforcement activities in a way that maximizes the impact on noncompliance. In addition, the data will provide better information on noncompliance that can be corrected through legislation.

To implement this new approach, the sample design had to accommodate:

- The need for statistically valid data by market segment and by geographic area.
- The need to trend newly gathered market segment data to past reported income/asset level data.

The planned survey also incorporates different types of returns that had previously been handled in separate surveys. The sample was designed to take into account all of the following factors:

- 6 Return Types (Non-business Individual Returns, Sole Proprietor Individual Returns, Corporate Returns, S Corporate Returns, Partnerships, and Foreign Controlled Corporations);
- 30 Geographic Areas;
- 10 Reported Income Level Categories for Individual Returns;
- 5 Reported Asset Level Categories for Corporate Returns; and
- 27 Market/Industry Groupings.

Considering these factors, the 153,000 sample is only slightly larger than the 111,000 sample size for the previous surveys conducted. The 153,000 sample size represents a filing population of over 123.9 million returns -- only about one-tenth of one percent of the total filing population.

In recent months, to ensure that the planned TCMP audits are of the highest quality, the IRS has improved two of its examination tools -- case building and market segment specialization program. Through the use of technology, the IRS has greatly enhanced its capability for case building. To improve the efficiency of our auditors and reduce the time it takes to perform an audit, before an examination is started, we now build a more complete case file, including prior and subsequent year tax return data, copies of related information returns, and copies of currency transaction documents. In the past, due to the limitations of our computer systems, taxpayers were asked to provide copies of the prior and subsequent year returns for the examiner to review. Because the examiner is better equipped and more familiar with the taxpayer's overall tax situation, the taxpayer's time and cost of the examination are minimized.

Also, to the extent possible, TCMP examinations will be assigned to market segment specialists, examiners trained in the unique operating procedures, issues, and applicable tax law specifically related to a particular business, group, industry or profession. The market segment specialists are trained to identify and develop industry specific issues. Also, because the specialists will perform audits of certain groups there will be a high degree of consistency and uniformity in the treatment of issues. Of equal importance, MSSP reduces burden, time and cost on the part of taxpayers as a result of the examiner's increased understanding and knowledge of the taxpayer's business and accounting procedures.

The examination phase of the upcoming survey is 30 months with examinations beginning October 1995 and all examinations to be completed before

April 1998. Since most of the examination work will occur in Fiscal Years 1996 and 1997, our costs will be greater in those fiscal years. In Fiscal Year 1996, we estimate that approximately 23.5 percent of our total revenue agent and tax auditor staffing will be devoted to TCMP examinations. In Fiscal Year 1997, this will decrease to 16.4 percent with a further decline in Fiscal Year 1998 to 7 percent of the total revenue agent and tax auditor staffing.

Although this TCMP survey does require a fair amount of examination resources, GAO has stated that the concern that TCMP is too costly has little merit. The more effective allocation of enforcement resources and additional recommended tax law changes that data from TCMP will provide should generate millions more in revenues than the cost of the TCMP survey.

TCMP audits carefully review all aspects of the tax return and the extent to which it reflects the taxpayer's true tax situation. However, our examiners do have flexibility as to the depth that this review must take. Thus, we balance the need for accurate data with the burden this places on the taxpayer.

The IRS has considered alternative ways to capture the data we need to administer the tax system, including gathering enforcement data from operational programs; conducting numerous, specific studies; and conducting opinion surveys.

While these alternatives would provide some measure of compliance, there are a number of shortcomings to such data. The alternatives we have investigated -- and tried -- have not proven up to the task of supporting accurate, verifiable compliance measures.

Uses of TCMP Data by the IRS

New data that is statistically valid by market segment and geographic area is critical to enabling us to focus our compliance efforts on the most non-compliant taxpayers. With this new information, IRS resources will be applied more effectively and consistently -- geographically, within market segments and by issue.

The IRS uses TCMP data to:

- Develop DIF formulas to identify and select returns for examination that have the highest potential for tax change;
- Identify emerging noncompliance trends;
- Identify compliance problems which can be corrected through legislative change;
- Assign resources to the areas with the highest noncompliance; and
- Develop tax gap estimates.

Earlier in my testimony, I shared with this Subcommittee the impact that TCMP has had with respect to the development of DIF formulas -- a significant reduction in the percentage of returns that are examined and result in no change to the reported tax liability.

Now, I would like to share three examples of how TCMP results have uncovered compliance problems which were addressed through legislative changes. First, through data compiled by TCMP, the IRS identified a problem with the number of dependents being claimed. This discovery resulted in legislation that required a Social Security Number for dependents claimed as exemptions. This legislative change, effective for tax year 1987 returns, resulted in 7 million fewer dependents being claimed in 1987 -- an estimated \$2.9 billion in additional revenue.

Another compliance problem identified using TCMP data was the overstating of the child care credit. Again, legislation was enacted requiring the taxpayer claiming the credit to provide a taxpayer identification number for the child care provider. In tax year 1989 (the effective date for the legislation), 2.7 million fewer taxpayers claimed the credit yielding \$1.2 billion in additional revenues. Also, 252,000 new taxpayers began filing Schedule Cs as child care providers which resulted in \$343 million in additional self-employment and income taxes.

Finally, by using TCMP data, we discovered that taxpayers were not fully reporting their state tax refunds. Through a legislative change requiring the states to file an information return (Form 1099G) with the taxpayer and the IRS, tax year 1989 returns reported additional income from state refunds resulting in \$144 million in additional tax revenues.

These examples represent the importance of TCMP data to IRS' compliance

activities. We believe that the information from the planned survey will have even far more reaching results in terms of our effectiveness in increasing tax collections through a combination of voluntary payments and IRS collection efforts.

Uses of TCMP Data by Others

TCMP data is also used by other agencies in the Executive and Legislative Branches of government, such as:

- The Bureau of Economic Analysis (BEA) uses tabulations of TCMP data in conjunction with other data to adjust national income and products accounts;
- The Joint Committee on Taxation uses TCMP data to estimate potential revenue gains from tax proposals intended or expected to affect compliance;
- The Department of the Treasury uses TCMP as a tool in developing tax policy proposals and in estimating revenue effects of proposals to improve taxpayer compliance; and
- The GAO uses TCMP data for a variety of studies.

In addition, two states have obtained the relevant portions of our TCMP data files for studies of compliance with their income tax laws.

Conclusion

In conclusion, our goal is to improve our detection of noncompliance; to more effectively assign our resources to the areas with the highest noncompliance; and to identify compliance problems which can be corrected through legislative change. To achieve this goal, the IRS needs data that is statistically valid within market segments and on a geographic basis. The best methodology that we have identified for securing this data is TCMP.

The IRS is on target to implement the upcoming survey on time. I assure you that we will meet the challenge of conducting these examinations in a timely manner with the least possible burden to taxpayers.

Madame Chairman, this concludes my prepared remarks. I would be happy to answer any questions you or other Subcommittee members may have.

Chairman JOHNSON. Thank you, Mr. Brand.
Ms. Stathis.

**STATEMENT OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY
AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT
DIVISION, U.S. GENERAL ACCOUNTING OFFICE**

Ms. STATHIS. Thank you, Madam Chairman.

We are pleased to be here today, Madam Chairman, and members of the subcommittee. To my left is Ralph Block. He is an Assistant Director in our San Francisco office, who is our person responsible for doing most of our studies of TCMP.

I will summarize my statement and submit it for the record if I might.

Sound tax policy and administration decisions depend on comprehensive, reliable, and timely information on taxpayer compliance. For about 30 years the Taxpayer Compliance Measurement Program has been IRS' primary program for gathering such information. TCMP is unique. Of all the various methodologies that IRS has, it is the only one that gives a statistically reliable indication of nationwide compliance with the Federal Tax Code.

IRS also uses TCMP data to estimate the tax gap, to identify compliance issues, to develop formulas for objectively selecting returns to audit, and to allocate audit resources. Congress and Federal and State agencies rely on this data for policy analysis, for revenue estimating, and for research.

In 1991 IRS proposed a much smaller TCMP because of criticisms that it was too costly, too intrusive, and too untimely. We reported in 1993 that the proposed changes would reduce the TCMP's usefulness and that the criticisms did not justify such a major modification.

We concluded that the additional revenues generated because of tax law and administrative changes resulting from TCMP analyses had far exceeded the costs. TCMP audits may be intrusive but they affect relatively few taxpayers and they help many others avoid an IRS audit. While timeliness is of concern, we concluded that IRS could speed up its analysis of TCMP data if, for example, it validated data earlier in the process.

IRS is getting ready to conduct the most comprehensive TCMP ever undertaken. Currently planned to begin in November, it will include about 153,000 returns of individuals, partnerships, S corporations, and small corporations.

In comparison to past surveys, the upcoming TCMP should provide IRS auditors with more information and better tools with which to perform more efficient, more effective audits. IRS hopes to collect data for the first time on the reasons for noncompliance and on the particular tax issues involved.

Some of the steps most critical to the success of this TCMP are scheduled to occur within the next several months. These include testing a computerized data collection system and training the auditors who will do the TCMP audits. If the planned data collection system does not work, IRS has developed a backup system but it has fewer capabilities. Even if the planned system does work, IRS currently does not have enough computers for all of the auditors to use the system. That problem needs to be resolved to make the results more useful for compliance research.

IRS also needs to modify the TCMP data base to make available all of the data that the data collection system can provide and to work on computerizing the audit workpapers so that they will be more readily available to researchers.

With that, I will conclude my oral statement and be pleased to answer your questions.

[The prepared statement and attachments follow:]

TAXPAYER COMPLIANCE MEASUREMENT PROGRAM

SUMMARY OF STATEMENT OF
JENNIE S. STATHIS
DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Sound tax policy and administration decisions depend on comprehensive, reliable, and timely information on taxpayer compliance. For about 30 years, the Taxpayer Compliance Measurement Program (TCMP) has been the Internal Revenue Service's (IRS) primary program for gathering such information. IRS uses the data for measuring compliance levels, estimating the tax gap (i.e., the difference between the amount of income tax owed and the amount voluntarily paid in a year), identifying compliance issues, developing formulas for objectively selecting returns to audit, and allocating audit resources. Congress and federal and state agencies use TCMP data for policy analysis, revenue estimating, and research purposes.

In 1991, IRS proposed a much smaller TCMP because of criticisms that it was too costly, too intrusive, and too untimely. GAO reported in 1993 that IRS' proposed changes would reduce the TCMP's usefulness and that the criticisms did not justify such a major modification. GAO concluded that the additional revenues generated because of tax law and administrative changes resulting from TCMP analyses have far exceeded the cost. And while TCMP audits may be intrusive, they affect relatively few taxpayers but help many others avoid an IRS audit. While timeliness is of concern, GAO concluded that IRS could speed up its analysis of TCMP data if, for example, it validated data earlier in the process.

IRS is getting ready to conduct the most comprehensive TCMP ever undertaken. Currently planned to begin in November 1995, it will include about 153,000 individual and business taxpayers. In comparison to past TCMP surveys, this one should provide auditors with more information and give them better tools with which to perform more efficient, more effective audits. IRS hopes to collect data for the first time on the reasons for noncompliance and on the specific tax issues involved.

Some of the steps most critical to the success of this TCMP are scheduled to occur within the next several months. These include testing the computerized data collection system and training the auditors. If the planned computerized data collection system does not work, a backup system may be used that has fewer capabilities. However, even if the system does work, IRS does not currently have enough computers for all of its auditors to use it. To make the results most useful for compliance research, IRS also needs to modify the TCMP database to make available all the data the system can provide and computerize the audit workpapers.

Madam Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the Internal Revenue Service's (IRS) Taxpayer Compliance Measurement Program (TCMP). TCMP is a key component of IRS' overall compliance strategy, providing both baseline compliance measurements and data to help IRS improve its compliance programs. IRS collects TCMP data by performing audits on a random sample of taxpayer returns in which every line of every return is examined.

My statement today covers the importance of the TCMP, our conclusions on criticisms of the TCMP, and features and status of the planned TCMP of 1994 tax returns.

I would like to begin with a brief description of TCMP.

TCMP AND ITS USES

TCMP began in 1962 when IRS recognized the increased importance of measuring compliance with the tax laws. Since then, TCMP audits have covered 11 different types of returns. TCMP audits of individual returns have been the most frequently employed, generally being conducted every 3 years. TCMP audits have also been conducted on the returns of corporations, partnerships, and S-corporations, but less frequently than on those submitted by individuals. It has taken IRS more than 4 1/2 years to complete a TCMP. This time frame covers the planning phase (which occurs before tax returns are filed) to final data analysis, which includes estimating compliance levels and developing formulas for selecting returns to audit in succeeding years.

TCMP is a unique tool in IRS' array of strategies to measure and correct noncompliance. It is the only tool that allows IRS to make statistically reliable estimates of compliance nationwide. TCMP data are also important to non-IRS users in congressional and executive branch agencies and academia for policy formulation, research, and revenue estimation purposes.

IRS uses TCMP data to develop objective, mathematical formulas, which it then uses to score returns for audit selection. In this way, IRS can make more efficient use of its audit resources and avoid burdening compliant taxpayers. For example, in 1968, the year before IRS started using this scoring system, about 43 percent of IRS' audits resulted in no change to an individual's tax liability. By using TCMP-based formulas, IRS has been able to more accurately select tax returns requiring changes, thus reducing the no-change rate to less than 15 percent in 1994.

Also, given TCMP's statistical validity and comprehensiveness, it is useful for identifying compliance trends for specific issues and groups of taxpayers. For example, by analyzing 1979 and 1982

TCMP data, IRS identified a significant compliance problem with the number of dependents claimed on tax returns. IRS reasoned that this problem could be mitigated if dependents' Social Security Numbers were required to be entered on tax returns. The 1986 Tax Reform Act required this entry for most dependents claimed. The Joint Committee on Taxation estimated that this change would generate an additional \$300 million in tax revenues annually. IRS has estimated that, as a result of this requirement, taxpayers claimed 7 million fewer dependents on their 1987 tax returns than they did the year before.

TCMP data also allow IRS to estimate the tax gap and its components. The tax gap is the difference between the amount of taxes owed and the amount of taxes voluntarily paid in a year. TCMP data are used to identify the compliance levels with all types of income and deductions and these are the data from which tax gap estimates are constructed.

TCMP data are also used outside IRS to (1) estimate the revenue impact of proposed legislation; (2) adjust the national income accounts, such as the gross domestic product; and (3) conduct research on tax compliance. We have made extensive use of TCMP data in our own analyses of tax administration issues. For example, we used TCMP to identify problems with the Earned Income Tax Credit and erroneous dependent and filing status claims. (A summary of reports in which we made use of TCMP data can be found in appendix I to this statement.)

CRITICISMS OF TCMP

In 1991, IRS decided that, despite its many benefits, TCMP had to be changed to make it less costly, less intrusive on compliant taxpayers, and more timely in producing results. IRS officials believed that these concerns were significant enough for them to undertake a major effort to redesign TCMP. By September of 1992, IRS officials had proposed cutting the sample size by half--to about 25,000 returns for individual taxpayers. IRS officials also proposed modifying TCMP procedures so that not all tax return lines would be audited. In addition, IRS began developing other programs to replace TCMP data, including proposals to use data from operational audits and non-IRS databases to identify noncompliance.

In an April 1993 report, we noted that while these concerns had some validity and TCMP could probably be improved, our analysis of TCMP cases and IRS' support for its concerns led us to believe that these problems were not as significant as IRS asserted.¹ We reported that TCMP was not too costly because past TCMP

¹Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, April 5, 1993).

results had been used to more efficiently allocate billions of dollars in enforcement resources and to recommend tax law changes that generated millions of dollars of revenue a year. We also noted that the burden was small compared with the benefits derived from the TCMP audits. We pointed out that TCMP audits actually reduced the audit burden on taxpayers not included in TCMP to the extent that the use of TCMP data reduced the number of compliant taxpayers selected for other IRS audits. We also noted that IRS could speed up its analysis of TCMP data if, for example, it validated data earlier in the process.

We concluded that the proposed changes to the size and scope of TCMP would undercut its significant benefits. Moreover, IRS itself recognized the value of TCMP as an important source for objective compliance data. Out of this recognition came a new TCMP covering tax year 1994 returns that is larger than previous surveys and for which audits are slated to begin in late 1995.

1994 TCMP--A COMPREHENSIVE EFFORT

The 1994 TCMP will be the most comprehensive TCMP effort ever undertaken. With a sample of about 153,000 income tax returns, this TCMP is designed to obtain compliance information for individuals, small corporations (i.e., those with assets of \$10 million or less), partnerships, and S corporations.² Previously, IRS had done separate TCMP surveys for each of these entity types.

IRS estimates that the TCMP will cost about \$559 million in direct costs over the next 3 fiscal years (1996-1998)--about 16 percent of IRS' estimated \$3.4 billion examination budget--and about \$1.5 billion in opportunity costs, which are the revenues that will not be realized from conducting regular audits. While the primary purpose of TCMP audits is not to produce revenues, IRS also estimates that the revenue yield from these cases will be about \$685 million. The 153,000 taxpayers that will be audited represent about 1/10 of 1 percent (0.1 percent) of the 125 million individual and business taxpayers covered by this TCMP. Thus, relatively few taxpayers will be burdened by TCMP audits. These audits are scheduled to begin in November 1995 and be concluded by May 1998.

The 1994 TCMP sample will stratify tax returns by market segment. A market segment represents a group of taxpayers with similar characteristics, such as those in manufacturing, regardless of

²An S corporation is one taxed similarly to a partnership. A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders then include in their income their share of the corporation's separately stated items of income, deduction, loss, and credit.

the type of return they file. IRS plans to stratify the sampled returns into 24 business (including one on foreign controlled corporations) and 3 nonbusiness (individual) market segments. IRS believes that stratifying the sample in this manner will allow it to more effectively use TCMP data for identifying noncompliance trends and selecting cases for audit. To ensure comparability with previous TCMP surveys, the sample can also be analyzed in the groupings used in prior TCMP surveys (i.e., by return type, assets, and income). (Appendix II shows the number of sampled cases and estimated number of taxpayers in each market segment.)

IRS also plans to provide its auditors more information on each sample case than in the past. Auditors are to receive 3 years of tax returns (1994 and the two prior years), third-party information returns, and other taxpayer-specific data. Also, District Office Research and Analysis sites are to provide industry-specific profiles for each market segment in their geographical areas. IRS believes that this additional information will help auditors better plan their audits and reduce taxpayer burden by requesting only those taxpayer records that are needed for the audit. This additional information should also improve the results, and thus the value, of TCMP audits.

Unlike in prior surveys, in the 1994 TCMP auditors will try to identify and record the cause of noncompliance and the related tax issues. Knowing the specific tax issues involved and understanding the reasons for noncompliance will help IRS develop cost-effective ways to improve compliance.

IRS is emphasizing quality audits in this TCMP and is training auditors on how to spot potential noncompliant behavior in specific market segments. IRS has also modified its quality review program to help ensure quality audits. In past TCMP surveys, quality control was left largely to line supervisors. For the 1994 survey, IRS plans to have a three-tier quality control program, in addition to supervisory review. In the first tier, an "in-process" review team will review audit workpapers on a sample basis while the audits are still under way to help ensure that auditors are doing quality audits. For the second tier, audit managers will review each case prior to closure. Finally, IRS' audit quality review group will review a sample of closed cases. In addition, the District Office Research and Analysis sites plan to review data entered onto the TCMP database for input accuracy.

In past TCMP surveys, IRS concentrated primarily on income tax issues. In the 1994 survey, employment taxes will receive more attention. Examiners will be told to refer businesses that appear to be in violation of employment tax regulations to employment tax auditors. Information from these audits will also

be part of the TCMP database. This effort should provide much needed information on employment tax compliance as well as data on the treatment of workers as independent contractors--an issue that has suffered from the lack of statistical data and has been the subject of extensive controversy.

Finally, IRS hopes to improve the data collection process. In past TCMP surveys, auditors manually recorded audit adjustments on a checksheet, which was later transcribed into the TCMP database by district or regional office clerical staff. IRS officials have long had a concern about errors that occurred during this data entry process and were not detected until long after the audits were complete. In the 1994 TCMP, for the first time, all case data will be entered directly into computers. To help ensure accurate data, IRS plans to have computer software to do consistency checks that will alert the auditor to correct errors while the audit workpapers are still available for reference. Using such computerized input should reduce the potential for transcription errors and improve the quality of the data transmitted to the TCMP database maintained at IRS' Detroit Computing Center.

STATUS OF THE 1994 TCMP

The 1994 TCMP offers IRS an opportunity to obtain information on the compliance characteristics of a broad segment of the taxpaying population. It is important that TCMP proceed on a timely basis because IRS' compliance data are becoming quite old. The longer the interval between TCMP surveys, the less useful is TCMP, given changes in the economy and the tax law. The latest TCMP surveys were made of 1988 individual returns, 1987 small corporation returns, 1984 S corporation returns, and 1981 partnership returns. The 1994 TCMP, however, is not progressing as smoothly as IRS expected.³

IRS has not met some of its key milestones, including testing of the data collection system to be used for gathering data and development of training materials. Consequently, the first audits will be delayed at least one month, to November 1995.

- IRS is developing two electronic checksheets or data collection systems for TCMP. The Totally Integrated Examination System (TIES), under development for use in the regular audit program, is being modified to meet TCMP specifications. Because IRS officials are not sure whether TIES will meet the TCMP data requirements, IRS is also

³In December 1994, we issued a status report on the progress IRS was making on planning for TCMP entitled Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

developing a backup system specifically for TCMP. IRS had planned to test these systems in June 1995; but at that time neither was ready. IRS now hopes to have these tests completed by August 31, 1995.

- IRS had planned to have training materials available by March 1995 and to complete training of the auditors by September 1995. As of July 12, 1995, the training materials were not complete. Auditor training is now planned to begin in October 1995, with most auditors trained by the end of November 1995.

It is important to have a fully functional data collection system as soon as possible because other steps in the planning process, such as auditor training and development of TCMP procedures, depend on it. IRS is counting on TIES to work, but is also developing a backup system in case TIES fails. TIES has the capability to do more audit routines better and faster than the backup system. For example, TIES can automatically produce the Revenue Agent Report that taxpayers receive on the results of their audits. TIES also has the capability to perform on-line data validity and consistency checks, helping ensure that TCMP data are accurate. The backup system does not have these capabilities. Therefore, if TIES cannot be used for TCMP, it may take auditors longer to complete each audit; and TCMP data will be more prone to error.

IRS officials are confident that TIES will pass the August tests, but do not have the same level of confidence that TIES can be used for all TCMP audits. They told us that all revenue agents who will conduct audits at a taxpayer's place of business are scheduled to have portable computers that can handle TIES. These agents are scheduled to conduct about 57,000 of the 93,000 Form 1040 TCMP audits. The remaining 36,000 Form 1040 audits are supposed to be done by tax auditors in IRS field offices. However, all tax auditors do not have access to computers that can use TIES.

According to IRS officials, only 29 of the 63 district offices have computers with TIES capability that tax auditors can use. IRS estimates that about 21,000 TCMP returns will have to be audited either by having tax auditors use the backup data collection system or having revenue agents who have adequate computers conduct the audits. Using the backup data collection system could delay audits and adversely affect the quality of the TCMP data. Having revenue agents audit the returns would increase program costs.⁴

⁴IRS estimated that having revenue agents conduct the audits would reduce examination yield by \$394 million over fiscal years 1996 through 1998.

IRS has estimated that it would cost about \$1.7 million to provide the additional 425 computers and related furniture needed to properly equip tax auditors. IRS officials said that funds are not available to make these purchases. IRS has thus encouraged the districts where tax auditors do not have computers with TIES capability to canvas their districts for computers that can be given to tax auditors doing TCMP audits.

We are concerned that the districts may not find enough computers and will therefore use either more costly revenue agents to conduct the audits or have tax auditors use the less efficient backup collection system.

We are also concerned that IRS will not be taking full advantage of all TIES features for TCMP purposes. IRS officials told us that the "other expenses" and the "other income" lines on business returns are often adjusted during audits, sometimes relating to more than one type of expense or income. Using TIES, auditors may assign codes that identify the specific reason and related tax issue for each type of adjustment made to these lines. However, only one adjustment code will be put on the TCMP database at the Detroit Computing Center.

We were told that the TCMP database would have to be modified to accommodate more than one code and that it would be too costly to do so. However, it may be possible to create a subsidiary file that could be attached to the database that would allow additional codes to be captured. IRS may want to consider this option so that these data can be used for compliance research purposes.

Similarly, TIES allows for computerized workpapers, with detailed information on reasons for noncompliance and audit techniques used. However, according to IRS officials, while auditors are required to use the TIES data collection feature, IRS cannot require auditors to use the TIES workpaper feature because the union contract gives auditors the option of generating workpapers by hand. In our 1994 TCMP status report, we suggested that IRS find ways to make workpapers available through electronic media so that the workpapers would be readily available for compliance research.

IRS agreed to explore the feasibility of at least retaining the disks in cases where auditors use computerized workpapers. We are not aware of any action that IRS has taken on this issue. Better, more efficient compliance research could be done if all audit workpapers were computerized and readily accessible to researchers.

In concluding my testimony, I would like to again take this opportunity to indicate our support for TCMP. IRS' 1994 TCMP plans, if effectively implemented, should go a long way towards improving its collection of compliance data. Better data provide the foundation for better compliance programs as well as the capability to avoid auditing compliant taxpayers. While the start of audits will be delayed at least 1 month, it appears that TCMP audits can still be completed on time. This can only be done, however, if IRS makes a concerted effort to finish development and testing of its data collection system, as well as ensure that all auditors are adequately equipped and trained by the end of 1995.

This concludes my testimony. We will be pleased to answer any questions you may have.

GAO REPORTS THAT USED TCMP DATAErroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993)

We found that the dependent support test was too complex and burdensome for many taxpayers to voluntarily comply with; about 73 percent of dependent claims failed to meet the dependent support test. We recommended that Congress consider enacting legislation that would substitute a residency test for the support test and consider eliminating the household maintenance test from the head-of-household filing status. We recommended that IRS correct the problems in its limited matching program and implement a 100-percent computer matching program to identify erroneous dependent claims. We used a sample of 1988 TCMP cases to determine the sources of erroneous dependent and filing status claims.

Many Benefits and Few Costs to Reporting Net Operating Loss Carryover (GAO/GGD-93-131, Sept. 23, 1993)

We found that IRS instructions on the amounts that corporations should report on the net operating loss deduction line were incomplete and confusing. We also found that it was profitable to audit NOLD returns. We recommended that IRS revise its instructions on reporting the deduction to clarify amounts that can be deducted, clearly define net operating loss carryover, require corporations to annually report their carryovers, and use the reported amounts to track corporate deductions of these losses. IRS has implemented our recommendations. We used the 1987 corporate TCMP to identify taxpayers who claimed the NOLD incorrectly.

Computer Matching Could Identify Overstated Business Deductions (GAO/GGD-93-133, August 13, 1993)

Small business tax noncompliance is a serious problem. TCMP audits showed that small corporations in 1987 and sole proprietors in 1988 overstated their deductions by an estimated \$40 billion and did not file required information returns on at least \$19 billion in payments to individual taxpayers. Our analysis of TCMP databases showed reverse matching could have identified overstated deductions and unreported wages. We recommended that IRS do a limited test of a reverse matching program on wages while it addresses the limitations to an expanded program for other deductions, such as for services and bad debts.

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

We found that EITC appears to be achieving its goals. Those workers who receive the credit and are below the poverty line have their overall federal tax burden substantially reduced, while those qualified workers who are above the poverty line have their taxes reduced somewhat. Also, work incentives for some workers appear to be enhanced by the credit. However, we also found that one-third of the taxpayers who received the credit were not entitled to it. This occurred primarily because tax filers claimed the wrong filing status. We recommended that IRS modify the tax return to capture all the requisite qualifications information. We used TCMP data to determine the magnitude and types of erroneous EIC claims that IRS' processing procedures could not detect.

IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, August 2, 1994)

Sole proprietors account for a disproportionate share of noncompliance. Although only 13 percent of individual taxpayers, they account for an estimated 40 percent of the noncompliance. We found that IRS did not have a comprehensive compliance strategy for sole proprietors. We noted that IRS could better use existing TCMP data to identify root causes of noncompliance. We demonstrated this by using TCMP data to look at the causes of noncompliance for truckers and automobile body repair shops. We recommended that IRS develop pro forma recordkeeping for truckers and ensure that insurance companies provided information returns on payments to automobile repair shops.

Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, December 28, 1994)

Using the 1988 TCMP and the broadest definition of service provider, we estimated that between 0.2 million and 1.6 million of the 11.5 million service providers may be misclassified employees. The estimate of the 1992 income tax gap for these service providers ranged from \$21 billion to over \$30 billion. If those misclassified workers were reclassified as employees, a significant amount of the taxes owed would likely have been withheld by the employers. IRS studies have indicated that taxpayers subject to withholding were substantially more compliant.

MARKET SEGMENTS AND SAMPLE SIZES FOR IRS' 1994 TCMP

Table II.1: Market Segments and Sample Sizes for IRS' 1994 TCMP--
Individuals

Market segment	Population of market segment (000)	Sample size		
		Form 1040s	All returns	Percent that are 1040s
Nonbusiness--no schedules	66,069	5,042	5,042	100.0
Nonbusiness--no Schedules C, E, or F	24,647	15,175	15,175	100.0
Nonbusiness with Schedule E	10,250	7,958	7,958	100.0
Very small business	9,785	5,105	5,105	100.0
Farm business	850	6,852	8,602	79.7
Building trade contractors	942	3,135	5,851	53.6
All other construction	226	2,759	6,049	45.6
Manufacturing	201	1,502	6,313	23.8
Mining and minerals	28	1,502	3,457	43.4
Agricultural services	233	1,506	3,067	49.1
Wholesale trade	241	2,167	7,792	27.8
Direct sales to individual	187	1,506	1,595	94.4
Auto and boat dealers and service stations	149	1,504	3,965	37.9
Food and beverage	342	2,841	4,931	57.6
Apparel, furniture, and general merchandise	130	1,506	3,540	42.5
Retail--all other	295	1,526	4,268	35.8
Real estate	312	1,506	5,759	26.2

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.1: Market Segments and Sample Sizes for IRS' 1994 TCMP--
Individuals

Market segment	Population of market segment (000)	Sample size		
		1040s	All returns	Percent that are 1040s
Finance and insurance	246	1,758	4,040	43.5
Air, bus, and taxi	75	1,508	2,805	53.8
Other transportation and utilities	381	1,522	3,703	41.1
Amusement, recreation, and motion pictures	194	1,507	3,671	41.1
Medical and health	444	2,042	5,034	40.6
Business and personal services	509	1,682	6,144	27.4
Hotel, lodging, automotive	813	1,509	5,473	27.6
Unable to classify	57	12,024	15,317	78.5
Miscellaneous business and personal services	532	2,382	2,382	100.0
Miscellaneous services	465	3,159	5,496	57.5
Total*	118,071	92,185	152,534	60.4

*Totals may not add due to rounding.

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.2: Market Segments and Sample Sizes for IRS' 1994 TCMP--Corporations

Market segment	Population of market segment (000)	Sample size		
		Form 1120s	All returns	Percent that are 1120s
Nonbusiness--no schedules	0	0	5,042	0.0
Nonbusiness--no Schedules C, E, or F	0	0	15,175	0.0
Nonbusiness with Schedule E	0	0	7,958	0.0
Very small business	0	0	5,105	0.0
Farm business	50	538	8,602	6.3
Building trade contractors	144	1,615	5,851	27.6
All other construction	116	2,175	6,049	36.0
Manufacturing	216	3,662	6,313	58.0
Mining and minerals	25	665	3,457	19.2
Agricultural services	17	444	3,067	14.5
Wholesale trade	213	4,502	7,792	57.8
Direct sales to individual	not available	0	1,595	0
Auto and boat dealers and service stations	74	1,369	3,965	34.5
Food and beverage	129	936	4,931	19.0
Apparel, furniture, and general merchandise	51	917	3,540	25.9
Retail--all other	175	1,625	4,268	38.1
Real estate	266	2,967	5,759	51.5

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.2: Market Segments and Sample Sizes for IRS' 1994 TCMP--
Corporations

Market segment	Market segment population (000)	Sample size		
		1120s	All returns	Percent that are 1120s
Finance and insurance	103	994	4,040	24.6
Air, bus, and taxi	8	382	2,805	13.6
Other transportation and utilities	76	963	3,703	26.0
Amusement, recreation, and motion pictures	46	963	3,671	26.2
Medical and health	210	1,708	5,034	33.9
Business and personal services	175	3,173	6,144	51.6
Hotel, lodging, automotive	127	2,680	5,473	49.0
Unable to classify	0	2,002	15,317	13.1
Miscellaneous business and personal services	not available	0	2,382	0.0
Miscellaneous services	294	1,080	5,496	19.7
Total ^a	2,514	35,360	152,534	23.2

^aTotals may not add due to rounding.

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.3: Market Segments and Sample Sizes for IRS' 1994 TCMP--S-corporations

Market segment	Market segment population (000)	Sample size		
		Form 1120Ss	All returns	Percent that are 1120Ss
Nonbusiness--no schedules	0	0	5,042	0.0
Nonbusiness--no Schedules C, E, or F	0	0	15,175	0.0
Nonbusiness with Schedule E	0	0	7,958	0.0
Very small business	0	0	5,105	0.0
Farm business	37	591	8,602	6.9
Building trade contractors	109	598	5,851	10.2
All other construction	80	594	6,049	9.8
Manufacturing	121	595	6,313	9.4
Mining and minerals	17	597	3,457	17.3
Agricultural services	25	596	3,067	19.4
Wholesale trade	111	595	7,792	7.6
Direct sales to individual	not available	0	1,595	0.0
Auto and boat dealers and service stations	46	596	3,965	15.0
Food and beverage	135	597	4,931	12.1
Apparel, furniture, and general merchandise	40	596	3,540	16.8
Retail--all other	128	593	4,268	13.9
Real estate	204	594	5,759	10.3

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.3: Market Segments and Sample Sizes for IRS' 1994 TCMP--S-corporations

Market segment	Market segment population (000)	Sample size		
		Form 1120Ss	All returns	Percent that are 1120Ss
Finance and insurance	68	598	4,040	14.8
Air, bus, and taxi	11	599	2,805	21.4
Other transportation and utilities	64	594	3,703	16.0
Amusement, recreation, and motion pictures	52	594	3,671	16.2
Medical and health	74	595	5,034	11.8
Business and personal	244	593	6,144	9.7
Hotel, lodging, automotive	78	593	5,473	10.8
Unable to classify	32	595	15,317	3.9
Miscellaneous business and personal services	Not available	0	2,382	0.0
Other miscellaneous services	139	598	5,496	10.9
Total ^a	1,815	12,501	152,534	8.2

^aTotals may not add due to rounding.

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.4: Market Segments and Sample Sizes for IRS' 1994 TCMP--
Partnerships

Market segment	Market segment population (000)	Sample size		
		Form 1065s	All returns	Percent that are 1065s
Nonbusiness--no Schedules	0	0	5,042	0.0
Nonbusiness--no Schedules C, E, or F	0	0	15,175	0.0
Nonbusiness with Schedule E	0	0	7,958	0.0
Very small business	0	0	5,105	0.0
Farm business	104	621	8,602	7.2
Building trade contractors	31	503	5,851	8.6
All other construction	25	521	6,049	8.6
Manufacturing	24	554	6,313	8.8
Mining and minerals	39	693	3,457	20.0
Agricultural services	21	521	3,067	17.0
Wholesale trade	18	528	7,792	6.8
Direct sales to individual	1	89	1,595	5.6
Auto and boat dealers and service stations	16	496	3,965	12.5
Food and beverage	56	557	4,931	11.3
Apparel, furniture, and general merchandise	23	521	3,540	14.7
Retail--all other	56	524	4,268	12.3
Real estate	662	692	5,759	12.0

Source: Final 1994 TCMP Sample Design.

APPENDIX II

APPENDIX II

Table II.4: Market Segments and Sample Sizes for IRS' 1994 TCMP--
Partnerships

Market segment	Market segment population (000)	Sample size		
		Form 1065s	All returns	Percent that are 1065s
Finance and insurance	134	690	4,040	17.1
Air, bus, and taxi	3	316	2,805	11.3
Other transportation and utilities	23	624	3,703	16.9
Amusement, recreation, and motion pictures	23	607	3,671	16.5
Medical and health	29	689	5,034	13.7
Business and personal services	76	696	6,144	11.3
Hotel, lodging, automotive	58	691	5,473	12.6
Unable to classify	7	696	15,317	4.5
Miscellaneous business and personal services	Not available	0	2,382	0.0
Miscellaneous services	72	659	5,496	12.0
Total*	1,501	12,488	152,534	8.2

*Totals may not add due to rounding.

Source: Final 1994 TCMP Sample Design.

(268676)

Chairman JOHNSON. Thank you, very much.

There are a number of questions that we would like to pursue and the first of them focuses on this issue of whether the IRS is on target in implementing the upcoming survey. The GAO reports that the Service did not meet its June milestone of testing the data collection, nor did it meet its March expectation of having training materials available.

Mr. Brand, would you like to comment?

Mr. BRAND. Yes, I would, Madam Chairman.

We will have the training materials developed by August 1. The training is scheduled for September and October and we do not anticipate any problems with that. I do not recall the milestone being earlier, but if it was, it was.

In terms of the data collection and gathering process, we have developed something we call TIES which is our automated system for revenue agents. We have been concerned because of a lack of computers in all of our offices, so we did design a backup system. That backup system is in place and we will be able to gather the data.

So I believe we have met the GAO concerns. We did work with them on the audit. We have been responsive to the audit recommendations and I believe we are on target to commence.

Chairman JOHNSON. Would you like to comment, Ms. Stathis?

Ms. STATHIS. We are hopeful that TIES will work for TCMP because it does online data consistency and validity checks as the data is being entered.

It also automatically generates the audit report, so the taxpayer will have it immediately at the end of the audit and know what the results are. Because of their automatic generation, the amount of work that the auditors have to put into doing the reports will be reduced. So we are really hopeful that TIES will work for the TCMP and that IRS will not have to use the backup system for any of the audits.

I think this is one of the issues with having enough computers. Having enough will allow TIES to be used for all of the TCMP audits.

Chairman JOHNSON. But is it true that you have not tested your system of collecting this information, and so while you have a backup system, you do not know whether your planned system is even going to work and you have not tested the backup system?

Mr. BRAND. We believe we have tested it sufficiently to know that it will, in fact, work. The issue is, can we get enough computers to some of our front-line employees? We are looking now for re-direction of computers from other areas.

What we will probably end up with is a mix with our most difficult cases being done by the TIES system. We will use some of the other cases that are not as complex. We may need to use those. But in both instances, again, the data gathered will be the same, it will be loaded in an automated manner, it will be analyzed in an automated manner. The real difference is the generation of the examination reports we will be able to do electronically through TIES. If we do not have TIES, we will have to generate the examination reports manually; that is the difference.

Chairman JOHNSON. But is there not a difference in the ability of the different systems to collect information?

Mr. BRAND. No. Both systems will gather the same amount of data collected from the TCMP. It is the ease with which you complete the examination and the ease with which you issue the revenue agent's report, that is the difference between the two systems.

Chairman JOHNSON. Are you satisfied that they will be able to do this?

Ms. STATHIS. We are very hopeful that it is going to work.

Chairman JOHNSON. You mentioned, Ms. Stathis, in your comments that the criticism of the surveys has been, in part, that they have not identified the underlying reasons for taxpayer errors. Do you think that this new TCMP effort will do a better job of identifying the reasons for taxpayer noncompliance?

Ms. STATHIS. It should. In the past, information on the reasons for noncompliance was not routinely collected in any kind of checksheet fashion. Often the auditor would put a reason in the workpapers but those were not computerized, so you had to do a lot of research and work to find the reasons. This year the auditors are going to be asked to enter codes into the system to record what they think the reason is and to identify the tax issue. The information should be very helpful to Congress as it considers what changes should be made to the Tax Code. You will be able to know which particular issues are giving taxpayers the most problems.

Chairman JOHNSON. Do you think that the degree to which they are pursuing the issue of the status of various employees is adequately addressed in their plans?

Ms. STATHIS. IRS is going to be doing some followup work on employment issues and if it is carried out as currently planned, more information on employment issues will be available than was ever available before.

Chairman JOHNSON. One last question and then I will yield to my colleagues.

One of the things that concerns me about the amount of resources that we are putting into this effort is that it is very big money, and probably the biggest problem in the Tax Code is the underground economy. This seems to be totally irrelevant to the people who do not pay their taxes.

Now, is there any aspect of this program that tries to reach to that problem of the underground economy?

Mr. BRAND. This TCMP program is focusing primarily on the fact that the largest portion of the estimated tax gap is unreported income. Now, we have only estimated the legal sector income. We have tried various different times in the past to estimate the tax gap from the illegal sector. We have never been successful in coming up with a figure as far as legal sector income is concerned.

I would just say, however, that we do estimate that in the legal sector, as far as unreported income, that you are talking approximately \$62 or \$62.5 billion.

Chairman JOHNSON. That has been discovered in past report studies?

Mr. BRAND. In the past, we used two—I am sorry, Madam Chairman, I may have cut you off. We used two processes to basically estimate the tax gap. It is based on the TCMP but the TCMP data

then is revitalized and brought forward with a series of economic indicators that we get from different places. From these sources, we are able to do an estimate. It is an estimate of the tax gap on those factors.

Chairman JOHNSON. How much unreported income have you actually found in your last series of this sort?

Mr. BRAND. Using the last TCMP audit results for tax year 1992, we have estimated a tax gap for individuals of basically \$62.5 billion from unreported income.

Chairman JOHNSON. What proposals did you make to change the law so that we would better get at that unreported income in the future?

Mr. BRAND. There has been a series of proposals over the years. I can give you three or four examples.

Chairman JOHNSON. OK.

Mr. BRAND. One of the things that we uncovered in a previous TCMP was the fact that, by law, you are required, if you claim a deduction for your State income tax refund in one year, you are required to report any refund in the following year as income.

A recommendation was made and the law was changed requiring information reporting on that. The initial year that was worth \$144 million in additional tax revenue. We also know, through TCMP and other research methodologies, that TCMP statistically confirms areas that we have concerns about but we are not able to statistically confirm it.

In 1986, my recollection is that we asked for legislation, and Treasury asked for legislation that would require the listing of Social Security numbers to claim dependents. Almost 7 million dependents disappeared in the following tax year as a result of that change.

There are a number of instances where, in fact, we felt there may have been noncompliance and we were basically able to statistically prove it through the sampling process. It has resulted in revenues and tax law changes.

Chairman JOHNSON. So what I am gathering is you really are deriving information that has to do with compliance, and through noncompliance avoidance of taxes. But you are not finding ways to identify cash transactions that expand the income of many but do not then become reportable and taxable?

Mr. BRAND. Our process of examination does require probes for unreported income and that is a major part of the methodology that we use in examinations to verify income reported. The difference is that we do not attempt to use TCMP and we have not been successful with other methodologies to develop tax gap estimates of illegal sector income. We do not estimate the tax gap from narcotics, prostitution, or activities that are illegal.

Chairman JOHNSON. I understand that. I am not looking so much at illegal income. I understand the problems with that. I am looking at, in a sense, the whole cash economy that moves without accountability to the Federal Government for taxes due. The kinds of things you are describing to me are enforcement and compliance with existing tax law by taxpayers who are complying in general, but not adequately.

In doing those audits, have you been able to find any ways to get at other sources of income that are not being reported?

Mr. BRAND. Well, the audit techniques that we do will, in fact, allow us to make various judgments as to additional unreported income. As you go into the examination process, basically when you do the preanalysis of the income tax return, you begin to look at various different reasons that there may be unreported income and there are various different audit techniques that you apply that will, in fact, reveal unreported income.

Then you have to determine—

Chairman JOHNSON. Considering the dimensions of this problem, I do not hear your citing examples of changes in the law that have been made to better reach this income. But this is kind of a tangential issue and I am going to yield to my colleagues so that we can move along.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Madam Chairman.

Mr. Brand, I would like to know some of the practical impact of your program. In a hypothetical situation, if a working couple with two children and a combined income of between \$30,000 and \$50,000 is selected for the TCMP, how long will it take them, on average, to complete the audit?

Mr. BRAND. That is going to be dependent, of course, on what records they have available and so forth. If you are assuming that they are wage earners, and that their deductions are basically either standard deductions with some dependents or else it is a schedule A that has relatively small amounts of deductions and so forth. An audit like that with the records available should take on average 1½ hours to complete.

It gets more complex, obviously, as you get into other areas.

Mr. ZIMMER. Well, how often are the records not available in your experience?

Mr. BRAND. It depends on the individual taxpayer and their recordkeeping.

Mr. ZIMMER. Well, we are talking about the average. For instance, I do not know if I could find my marriage license and—

Mr. BRAND. I cannot give you that estimate, Mr. Zimmer.

Ms. STATHIS. I do know that from the last TCMP the average amount of time that the IRS auditors spent on an individual's return was 13 hours. But that—

Mr. ZIMMER. Is that with the individual?

Ms. STATHIS [continuing]. That is the auditor's entire time, beginning with preparation. The amount of time they would spend with the taxpayer would be a subset of that.

Mr. BRAND. From a scheduling standpoint for interviews, an examination of a nonbusiness individual return most likely would be done within the office. From a scheduling standpoint, we are normally scheduling four to five examinations a day; three to four in a situation if TCMP is what we are trying to do.

That allows our examiners to complete workpapers, an audit report, and the TCMP checksheet.

Mr. ZIMMER. Now, does the audit take place during normal business hours?

Mr. BRAND. Yes, sir.

Mr. ZIMMER. In the hypothetical situation both the husband and wife are working; do they both have to attend the audit?

Mr. BRAND. No. They would not have to both attend the audit. They could, depending on what the nature of the situation is, but one or the other is generally fine.

Mr. ZIMMER. What sorts of questions would they be asked?

Mr. BRAND. Basically we would ask for verification of income. We would, in fact, go through the tax return on a line-by-line basis in terms of what was reported so we would want to look at the W-2s that reflect the information on the tax return in terms of income. We would look at the 1099 forms. We would compare that, obviously, with the information that we have in the files in those particular areas. We would ask the question, is there other unreported income? We would look at the dependents.

The depth is up to the individual examiner. As you start the audit and, in fact, you start through the first 10 lines—and let us say there are 5 entries on the first 10 lines—you basically begin to develop a pattern that this is a compliant taxpayer.

Then the examiner has the ability to limit the scope of what they would accept for proof and what they would basically require the taxpayer to provide. It is partially judgment, but we do require them to make an entry, to make a comment on each line item. Because this is, in fact, a research examination as opposed to an examination strictly for tax.

Mr. ZIMMER. But, for example, how frequently would a married couple be asked for a marriage license?

Mr. BRAND. It would depend in many instances, but we would frequently ask for that. We would ask to prove marital status. One of the things we would want to prove is that there is a marital deduction.

If you have a situation where this was primarily a compliant taxpayer and all the other items were verified, then the judgment of the auditor could, in fact, say, I will accept the proof of what I have got. Part of it is based on oral testimony and other types of proof.

Mr. ZIMMER. Are they given a checklist of things to bring with them, including their marriage license, before they attend?

Mr. BRAND. As we send the letter out, we inform the taxpayer of the items that are under consideration and since all items are under consideration, we try to ask people to bring in what we think is needed for verification. Bring in some type of verification of marital status.

Mr. ZIMMER. How frequently do they have to come back? For what percentage of the audits?

Mr. BRAND. Let me provide that for the record. I do not have that with me, but I will be glad to provide that for the record.

Mr. ZIMMER. Does the IRS ask people in these circumstances extraneous questions such as income from nontaxable municipal bonds that do not relate to any line-by-line analysis of the tax return?

Mr. BRAND. We do attempt to get a picture of the taxpayer's financial situation and their economic situation. This goes back to the issue that the chair asked about unreported income, how do you probe for unreported income? So we are looking for indicators

of unreported income to see if, in fact, the tax return is reflective of the individual's financial situation.

But we should not be into an area that is not related to that tax return and is not related to verifying income or assuring that the right amount has been reported.

Mr. ZIMMER. Would the IRS ask about noninterest bearing checking accounts?

Mr. BRAND. We could, yes, sir.

Mr. ZIMMER. About gifts that the taxpayer has received?

Mr. BRAND. The way you would get into discussions in this particular area, Mr. Zimmer, would be if there were indications during the examination that there was income in excess of what had been reported, or there were expenditures in excess of the income that is reported. At that particular point in time, we are trying to determine the source of that additional income. There could be a legitimate source, such as gifts being received or expenditures from gifts, or outlays that might be subject to discussion.

Because what we are trying, again, to determine is the financial picture. Is there a reality as far as the tax return is concerned? Does that tax return represent the financial picture of the taxpayer?

Mr. ZIMMER. So the only questions that you ask are questions that relate to the validity of that tax return, not to other research objectives or data collection interests that you have?

Mr. BRAND. In terms of the research, it is related to the tax return and the financial issues involving that tax return.

Mr. ZIMMER. Well, let us say that the couple refuses to divulge information about a noninterest bearing checking account, would you subpoena that information?

Mr. BRAND. It would depend on the extent of what we felt other noncompliance is. IRS has the ability to summons that but again, I do not know what the situations are. But not with a small income-tax payer in a situation like that, depending on what the other circumstances were. If this largely appeared to be a compliant taxpayer, I doubt we would do that, but, yes, sir, it could happen. It depends on the individual situation.

Mr. ZIMMER. But if your interest was only to develop a data base for your research purposes—

Mr. BRAND. Well, again, I think what we may be doing is two things. The TCMP audit is only slightly different than a regular examination. From the standpoint of the Taxpayer Compliance Measurement Program examination, examiners are expected to exercise the same judgment about the level of proof and need for information as in a regular examination.

Mr. ZIMMER [continuing]. So for TCMP, you are only looking at—might you have a broader scope?

Mr. BRAND. We would only broaden the scope if we felt that there was unreported income on that particular examination. Absent unreported income, there would not be any reason for us to go into it.

Mr. ZIMMER. All right, thank you, very much.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairman.

Ms. Stathis, in your testimony, you state that the additional revenues for the TCMP analysis far exceeded the costs. You gave the example of requiring dependent Social Security numbers to be included and that caused, in 1 year's time, 7 million dependents to be dropped from the claim.

How much revenue did that produce by the dropping of these 7 million dependents, and can you tell us how that related to the cost of the TCMP?

Ms. STATHIS. In our 1993 report, we show that the individual TCMP, the last one that was done, cost \$88 million. The Joint Committee on Taxation had estimated that the dependent SSN change would bring in \$300 million a year. I believe that estimate was before the actual number of 7 million dependents was realized, however. I have seen different estimates on the 7 million, ranging from \$1 billion up to \$3 billion a year. So I am not quite sure what the right number is but I think it is probably the billion dollar figure.

Mr. LAUGHLIN. A billion dollars in additional revenues resulting from this 7 million dependents being dropped from the tax returns?

Ms. STATHIS. That is right.

Mr. LAUGHLIN. Now, what other examples—first before I go there, did those 7 million dependents that were dropped show up as taxpayers somewhere else or did the TCMP indicate what happened to the 7 million that got dropped?

Ms. STATHIS. No, the TCMP was what led to requiring taxpayers to report dependent SSNs. The numbers that were dropped, the 7 million, come from a comparison of the number of dependents who were reported on 1986 tax returns versus the numbers who were reported on 1987 tax returns.

Mr. LAUGHLIN. Can you give us any other examples of changes that resulted in additional revenues? Again, give us the relationship the change caused by way of increased revenues and cost to the TCMP.

Ms. STATHIS. Well, for example, real estate gains are now required to be reported—

Mr. LAUGHLIN. Real estate what?

Ms. STATHIS. Real estate transactions. IRS now gets some form 1099 reporting on real estate transactions because, through TCMP, IRS determined that there was a tax gap in that area approaching \$8 billion. Stock transactions are now reported because that had been found to be about a \$2 billion tax gap issue.

Generally, when additional reporting on a tax return or through a form 1099 information return is required, IRS expects it to increase voluntary compliance and, thus, more of that type of income will be reported.

Going back to Chairman Johnson's question earlier about unreported income, one of the proposals that the Service offered up a year or so ago was something called SINC. I have forgotten what the acronym stood for but SINC, too, was a proposal to have more information reporting on this type of cash income.

Information reporting generally has proven to increase compliance levels and bring in greater revenues.

Mr. BRAND. Mr. Laughlin, if I might, I might be able to give you a couple of more examples if you are interested.

Mr. LAUGHLIN. Yes, sir.

Mr. BRAND. Alimony income was going unreported. That is a \$316 million gain in revenue as a result of requiring information reporting in that area. There were also excessive exemptions for people claiming the additional exemption for being 65 or older. Child care credit was going unreported and being overreported in one instance, and being underreported by the providers of child care. There are a number of examples like that that show billions of dollars of additional revenue.

Mr. LAUGHLIN. You anticipate by doing another TCMP audit that you will uncover other areas where legislation will bring forward additional revenues?

Mr. BRAND. I think the thing to realize about the TCMP is that the primary purpose is to improve the selection process for tax returns. There is the ancillary benefit that we sometimes walk in and find these particular trends. Oftentimes, we confirm the trends statistically that we believe are occurring through our normal examination program, but it provides statistical validity to the problem.

Mr. LAUGHLIN. Ms. Stathis, I have one other area of inquiry and that is that you have stated that the IRS could speed up its analysis of the TCMP data. Did that also include a discovery that the IRS could speed up the time the taxpayer spends going through the audit, and if you could give us some examples of specific recommendations you had in mind when you said they could speed up their analysis?

Mr. BLOCK. I would like to answer that question. IRS is doing a couple of things in this TCMP audit that should reduce the amount of time auditors have to spend with taxpayers. Before the audit begins, each auditor will be supplied with 3 years' worth of taxpayer information. They will have information return data on taxpayers and a number of other types of taxpayer related information. With this information, the auditors should be able to plan their audits and know exactly what questions they will have for taxpayers.

When they visit taxpayers, they should not have to burden them for copies of data they, the auditors, already have. For example, if the auditor already has a W-2, there is no need to ask the taxpayer for the same W-2.

We believe IRS will be able to use the data faster under this TCMP because it will all be entered electronically by auditors. Although IRS will not be able to update its audit selection formulas until all of the data is in, IRS can still use the data as it is being entered to look at trends in noncompliance by geographical area. This should help IRS see some potential problems long before the data from all TCMP cases is analyzed, and it then could start to work on those problems.

That is how we believe IRS should be able to reduce taxpayer burden and speed up use of the data. We do not know for certain that IRS will do that, but we have hopes that it will, and we will be monitoring this process.

Mr. LAUGHLIN. Your response has prompted a second question and that is, you stated the IRS agent will prepare his or her questions for the taxpayer as they come in. It occurred to me that it would also speed up the whole time involved in the audit if the

agent were to give the taxpayer the questions or the areas of inquiry so that they might come prepared rather than feeling like they are going to get sandbagged. I wonder if the IRS or the GAO has given consideration to a decision of having the agent tell the taxpayer what the area of inquiry is going to be?

Mr. BLOCK. Well, the auditors do that in an oblique way when they ask taxpayers to provide various information.

Mr. LAUGHLIN. Is this preliminary to the taxpayer showing up at the audit?

Mr. BLOCK. Yes.

Ms. STATHIS. The letter they receive informing them of the audit should give them that information.

Mr. LAUGHLIN. The information of the areas of inquiry that the agent intends to go into?

Ms. STATHIS. That is right.

Mr. LAUGHLIN. OK. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairman.

Ms. Stathis, I notice in your testimony you say that it has taken IRS more than 4½ years to complete a TCMP. I am assuming that because of the changes in the income tax law that you have got something after you complete it. Because you are making an analysis of what the law was at least 4 years ago, is that correct?

Ms. STATHIS. That is correct.

Mr. HANCOCK. So you have made an analysis that is already 4 years old?

Ms. STATHIS. That is right.

Mr. HANCOCK. So you still do not know. You just know what it was 4 years ago?

Ms. STATHIS. That is right. Timeliness is an issue. It always is, there is always a lag. Not only are there tax law changes, there are other kinds of economic changes.

Mr. HANCOCK. So we know now then that your last compliance report is at least 4 years old, so you do not really know what the compliance is going to be for last year? You only know what it was in 1990 based on the law in 1990.

Ms. STATHIS. Right. Actually some TCMPs are a lot older than that. The last TCMP that was done of partnerships used 1981 tax returns. For S corporations, I believe it was 1984 returns. For small corporations, it was 1987 returns, and for individuals it was 1988 returns.

So the data available right now is very dated.

Mr. HANCOCK. I just want it in the record that this is another indication that we ought to leave the tax law alone for a while until people can figure out what we are doing, because we are already outdated even on your compliance reports. You are spending millions of dollars to make these reports, but by the time you get them completed, it is 5 years old, so you really do not know. You just know what it was 5 years ago. Historical data is all we are talking about.

Ms. STATHIS. That is correct. That is why the point Mr. Block was making is important. For the first time, if IRS is able to enter the TCMP data in the computerized system and have it available

on a more real time basis, there is hope that some of it will be more immediately useable. It will not be valid until all of it is put into the computerized system. But, if sufficient amounts of data are put into the system fast enough, some early indications can be obtained. I think that is the real hope with having the computerized data entry system. That is why we think it is very important.

Mr. HANCOCK. In your compliance investigations, Mr. Brand, do you find that where you get into some particular area that the tax preparers are involved from the standpoint of merely giving incorrect advice to the income-tax payer?

Mr. BRAND. It is one of the things that we will attempt to determine with this particular TCMP. In response to a question of the chair earlier, Ms. Stathis has referenced that we are looking at the causes of noncompliance as we go through the examination process. That is one of the areas we want to look at.

We do know from our compliance programs that you tend to find more changes in returns where the taxpayers are represented. However, those returns also tend to be more complex and there is more tax planning, so it is hard to read a conclusion. I would not want to draw the conclusion that there is a cause and effect. I suspect you would find it in some instances. It is going to be dependent on the individual practitioners, but I believe the complexity of tax returns also enters into it.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Brand, just to follow up briefly, you expressed some concern earlier, as did Ms. Stathis, as to whether or not all of your revenue agents would have adequate computer capability as they move forward in this audit. My understanding is that you need about \$1.7 million to provide the necessary equipment. In the context of a \$550 million program, and considering that the success of the computer aspects of the program will determine the timeliness of the information, are you going to be able to find the \$1.7 million?

Mr. BRAND. Whether we find the \$1.7 million or whether we divert computers from other parts of our operation, we will do this in an automated manner.

Chairman JOHNSON. So you have no question in your mind but that all of the agents participating in this audit program will have good solid computer capability?

Mr. BRAND. We will have the ability to load this data in automated format and be able to analyze in an automated way.

Chairman JOHNSON. Given that fact, can you tell us when this subcommittee could expect a broad outline of your findings?

Mr. BRAND. I believe that you have asked—as I recall, there has been some discussion, Madam Chairman—about us providing reports to you on a periodic basis. We will be more than happy to provide reports as we go through the process of TCMP as to its progress and what we find preliminarily as we go through the process.

The thing that I want to say, though, is that what we are driving for is statistical validity so we can use this for the basis of selection of work and for recommended changes. So what we want to make sure is, whatever we provide, we are going to provide with the

right cautionary note that it may not be valid at this particular point in time.

Chairman JOHNSON. At this time, in looking at the plan that you have laid out, would you estimate that we could have a pretty solid report before us in 3 years?

Mr. BRAND. Yes, ma'am.

Chairman JOHNSON. So we do not have to think in terms of the 5 years of the past?

Mr. BRAND. Again, when we talk about the analysis of the report, I think we may be talking about two things. There is the TCMP data itself. I believe the reports you may be referring to are the estimates that we do on the tax gap which is based on TCMP, but then annually refreshed or refreshed when we do reports with other economic data. We can provide those on a timely basis.

Chairman JOHNSON. We certainly will be interested in those, but we will be more interested in the specific conclusions of the TCMP and their policy implications. Ms. Stathis, do you have any concerns about the ability to provide us with a substantial report in 3 years?

Ms. STATHIS. Not on the TCMP results. One of the things to keep in mind is that the results of the TCMP are used long before the tax gap studies are released. The TCMP results are going to be used to update the selection formulas for identifying returns to audit in the regular audit program. That has already been done using 1988 TCMP results. In fact, updated formulas were used for 1993 tax returns. There are a variety of other uses made of TCMP data long before the tax gap estimates are released.

Chairman JOHNSON. Is that data from which you can draw policy implications that would be available earlier than 3 years?

Ms. STATHIS. Yes.

Chairman JOHNSON. My understanding is that you will not finish the audits for the first 2 years, it will take them 2 years to go through this.

Ms. STATHIS. Well, at the end of 3 years, IRS definitely should have valid data. There will be points along the process when there will be a sufficient sample of particular returns that will be valid earlier than 3 years. Data may not be valid for other types of returns until all results are put into the system, which may take 3 years.

If IRS were to get down to one line item on the return and there were only a certain number of those returns filed, a very large sample would have to be examined in order to obtain valid results. But if the sample was stratified in certain ways, some kind of nationwide sense of compliance problems could be obtained earlier.

We have done a variety of studies for Congress in which we have been asked to study a particular issue. In doing them, IRS has allowed us to use the old TCMP data. So, on a number of our studies, we have gone back in and used the 1988 TCMP workpapers and data in order to analyze—

Chairman JOHNSON. Some of it is very old.

Ms. STATHIS. That is true but the point is the data is useable way before IRS issues the tax gap report.

Chairman JOHNSON. Mr. Portman.

Mr. PORTMAN. I thank the chair.

I thank you all for being here this morning to bring us up to speed on TCMP. I have a number of questions that were really echoed by some of my colleagues already, but I wanted to focus a little more on them.

The two concerns I have are taxpayer burden and the cost of the program. I do not question the value of the previous TCMPs. I wonder if this one is overbroad, whether it is timely, and whether there are ways to make it more efficient.

In terms of the cost to the government, I have heard various numbers this morning and there are various numbers in the testimony that I have looked at. I have seen anywhere from \$200 to \$500-plus million. I guess all I can say is unless someone has some comment on that that gives us a more precise number, that is sort of the range that I would be thinking, \$200 to \$500 million in cost to the IRS to conduct this.

Mr. BRAND. Mr. Portman, I think there are a number of ways to look at cost. The fact is that we will have the employees on board and we will be paying the salaries of the employees, whether they are involved in TCMP examinations or other examination work. So to basically look at the staff years, FTEs and moneys applied, there is one way to estimate it.

The way that I prefer to estimate it is the opportunity cost that is lost. We know by working TCMP examinations that we will suffer a decline in the amount of penalty and interest or the amount of tax and penalties that are recommended, because this is a random sample, and by its very nature, a no change rate is high.

I believe a correct way of estimating cost is to look at revenue projections had we not done the TCMP and applied these FTEs in that manner. My recollection is that that is about \$1.5 billion that we would have received from these particular resources. We know the results. We estimate the results of the TCMP to be about half that, so your opportunity costs are really in terms of revenue over the life of this. The cost of the employees, and so forth, are expended by the—

Mr. PORTMAN. Let us focus a little more on that, if we can. I was not planning to get into this area, but you raise an interesting question and that is what the projected savings are over time really to the system through increased compliance and what are the opportunity costs that would be missed without doing this.

We are talking seriously in this subcommittee and it is a national debate now about fundamental change in the tax system. We are talking about a flat tax, we are talking about a consumption tax. There are various proposals, but all of them are, in essence, replacing the current system with a new one, a radical overhaul of our existing system.

I would think that the TCMP results might well not be generating that kind of savings over time, if indeed we go ahead with this. I think the projections are based on our current system, which I think is unlikely to survive at least past 1997. I think to go ahead with such a massive undertaking of 153,000 individuals and all of the time and effort that the IRS is going to put into this, where otherwise IRS would be focused on making the current system work better over the short term, is questionable, given where we are in terms of major tax reform.

The second issue I have generally is on the burden on the taxpayer. Now, we can make that less, and I think that is in the interest of all of us. Mr. Brand, as you indicated in your response to Mr. Zimmer, it might take about 1 hour for a person in the \$30,000 to \$50,000 range to respond to the audit. I think that is quite optimistic, from my point of view.

I note that, based on some other testimony I have just read through, that up to 60,000 of these returns may well be business returns. I assume that is S corporations, partnerships, sole proprietors, and so on. I cannot imagine that it is going to take 1 hour. I cannot imagine it is going to take 20 hours. I cannot imagine it is going to take anything less than something like 20 to 100 hours for those kinds of taxpayers to pull this information together and to be responsive to all this information.

I have looked through your indirect methods worksheet that I guess all the agents will have. I have looked through the components of so-called economic reality, including club memberships, including hobbies and toys and weddings, including level of sophistication, cultural background, education and work experience, and so on, alimony—there is a lot of information to be compiled and it is a very intrusive process. I think we ought to be realistic about it and not talk about taking 1 hour of the taxpayer's time.

Mr. BRAND. Mr. Portman, I certainly would not want to have indicated, though I believe that is the time that it would take for most of the nonbusiness individuals involved in the TCMP. That would be a mischaracterization on my part.

Mr. PORTMAN. What would you say the average is?

Mr. BRAND. Again, it depends on the type of tax return that is involved—corporate, individual, business, schedule C. We can provide that information for the record and would be more than glad to do that. I think that is an important issue. Again, I would not want to leave this subcommittee with the fact that we do not understand that there is a degree of difficulty that this requires of taxpayers, especially those involved in the no change.

The key here to remember, one thing I would ask you to remember, as you think about this process, is that it does have long-range implications of fairness, because it does provide us with a basis of selecting tax returns on some methodology that is developed and understood, as opposed to us simply shopping for those who we might think within our experience might be noncompliant. This drives our methodology of scoring the selection of tax returns for examination.

The second point that I would ask you to remember is that with this system in the past, with the development of it, we have been able to drive the no-change rate on millions and millions of other taxpayers down to the point that we have been less intrusive. So it is a tradeoff, no question about it.

Mr. PORTMAN. I would just make three comments. No. 1, if we are talking about a 3-year or a 4-year life as we had in 1988, I wonder whether it is going to be relevant. No. 2, I think there have got to be ways, Mr. Brand, for us to make this more efficient than what we are seeing here. It is sort of like a huge focus group. With the current technology and the probability statistics of information that we now have available to us, I find it hard to believe we need

153,000 people in this focus group, so I would think there might be a way to just make it work better, work more efficiently.

Finally, I would say that I think any time we get into these kinds of audits—and I know this is only 153,000 Americans and the benefits could potentially accrue to millions of Americans in terms of less audits in the future—I think we have to look carefully at who is doing these audits, whose word is taken.

You said earlier there will be a lot of discretion with the auditor. Who are these auditors? Are these the junior auditors who often go out on these audits to cut their teeth? Are these people who are going to have some experience, some background?

I think we need to be very careful about doing this, if we are going to do what I perceive to be perhaps an overly broad approach, to do it in a way that gives the taxpayer the ability to have an appeal process or to come back with information that, although it might not be all the documentation lined up as the IRS agent would like, it is something that the IRS can accept and then move on.

Mr. BRAND. One of the things we have done this year to increase quality and to speed up the process is that we have required specific levels of experience before an auditor can be assigned to a TCMP audit. That level of experience obviously will vary dependent on the complexity of the tax return.

Just one other point, too, in terms of the size of the sample. What the TCMP gives us that we have never had before, with the construct of this TCMP, are really two very important items that we have not had before, from a tax compliance standpoint. The first is for the first time in our history we will have compliance rates by 30 geographical areas across the United States which are analogous to our district operations. We will be able to determine what the compliance rate is within a much tighter geographical area.

Before, everything we did was national in its estimation and national in its scope. We know from the prototype work that we have done, that there is substantial difference in compliance in various geographic areas, and so that helps us allocate resources.

The second item is that this will give us compliance by market segment. In the past, someone could be involved in retail, either at the corporate level or the individual level or subchapter S, and that all got buried more or less in the same type of situation. What we believe now is that there are different compliance levels, depending on the market segment, whether it is retail, wholesale, mining, or manufacturing. Again, the purpose of the expanded examinations is to give us compliance rates that are both geographically sensitive and also by market segment.

Mr. PORTMAN. I thank you for that.

One final question and then a comment. Has there been thought given to compensating individuals who go through this process, who expend these hours that we will be learning about from the information Mr. Brand is going to provide us? I would think the subcommittee could also benefit from some analysis of what the cost might be to the taxpayer, given the realities. If you are looking to people who have business income, I think it is going to require professional assistance and there will be tremendous cost to that.

But after someone has gone through all of this process, is there any talk about compensating people who in the end are found to have been fully in compliance and have cooperated with the IRS in this effort?

Mr. BRAND. Mr. Portman, the discussion has been external. There has not been internal discussion. We have done some estimates based on the fact that we know the issue has been raised and is a question. Really, it is a question more appropriately answered by Treasury, as opposed to IRS, I believe, because I believe it enters into the realm of tax policy.

Mr. PORTMAN. That is fine. I guess my final comment would be that we would appreciate, certainly I would, any information you have on just the average time you think this will entail based on previous audits. Although I know there have not been audits of this type of looking at the economic realities, and then the cost, the cost to taxpayers, just so we know that up front and we can deal with that issue.

I appreciate your testimony this morning.

Ms. STATHIS. Mr. Portman, it will not make the person who is involved in a TCMP audit feel any better, but if the IRS auditors were not doing a TCMP audit, they would be doing more of other kinds of audits. So, in a way, the burden may not be that different in total. It just is distributed differently and the people who are involved in the TCMP audits are going to bear more of that burden than they would otherwise.

Chairman JOHNSON. Before I recognize Mr. Herger, let me just comment that this subcommittee will be looking at compensation and we do hope that you will get your opinions back to us, because the people who are the object of ordinary audits, in a sense, have done something to trigger that. It does not mean that they are wrong, but there is something about their return that triggers the attention of the professional in the IRS. These folks are selected at random and may be in substantial compliance, and for the majority there is no change. I think there is an equity issue here and we do want to look at that, and I appreciate the gentleman from Ohio raising it.

Ms. STATHIS. There is a committee of the Commissioner's advisory group that has explored this issue and you may want to chat with some of them.

Chairman JOHNSON. We will check with them. Thank you for that comment. I was not aware they were doing that.

Mr. Herger.

Mr. HERGER. Thank you, Madam Chair.

Mr. Brand, GAO has raised a concern that no effort has been made to retain auditors' workpapers in an accessible format for purposes of more detailed research. I am just wondering, is such data useful and, if so, are any steps being taken to make the data available?

Mr. BRAND. We are hopeful that the electronic gathering of information will do that and we will be able to more readily use those workpapers and gather them. That is a fairly awesome task, as you can imagine, because the electronic gathering of information is a summary of changes, data, and information, while the workpapers

themselves are often paper files. In fact, they are workpapers and it becomes more difficult to extract that.

What we want to do, and this is the whole heart of this process, what we are after is a methodology that would help us measure compliance and select workload in a way that is the least intrusive to the taxpayer and is the most efficient in revenue yield for us and for the government. Whatever we can do, we are open to suggestions on anything that we can basically do that will help us balance this particular process. So we accept the suggestions of the GAO and will try to act on them, yes, sir.

Mr. HERGER. Thank you.

You indicated that you will be including samples of partnership and S corporation returns in the sample. Will the issues be followed through to the partner and stockholder returns to measure the tax impact?

Mr. BRAND. Yes, we do what we call pickups on various examinations. In fact, dependent again on what we find, we may go through and do the pickups and follow up with adjustments. We do those on regular examinations, too, if we get into a partnership return.

Mr. HERGER. Ms. Stathis, if we could return to an earlier question of how far back we would be going. I think we are shooting for 3 years, but I believe I heard you mention 1988 and back to 1981. Would you mind commenting on that?

Ms. STATHIS. Mr. Hancock's point is that the data is old by the time they are available, 3 or 4 years out of date, and I was explaining to him that because the TCMP of partnerships, for example, has not been done since the 1981 tax returns, the data currently available is old.

We are in 1995, so the partnership data is 14 years old. We know that enormous changes have taken place in partnerships over that many years. So the TCMP data that is available to think about alternative changes to the tax system and how that might affect partnerships are very unreliable at this point.

Mr. HERGER. Very good. Thank you.

Chairman JOHNSON. Thank you. Mr. Levin.

Mr. LEVIN. Thank you.

I am sure I missed the earlier part of the hearing and your opening statements. As I went over the materials yesterday, I really was not clear, is the purpose of the hearing this morning kind of a traditional oversight hearing, or is there some contemplation of legislation that would alter the planned reinstitution of the program? I am not quite sure what our purpose is here this morning.

Chairman JOHNSON. Our purpose is to hear in more detail the IRS' plans for this audit. There has been some significant criticism of the TCMP, and were we to determine that that criticism was overwhelming, that the program ought to be canceled, we might want to do that.

The initial materials and testimony raised those questions, but certainly no one on the subcommittee to my knowledge has made any judgment that that might be the right thing to do. I think, more importantly, there are some ways in which the burden on the taxpayer might be alleviated. There are some ways in which the data might be gathered in a more timely fashion and reported to

us in a more timely fashion, so that we could make better use of it.

Some of us are interested in whether or not we are looking in the right place. This does not look at the underground economy, and that is of concern. So there is a variety of issues that are appropriate to this hearing. If the hearing material is overwhelmingly critical and can demonstrate that there is no value to this program, then this subcommittee would be forced to recommend to the full committee that the program be dropped. I do not see that that is the evidence of the hearing, but there will be people who will testify who believe that is the case.

So I would say that this was an oversight hearing in the best tradition of oversight. On the other hand, it is a hearing from which we would have to act promptly if we wanted to alter the course planned by the executive branch.

Mr. LEVIN. At this point, there is no plan or—

Chairman JOHNSON. There is no preconceived plan of either legislation or action that might come out of this hearing.

Mr. LEVIN [continuing]. In simple terms—and you probably have already stated this—why have you done what you are doing? Why the reinstatement of the plan? Why is this now being recommenced?

Mr. BRAND. We are concerned about the age of the data and also the fact that over a period of time, as your data gets old, your no-change rate starts to climb because of the fact that there is a change in law, et cetera. It also helps us allocate our resources in the areas where we can be most productive. It also helps us confirm what we believe from our examiners' experience in the field. Statistically, it helps us confirm that there are particular areas that need legislative change. We would normally be doing TCMP surveys on a more regular cycle.

The Service did enter into a policy debate around this with previous Commissioners over what should be the size of TCMP surveys, what should be the TCMP process. I think Ms. Stathis has testified previously to some of that particular debate. We reached the point within the Service that we felt it was time to go ahead with another TCMP. We wish to gain some additional information as I talked about in terms of market segments and geographical area sensitivity, and felt the time was right to do that.

Mr. LEVIN. So you think that this step is important in terms of your audit program?

Mr. BRAND. It is important beyond the audit program, Mr. Levin. The Service for the last 20 years has, through a combination of enforcement and voluntary compliance, collected about 87.5 percent of what we estimate the annual tax base to be. We have been challenged, partially because of the economic situation of government, to improve our collection of that tax base to at least 90 percent, a 3.5-percent increase.

We believe that moving toward understanding market segments, being able to deal with market segments in a wholesale methodology, information, education, negotiations, is a better methodology than what we have done in the past, which have been specific one-on-one examinations to deal with areas of noncompliance. We think this is one of the most vital things we have, understanding

compliance, where the noncompliance issues are, if we are going to reach our goal of increasing collection of that revenue base.

Mr. LEVIN. Thank you. I think between your comments in that response, I think it helps one understand why we are here today, and I am glad we are.

Thank you.

Chairman JOHNSON. For the record, I would note that this is the largest TCMP ever proposed. It is about three times as large as any program they have ever done. It is also structured differently and I think will give us better information. It is also going to go on over 24 to 30 months, and all of us on this side of the table are going to hear about it as a result of that.

There are a couple of questions that I want to complete for the record. There are then two votes on the floor, so we will recess between this panel and the next panel until the second vote is concluded.

There are three matters that I think did not get sufficiently clarified. First of all, would the IRS have any objection to a sanitized data base being prepared and made available to qualified researchers outside the Service?

Mr. BRAND. I believe that that is a Treasury tax policy question, Madam Chairman, but we would be glad to provide the answer for the record.

Chairman JOHNSON. If you would do that, I would appreciate it. Also, if you would include in that how long you think that would take. That would be useful to us. At the same time, if you could be specific about when you expect you could get information back to this subcommittee and over what sort of schedule, that would be useful to us, too.

[The information requested was not available at the time of printing.]

Chairman JOHNSON. Then there is the issue of the other expense line that GAO raised, and I do not believe we discussed adequately. The other expense line covers a multitude of problems, and it is one of the reasons why there is too little detail in that area, the lack of detail under other expenses will make it hard for us to judge issues like the misclassification of workers.

Could you comment, Ms. Stathis, on why you think more information ought to be available under other. Mr. Brand, if you want to comment on any problems for the IRS in further detailing that section, I would be interested. To me, this is more important than workpaper issues. The workpapers I can appreciate researchers might like, but that is going to be a horrendous amount of information.

The other line it seems to me is very important, particularly in terms of spotting patterns of problems or patterns of noncompliance. We are dealing with some of the issues that frankly this subcommittee is really concerned with.

Ms. STATHIS. That is right. The parallel issues with other expenses and other income, it is sort of a catchall line where people put a lot of things. Unless there is enough information to separate out exactly what all was put there, it can be misleading as to what is really being observed.

The point we were making is that the TIES system IRS is hoping to use provides a lot of information on those details, and we are just hopeful that IRS will figure out a way to include that information in the TCMP data base. Otherwise, it will only be in the workpapers and somebody will have to go back and search through them. Even if the information is computerized, searching will still be necessary to find it. So I think it is really important in understanding the total picture to be able to have that information in the TCMP data base.

Chairman JOHNSON. Mr. Brand.

Mr. BRAND. I would echo that, and it is our intention to make sure we understand that area.

Chairman JOHNSON. There are two programs that you have developed, your primary computer program and your backup computer program. Did they allow for further detail being included in the other category?

Mr. BRAND. I would like to provide that for the record to make sure of that answer.

Chairman JOHNSON. Thank you.

Last, the issue of appeals, what is the average number of appeals under the normal audit program, and in what percentage of those appeals is the taxpayer's liability reduced?

Mr. BRAND. I would like to provide that for the record, too, Madam Chairman.

[The following was subsequently received:]

Responses to Questions from the Subcommittee on Oversight

A. MEASUREMENT OF TAXPAYER BURDEN

Background: There is no historical measure of taxpayer burden addressing the taxpayer's time, number of contacts and appointments, and out-of-pocket costs incurred in the course of compliance with a TCMP examination. The following information is estimated based upon Auditing Standards and Process Measures data compiled beginning April 1995. The Process Measures data have been accumulated from general program examinations in three of the seven IRS regions and capture the time and the number of contacts with the taxpayer and/or representative in the following four stages of the examination: Pre-audit Analysis, Inspection of Books and Records, Issue Resolution, and Closing. Contact with the taxpayer and/or representative takes place during Inspection of the Books and Records, and Issue Resolution stages. The time estimates are reflective of the actual hours the revenue agents and tax auditors allocated to the case in those stages when taxpayer contact takes place and assumes that taxpayers were active participants during these stages.

The number of times a taxpayer will need to meet with an examiner and the total time spent by the taxpayer in any examination (including TCMP) is dependent on many factors, such as the complexity of the return and the condition and availability of the taxpayer's books and records.

Question 1: An estimate of the average amount of time taxpayers must spend in meetings with IRS personnel when responding to a TCMP audit.

Answer: The process analysis data from the general program cases can be projected to TCMP cases using historical TCMP rates of increase in examination time as follows:

	<i>General Program</i>	<i>TCMP Increase Rate</i>	<i>TCMP Examination</i>
Revenue Agents	30	53%	46
Tax Auditors	7	88%	13

It is important to note that, for business audits, it is not customary for the taxpayer to be present for the entire process of the examiner's inspection of the books and records. Therefore, we would expect taxpayers or their representatives to participate in less than the 46 hours of examiner activities indicated above.

Questions 2: The percentage of the audits in which taxpayers must be seen more than once, more than twice.

Answer: Nearly 70 percent of individual returns examined in office examination are closed after the first appointment; an additional 20 percent are closed after the second appointment. Only 10 percent of all office examination cases require more than two visits with tax auditors. For returns examined by revenue agents, 24 percent of cases are closed after the second appointment, and 48 percent are closed after the fourth appointment.

Question 3: An estimate of the average amount of time taxpayers expend on all activities encompassed in their response to a TCMP audit, or in the alternative, a number of representative case studies.

Answer: There is no direct measure of the total amount of time taxpayers expend in the course of a general program or TCMP examination. The estimates computed in the answer to Question 1 reflect the total time expended by revenue agents and tax auditors during stages of the examination where taxpayer contact takes place.

Question 4: The estimated out-of-pocket cost to taxpayers.

Answer: The data from general program process measures indicates that 80 percent of the taxpayers examined by tax auditors in office examination did not have representation. Of the business returns examined by revenue agents in the field, nearly 60 percent were closed without representation. It is not possible to accurately estimate the out-of-pocket costs expended by taxpayers in the course of a TCMP examination.

B. APPEALS

Question 1: In the normal audit program, what is the average number and percentage of general program cases that are forwarded to Appeals?

Answer: For the period beginning October 1994 and ending June 1995, eight percent of general program cases were forwarded to Appeals.

General Program Cases	Cases Forwarded to Appeals	Total Cases Closed	Percentage of Total
Individual	14,931	239,145	6%
Corporate & Other	13,094	100,420	13%
Coordinated Exam Program	1,101	4,817	23%
Training	160	22,822	1%
Total	29,286	367,204	8%

Question 2: What percentage of those cases result in a reduction of the taxpayer's liability?

Answer: The Appeals function accounts for reduction in the taxpayer's liability using the total tax deficiency and does not maintain statistics by the number of cases. Of the eight (8) percent of cases forwarded to Appeals from October 1994 through June 1995, the total deficiency was reduced by 71%.

(dollars in thousands)	Total Cases	Revenue Agent	Tax Auditor
Proposed Deficiency	\$5,586,499	\$5,404,264	\$182,235
Revised Deficiency	\$1,622,141	\$1,556,271	\$65,870
Percentage Reduced Deficiency	71%	71%	64%

Question 3: How many individual and corporate returns included in the last TCMP surveys were forwarded to Appeals?

Answer: In the most recent TCMP survey of individuals (Form 1040 filers) 863 of the 54,088 taxpayers, or 1.6%, appealed the results of their audit. In the most recent TCMP survey of corporations (Form 1120 filers) 746 of the 18,138 taxpayers, or 4.1%, appealed the results of their audit.

TCMP Survey	Cases Forwarded to Appeals	Total Cases Closed	Percentage of Total
1988 Survey of Individuals	863	54,088	1.6%
1987 Survey of Businesses	746	18,138	4.1%

Question 4: What percentage of those cases resulted in a reduction of the taxpayer's liability?

Answer: The Appeals follow-up information has not been perfected. Therefore, we cannot directly measure the appeals suspension rate. However, since the appeal rates for the last two TCMP surveys are very low, we feel that the suspension rate is not a significant issue.

C. ADDRESSING TAXPAYER BURDEN

Question 1: Given the number of issues and the higher standard of documentation that taxpayers must meet in responding to a TCMP audit, how can the resulting inequity in adjustments between TCMP audits and non-TCMP audits be addressed?

Answer: The TCMP process does not increase the depth of the audit. As is normal operations, examiners are directed to use good judgement in investigating issues. In the TCMP process, examiners are directed to "consider" each line item. That does not mean that each line item must be investigated, and an adjustment resulting in additional tax does not have to be made if the adjustment is a small dollar amount. This is the same expectation as in other audits. However, in a TCMP audit, the adjustment is recorded on a checksheet regardless of whether the adjustment is made to the taxpayer. TCMP results often point to the fact that small dollar value compliance issues, if widespread enough, can amount to large compliance problems.

Question 2: What are the recommendations of the Commissioner's Advisory Group committee that studies the issue of taxpayer compensation for participation in TCMP audits?

Answer: The following is excerpted from the meeting minutes of the Compliance Subgroup of the Commissioner's Advisory Group for February 1, 1994:

"...reducing unnecessary burdens on taxpayers should be an important priority. There is a high level of no-change audits under TCMP because of the random selection of returns. These taxpayers are participating in a research project that has substantial benefits for the tax system as a whole. Many of the people the Subgroup members spoke to, both inside and outside the Service, felt that there should be a clear recognition of this in the way that the TCMP audits are handled. The Subgroup heard a complete spectrum of views on this -- (i) treating TCMP audits like any other audit, even for compliant taxpayers, (ii) reimbursing compliant taxpayers for some portion of the cost of the audit, (iii) giving participating

taxpayers a "hotline" number to assist them in handling tax problems that occur for the next couple of years, (iv) waiving certain penalties or interest, or even tax, and (v) granting even more extreme waivers to cooperative non-compliant taxpayers. The Subgroup is not endorsing any of these suggestions at this time but remains concerned about the burden that TCMP imposes on taxpayers, especially those who are found to have substantially complied with the law. The Service should continue to study this issue."

D. THE TCMP PROCESS

Question 1: Do both TIES and the backup data collection systems collect detailed information on the "other" categories of income and expenses?

Answer: No. The new TCMP checksheet portion of TIES is designed to allow for one issue to be captured per line item with a causal code and Uniform Issue Listing (UIL) code to be attributed to the largest issue, if multiple issues are present. The backup data collection system, Electronic Data Gathering for Examination (EDGE), is similarly designed. The TIES workcenter, however, normally allows for writing a Revenue Agent Report (RAR) that accounts for multiple issues related to a single line item.

Question 2: Will the detailed information on the "other" categories of income and expenses be recorded in the TCMP database for purposes of analysis?

Answer: No. The database that will capture and archive the TCMP results is not designed to display multiple adjustments per line item. The file transfer, data diskette creation, and data accumulation programs are likewise not designed to address multiple adjustments per line item. It is our intent to capture the causal code and UIL code for the largest adjustment to an "other" line item. It is important to note that this capture methodology is a vast improvement over prior TCMP surveys. In prior surveys, no information on causal codes or UIL codes was captured.

If there is interest in analyzing instances where multiple adjustments occur on an "other" line item on a return, we will be able to determine when multiple adjustments were made to a line item by analyzing the comments section of the TCMP file which will be available in computer sensible format on the TCMP file at the conclusion of the survey.

Question 3: If this is not to be done, how will compliance on the specific issues be measured and matched across the various types of returns?

Answer: It has always been our contention that there are relatively few times that multiple adjustments will need to be made to a single line item. Until GAO's report, no other internal or external stakeholders had requested sub-line-item, breakdown of information. Further contact with GAO revealed that in the cases with an adjustment of an "other" line item, multiple adjustments were present only three (3) percent of the time. Since cases where "other" line items are adjusted are, in turn, a subset of the total sample, the percentage of the cases in the upcoming TCMP where multiple adjustments would need to be made to an "other" line item would be expected to be substantially below three percent.

Comparison of compliance measures across form types does not depend upon multiple adjustments per line item. Rather, effective comparison depend upon consistent treatment and capture of information across form types. Regardless of the data capture mechanism the Service ultimately uses for TCMP, consistent treatment and capture of compliance information has been our utmost concern.

Source: IRS
Chief Compliance Officer
September 14, 1995

Chairman JOHNSON. I would like you to respond to the criticism of the TCMP that auditors are given little leeway to make the kinds of judgments that IRS reviewers commonly make and that tends to increase the number of adjustments made on appeal in the taxpayer's favor.

Mr. BRAND. The issue here is that we do require our examiners to, in fact, look at the line items. Again, the depth of that verification is the judgment that the auditor can exercise. As you understand, we are trying to determine compliance on a line-by-line basis so we can then use this to develop our discriminate function activities so we can select those tax returns that are most in need of change in future situations. So I believe it is a valid statement. Whether it is a criticism or not—

Chairman JOHNSON. I wish you would give some thought, Mr. Brand and Ms. Stathis, to this issue. I can understand that for research purposes you might want to draw a very hard line. But I think in fairness to taxpayers, they at least be given the information that under this program we do draw harder lines and the likelihood of success on appeal is very great, since the judgment that IRS officers could normally exercise would probably read this differently.

We have to do something to make sure that, in a sense, subjects or victims of these audits are not unduly punished. For many, the matter of going to appeal is a formidable challenge and many just may be simply discouraged from doing that because it is formidable. I think this issue of the different and harder standard that taxpayers are held to under the TCMP is a matter of equity that we need to think through, and we would like your recommendations as to how to handle that.

Mr. BRAND. Just one quick response in terms of the standard. The standard that is the same is that we do not assess de minimis amounts. So even though there is an adjustment as a result of a TCMP audit, it still would not result in additional tax. We would record that information and it would help us select returns. But we are not interested in assessing de minimis amounts. Again, we maintain those assessment levels as confidential, but we would not assess a small amount of tax, even though we would record it.

Chairman JOHNSON. Thank you very much. I thank the panel.

The next panel, we will use the lights both for those who are testifying and for the members. I always feel it is important that we have as much time as we want to get the professional administrators' side of these issues.

[Recess.]

Chairman JOHNSON. The subcommittee will reconvene. I regret that I do have another obligation at 12:15 that requires that I excuse myself, so I will not be able to hear all of the testimony, although I intend to return. But I am very anxious to hear as much as possible, and so I am going to start with Mr. Goldberg and move to you, Mr. Gibbs, and Mr. Sparrow. If you will adhere as closely as possible to the 5-minute rule, I would appreciate it.

Mr. Goldberg.

**STATEMENT OF FRED T. GOLDBERG, JR., PARTNER,
SKADDEN, ARPS, SLATE, MEAGHER & FLOM; AND FORMER
COMMISSIONER, INTERNAL REVENUE SERVICE**

Mr. GOLDBERG. Thank you, Madam Chairman, for the opportunity to appear before you today. I would like to submit my written statement for the record. I will keep my remarks brief.

It seems to me the place to start in thinking about the proposed 1994 TCMP is with what we know. What we know is that it will cost the government more than \$550 million. While there are no precise measures, I believe it will cost taxpayer citizens of this country well more than \$1 billion in out-of-pocket costs. I believe that it will consume hundreds of millions of hours of their time.

Second, we know that what we are measuring or at least what we have historically measured is not whether the taxpayers pay the proper amount of tax. What we are measuring is the revenue agent's views as to the law, the revenue agent's views as to whether the taxpayer has complied with applicable recordkeeping requirements, and whether the taxpayer has satisfied the revenue agent with respect to factual issues in dispute. Finally, we know that this will take 4 years or more to complete.

What we do not know are the benefits that have been claimed for the proposed 1994 TCMP, nor do we know whether there are better ways to accomplish the stated objectives. In very brief terms, five benefits have been cited for TCMP. The first is the historically intended use of TCMP, which was to permit the IRS to score and better select returns for audit.

It is often claimed that the result of TCMP is a decline in no-change audits of more than 40 percent to less than 15 percent, and to an increase in yield from examinations that are conducted. While TCMP has performed an important function in this regard, I believe that the primary factors causing that decline have little to do with either TCMP or the formula. I believe those declines are largely attributable to the IRS information returns program, which was nonexistent in the late sixties, to a dramatic decline in audit coverage of more than a sixfold decline, and to a more effective targeting of the special examination programs.

The question is—and I believe this is the question that should always be asked—is it worth \$550 million in taxpayer dollars, is it worth what I believe to be \$1 billion-plus of citizens' money, is it worth hundreds of millions of dollars of citizens' time to achieve whatever improvements might be achieved in the current IRS procedure for scoring returns? My own judgment is that the answer is no. I believe that improvements in scoring could be accomplished, but I believe they could be accomplished far less expensively and far less intrusively.

A second argument is that TCMP helps to identify compliance trends. I believe that any study that takes more than 4 years to complete calls into question on its face that assertion. Beyond that, I would suggest by way of example the most single important non-compliance trend of the late seventies and early eighties was tax shelters. I believe that TCMP played no role in identifying that trend. I believe the TCMP, if anything, inhibited the agency's ability to respond.

A third point is that the TCMP data facilitates the development of compliance legislation. Others have cited examples ranging from toys for tots to alimony reporting to State income tax refund reporting. I believe that in each and every one of those instances, the same results could have been accomplished at a tiny fraction of the cost and far more rapidly, if folks had sat around and thought carefully about the tax system, and the process of thought, reflection, contemplation would have led to those results far more effectively. TCMP was useful as a revenue estimating device, but I think that is the end of it.

Tax cap studies, again I question their value. I also question whether \$550 million of the taxpayers' money, more than \$1 billion of our citizens' out-of-pocket costs and hundreds of millions of hours, is worth whatever improvements could be achieved.

I think it is time to start over. TCMP served an invaluable purpose 25 years ago, but we are trying to retrofit a battleship and turn it into a speed boat. That effort is doomed, in my judgment, to fail.

I believe if I could commend you to one piece of testimony, it is not my own, it is Dr. Scheuren's testimony. I have known Fritz for years. I was unaware that he was going to testify today. I believe that he provides a practical, workable alternative that is far less expensive, far less intrusive, and will provide far more valuable results.

Thank you very much.

[The prepared statement follows:]

**JOINT STATEMENTS OF FRED T. GOLDBERG, JR.,
MICHAEL J. GRAETZ, AND THOMAS M. GOLDSTEIN
AS PRESENTED BY FRED T. GOLDBERG, JR.**

Madam Chairman and Members of the Subcommittee:

We appreciate the opportunity to submit this statement on the subject of the IRS' proposed Taxpayer Compliance Measurement Program for the tax year 1994 (the "1994 TCMP"). We are submitting this statement solely in our individual capacities and not on behalf of any client or organization.¹

In brief, our views are as follows: (1) It is universally acknowledged that the 1994 TCMP will be expensive and intrusive, and will take a long time to complete and evaluate. (2) The case has not been made that the reasonably anticipated benefits from the 1994 TCMP will justify either its cost to the government or its burden on taxpayers. (3) The benefits likely to result from the 1994 TCMP could be achieved more effectively and efficiently through other IRS research and enforcement strategies.

I. What We Know About TCMP We should begin with what we know about the proposed 1994 TCMP. It is a major investment of resources by the IRS; it will impose a substantial burden (without compensation) on taxpayers unlucky enough to be selected for TCMP audits; and it will take years before we learn anything from the effort.

A. Cost to the Government The IRS estimates that the 1994 TCMP will cost approximately \$550 million over three years, more than six times greater than the cost of the 1988 TCMP. To put this number in perspective, it represents more than 30% of what the IRS would like to spend over the next three years on the supplemental revenue initiative that was approved by

¹ Mr. Goldberg is currently a partner with the law firm of Skadden, Arps, Slate Meagher & Flom. He has served as IRS Commissioner (1989-1991) and as Assistant Secretary Tax Policy (1992). Professor Graetz is currently the Justus S. Hotchkiss Professor of Law at Yale Law School. He has served as Deputy Assistant Secretary (Tax Policy) (1989-1991) and Assistant to the Secretary and Special Counsel (1992). Mr. Goldstein is currently a student at Yale Law School and a summer associate with Skadden, Arps, Slate, Meagher & Flom.

In the interest of full disclosure, Mr. Goldberg notes the following: (1) Mr. Goldberg's comments during the hearing itself reflect solely his own views, and may not necessarily reflect the views of Professor Graetz or Mr. Goldstein. (2) While Mr. Goldberg is testifying in his individual capacity, the concerns expressed in the written statement and his testimony are the same as those he raised as IRS Commissioner and as Assistant Secretary (Tax Policy). (3) Mr. Goldberg was the "Commissioner" who was referenced in the 1993 and 1994 General Accounting Office ("GAO") reports on TCMP. Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993), and Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

Congress in 1993. It also represents more than 25% of what the IRS will probably spend on Tax Systems Modernization over the next three years. It is more than three times greater than the 3-year budgets for both the IRS Statistics of Income and Research Division functions.

B. *Burden on Taxpayers Beginning in* October of this year, more than 150,000 individuals, families and small businesses will be subject to TCMP audits. While there are no reliable estimates of the time that these taxpayers will spend or their out-of-pocket costs, no one doubts that TCMP audits are intrusive, burdensome, and expensive. Taxpayers must justify -- to the satisfaction of IRS agents -- every item on every line of their 1994 returns. If you claimed the right to file a joint return, you have to show the agent your marriage certificate. If you claimed dependents, you better have birth certificates available for the agent. Forget about simply reconciling reported income by matching W-2's and 1099's. You must explain every bank deposit and every investment to show that you had no unreported income. If it appears to the IRS agent that you are living beyond your means, there will be more explaining to do. Your "word" and some reconstructed notes will be worth little; contemporaneous documents and the affidavits of third parties are often required.

More than 60,000 1994 TCMP audits will involve business enterprises (corporations and partnerships), and most individual TCMP audits will involve taxpayers with complex returns. In the absence of any hard data, it seems reasonable to speculate that out-of-pocket costs (including employee and preparer time) will be in the range of \$5,000 to \$10,000, and that the average individual will spend at least 20 hours preparing for and dealing with a TCMP audit. On this basis, the 1994 TCMP would impose between **750 million and 1.5 billion dollars** in unreimbursed, private out-of-pocket costs on American citizens, and consume **more than three million hours** of their time. Coupled with the IRS's costs, the 1994 TCMP is an undertaking that will cost more than **one billion dollars** and could well cost **several billion dollars**.²

What do we learn from imposing this burden? For the moment, consider these results from the 1988 TCMP: (a) more than 50 percent of those audited owed no additional tax; (b) about 7.5 percent of those audited were entitled to refunds, averaging \$284; and (c) the average proposed adjustment for the 40 percent regarded by the agents as owing additional tax was \$780.

C. *Time To Completion* The IRS expects to complete the 1994 TCMP by the end of 1998. The December 1994 GAO report expressed doubt that the IRS would start as scheduled, and concluded that: "Even with this start date, the TCMP results cannot be used to fully

² In light of stated concerns over the burden imposed by TCMP, and the IRS' stated objective of reducing taxpayer compliance costs, it is somewhat surprising that the IRS does not plan to gather data on the time and money that taxpayers spend on TCMP audits (much less, gather data on compliance burdens faced by taxpayers in filing their original returns).

measure compliance levels or develop audit selection formulas until the end of 1998. By this time, the data will already be 4 years old." At that point, it should be noted, we may have a substantially different tax system.

II. What We Don't Know About TCMP Consider next what we don't know about TCMP. What is TCMP measuring? What will TCMP teach us? What will we do with what we learn?

A. What Does TCMP Measure? As the name implies, TCMP is intended to measure taxpayer compliance. Proper "compliance" means paying the proper amount of tax. But far too often that may be an uncertain number. Historically, TCMP has told us the amount of adjustments **proposed** by the revenue agents conducting the TCMP audits. TCMP data has never reflected final determinations of liability. TCMP measurements therefore turned on a particular revenue agent's view of the law, the revenue agent's conclusions in light of the taxpayer's record-keeping habits, and ultimately the revenue agent's factual determination when factual matters were in dispute.⁴

While there is no reliable data addressing these issues, IRS sustention rates in other areas are often less than forty or fifty percent. This raises a yellow caution flag in taking literally the conclusions drawn from TCMP data. The IRS has indicated that it will be able to track the results of 1994 TCMP audits through any subsequent administrative appeals or litigation. However, it is unclear whether the IRS intends to base the 1994 TCMP data on the final resolution of these cases.

³ GAO/GGD-95-39, at 3.

⁴ While erroneous or controversial revenue agent interpretations of the law confound some TCMP data, record-keeping and "standard of proof" issues are far more troublesome. For example, taxpayers filing joint returns, and claiming several dependents, will be subject to numerous adjustments during a TCMP audit if they do not produce marriage and birth (or adoption) certificates, and cannot demonstrate that they have provided more than one-half the dependents' support (as required by Code § 152(a)). Many of these taxpayers would prevail during the administrative appeals process or in litigation.

Similar situations may arise in many other areas, e.g., disallowed deductions or the assertion of additional earned income based on the agent's determination regarding "unreasonable compensation"; disallowed deductions and the assertion of additional income based on the agent's determination that a company has failed to adequately document expenses as business-related (rather than personal); increased capital gains tax liability based on the agent's determination that a taxpayer has failed to establish basis and/or holding periods; worker classification disputes over employee versus independent contractor status.

Moreover, many people will no doubt have exhausted their taste for dealing with the IRS after experiencing a TCMP audit. As a result, they may be less inclined than taxpayers undergoing regular audits to pursue those issues through appeals, particularly if the dollar amounts are not substantial. Indeed, some taxpayers may make this kind of cost-benefit calculation during the TCMP audit itself (choosing, for example, not to spend \$2,000 and a lot of time documenting and challenging a potential adjustment of \$1,500).

B. *What Will TCMP Teach Us; What Will We Do With What We Learn?* TCMP is supposed to accomplish four objectives: (1) improving the selection of returns for examination; (2) measuring the overall tax gap and its primary components; (3) permitting the IRS, and perhaps Congress to design and implement improved compliance strategies; and (4) providing useful statistical information to other users (e.g., the Commerce Department and private researchers).

1. Selecting returns for audit.

Originally, TCMP's sole purpose was to help the IRS select returns for audit. The application of various statistical techniques to TCMP data permitted the IRS to "score" returns based on their anticipated audit yield. In this respect, TCMP has made an important contribution to tax administration. Indeed, the most frequently cited data in defense of TCMP is that "no change" audits have declined from more than 43% in 1968 to less than 15% for 1991, and that examination yields per return audited during that period have increased.

Having said as much, however, it grossly overstates the case to ascribe such results entirely to TCMP. The decline in no change audits and increased yields have resulted largely from the following (particularly since the late 1970's): (1) the development and implementation of a comprehensive information returns reporting and matching program; (2) the dramatic decline in audit coverage (to about one-sixth its level in the 1960's); and (3) the improved focus of special program audits.

In this context, two points are worth emphasizing. First, we do not quarrel with the notion that the IRS should minimize no change audits and maximize yields. However, we are not convinced that this objective justifies the 1994 TCMP.

- It is far from clear that the proposed TCMP would improve materially the "scoring" techniques that the IRS currently has in place and regularly modifies in light of other information it receives (including information from other audit and enforcement activities).
- The "general audit" program is currently at a minimal level of less than one percent of returns filed; it has been at that level for some time; it seems very unlikely to expand in the years ahead. With coverage at such low levels, IRS has many more potential high yield returns than it can audit. Any improvements due to the 1994 TCMP would be likely to have little practical value.

- Improvements in sampling and statistical techniques suggest that the IRS' "scoring" objectives could be satisfied with samples that are both much smaller and more narrowly targeted than the proposed TCMP universe (particularly if such studies were conducted more frequently and completed more quickly).⁵

Stated differently, the key question that must be asked is: Given current IRS "scoring" techniques, alternative ways to improve those techniques, and the projected level of audit coverage, do the reasonably anticipated benefits of the 1994 TCMP justify the costs to the government and the costs and other burdens to be imposed on taxpayers, taking into account the time it will take to complete and evaluate the effort? Maybe that case can be made, but based on information provided by the IRS and others to date, we believe the answer is no.

Even if that question were answered "yes," and the proposed 1994 TCMP were the most cost effective way to improve the general audit program, a second question still requires an affirmative answer. Budget realities force the IRS to make hard choices and set priorities. In light of all the other efforts that the IRS could pursue to improve voluntary compliance and/or reduce taxpayer burden, is the 1994 TCMP the best place to allocate scarce resources? Once again, it may be possible to make a case for the 1994 TCMP. But once again, on the information provided to date by the IRS and others, we believe that the answer is no.

2. Measuring the tax gap and its components. While TCMP was not originally intended for this purpose, it has been used for some time as a basis for estimating the overall tax gap and its components. Here again, TCMP may have a useful purpose. We now know that:

- In absolute dollar terms, the aggregate tax gap is quite large.
- Most noncompliance involves the underreporting of income.
- Compliance levels are extremely high in circumstances where there is withholding, and relatively high when there is effective information reporting and matching.
- Compliance levels are low in circumstances where there is the opportunity to understate tax, such as where there is no withholding and no effective information reporting. It is even lower when the medium of payment is cash and the payor has no need for any record to substantiate payment for purposes of a tax deduction or a reimbursement claim.

⁵ For example, Professor Bradley Efron, Department of Statistics, Stanford University, has suggested that sample sizes as small as 1,000 might be sufficient for most purposes.

While much of this "learning" seems like common sense, various TCMP studies have provided useful order-of-magnitude measures and may have told us something about trends over time.

Nevertheless, there seems to be little real benefit to be gained from a new study of the tax gap based on the 1994 TCMP. In particular:

- From a qualitative standpoint, we are likely to learn nothing new about the overall tax gap and its major components.
- From a quantitative standpoint, the tax gap estimates are very crude measures. In absolute dollars, they are probably too high -- or too low -- by many tens of billions of dollars. Given the limitations on other researchers' development and use of individual taxpayer-level data, we probably will never know how far off the mark these estimates are, and never even know the direction of the error.
- From a quantitative standpoint, the 1994 TCMP will provide little reliable data regarding changes in voluntary compliance levels, much less the magnitude of any such changes.⁶
- From a quantitative standpoint, it is not clear that estimates derived from the 1994 TCMP will be materially different, or more accurate, than projections made from other data sources.

It has been suggested that the 1994 TCMP will provide far more accurate tax gap estimates, and will provide a useful baseline for determining whether the IRS achieves its stated goal of increasing voluntary compliance levels from "about 84%" to over 90% by the year 2000.⁷ This rationale is not persuasive for several reasons: (1) it suggests far higher reliability in the estimates than is warranted; (2) there are other, far less costly and intrusive ways to develop estimates of at least equal reliability; and (3) the resources in question could be better used to help achieve the stated objective.

In this context, we also question the underlying justification for ongoing estimates of the overall tax gap. What will happen differently if, based on the 1994 TCMP, the IRS estimates a tax gap of \$75 billion

⁶ There are many reasons to question whether the 1994 TCMP will permit a reliable analysis of compliance trends. For example, the IRS has made substantial changes in audit techniques, training programs, and the information provided to its auditors. It has also made substantial changes in its data collection and retrieval systems. See generally, GAO/GGD-95-39. Margins of error are quite large (particularly where unreported income is at issue), and there is no reason to believe the bias is the same for all TCMP studies.

⁷ GAO/GGD-93-52, at 12.

. \$150 billion \$300 billion? What will Congress or the IRS do differently if the 1994 TCMP produces estimates that voluntary compliance levels have gone up 2% have stayed the same have declined 2%? Will the Administration and Congress seek different levels of funding for the IRS? Will the IRS change its allocation of resources? The tax gap estimates, whatever they may be, seem likely to have little discernable impact on policies pursued by Congress and the Administration. Moreover, we find it difficult to imagine any different impact, whether the estimates are derived from the 1994 TCMP or from other data sources.

3. Improving voluntary compliance.

Another justification for TCMP is that it improves voluntary compliance by helping the IRS identify trends in noncompliance and by leading to specific legislative initiatives. We believe these particular claims are also overstated.

(a) *Trends in Noncompliance.*

Since it will take until the end of 1998 to complete the 1994 TCMP, claims regarding the ability of this exercise to identify new trends in noncompliance are somewhat suspect. The tax law, tax planning, and the context in which those activities take place are all in flux. In an environment characterized by frequent change, a study that takes four years to complete can at best be of limited use in identifying emerging trends.

One practical illustration of this point is provided by tax shelters and the 1976, 1979, and 1982 individual TCMP studies. During the late 1970's and early 1980's the retail marketing of tax shelters was easily the most important compliance problem of that period -- yet the TCMP studies did nothing to help identify the trend as it emerged. If anything, the IRS commitment to its "scoring" and return selection techniques distracted the IRS and delayed and distorted its response. The tax shelter phenomenon could have been identified and responded to far more rapidly through observation and reflection in a work environment that encouraged employees to "think" about the tax system, to communicate with each other, and to focus on events in the "outside" world.

(b) *Specific Legislative Initiatives.*

Despite recent IRS claims, TCMP is no key to specific legislative initiatives. The critical elements are an appropriate analytical framework, observation and reflection, sound research and sampling, common sense, and creative thinking. On occasion, TCMP data has been used in recent years to test hypotheses and estimate potential revenue gains from proposed compliance legislation. In this context, however, TCMP data is expensive and often unsuited to the task. There are more efficient and effective ways to identify areas of noncompliance, and to assess the potential impact of various compliance measures.

Two examples illustrate this point: legislation requiring taxpayers to obtain and list Social Security numbers for their claimed dependents ("TIN's for tots"), and the current debate over compliance with the Earned Income Tax Credit ("EITC").

TIN's for tots. One of the success stories frequently attributed to TCMP involves the TIN's for tots legislation enacted during the 1980's. Myth has it that TCMP caused IRS to figure out that taxpayers were overstating the number of dependents and that the problem might be solved by requiring taxpayers to obtain and list Social Security numbers for their children. Some have suggested that the revenue gains from just this one change more than cover the costs of TCMP.

In reality, the process was, as it should be, far different. The starting point was the recognition that voluntary compliance improves when the taxpayer has the information necessary to comply with the law and knows that the IRS has independent means to verify such compliance. The TIN's for tots proposal was the logical outgrowth of this analytical framework. Common sense suggested that, with no means for IRS to easily verify claims, taxpayers could overstate their dependents with no real fear of challenge. Requiring taxpayers to obtain and list Social Security numbers seemed like an obvious, relatively unintrusive way to improve compliance. TCMP data verified the hypothesis and provided a revenue estimate for purposes of scoring the legislation. All of the *thought* that prompted the TIN's for tots legislation could and should have been accomplished without TCMP. The hypothesis could have been tested, and revenues estimated, through a targeted research effort that would have been inexpensive, unintrusive, and completed in several months.

EITC reforms. The 1988 TCMP data has been cited frequently in Congress and by the media for the proposition that the EITC is rife with fraud and noncompliance. This assertion is misleading for several reasons.⁸ First, as noted above, the 1988 TCMP measured a revenue agent's judgement as to whether a taxpayer had complied with the law and applicable record-keeping requirements. We believe that many of the adjustments proposed during the 1988 TCMP audits would not have been sustained on administrative appeal or in litigation. The fact that a low income family cannot produce marriage and birth certificates and detailed information regarding family budgets -- to satisfy the demands of an IRS agent -- proves very little. To be perfectly frank, while EITC changes may be warranted, we would not base any policy decisions on the noncompliance estimates provided by the 1988 TCMP.

Second, the 1994 version of the EITC is far different from the 1988 version of the EITC. Moreover, the IRS is now taking numerous steps to improve compliance with the law as amended. The simplifying changes since 1988, together with ongoing IRS efforts in this

⁸ As a preliminary matter, while the 1988 TCMP data suggested high levels of noncompliance, it did *not* suggest that the noncompliance was intentional or fraudulent.

area, should have greatly reduced levels of noncompliance.⁹

The important point is that the 1988 TCMP has **hindered**, not helped, thoughtful analysis of the EITC. The 1994 TCMP will come far too late to affect the EITC reform discussions currently under way. Given the currency and importance of this issue, all concerned would be better served by a well-designed and properly executed research program that might be completed this fall.¹⁰

4. Meeting the needs of other users. Another argument often advanced in support of the 1994 TCMP is that it will serve the needs of other users, such as the General Accounting Office, the Joint Committee on Taxation, the Treasury Department's Office of Tax Policy, the Commerce Department's Bureau of Economic Analysis, various state governments, and private sector researchers.

As a preliminary matter, of course, anyone who relies on data always wants more. The question is whether the benefits of additional data justify the costs of collection. With respect to uses directly related to the tax system, we do not believe that the either IRS or these other potential users have made the case. We believe that the principal objectives to be served by the 1994 TCMP could be achieved more effectively and efficiently, at less cost to the government and with less burden on citizens.

One way to attempt a "cost-benefit" analysis as it relates to other potential users of the 1994 TCMP data would be to ask them the following question: how much would you be willing to compensate the IRS and taxpayers for costs they incur due to the 1994 TCMP?

III. Conclusion: A Suggested Alternative We believe the IRS, taxpayers and tax administration would be better served by abandoning plans for the 1994 TCMP. Quite simply, we are not persuaded that the likely benefits will offset the certain costs to the government and taxpayers.

While TCMP has served a useful function for many years, it was designed in a different era to meet very different needs. During the past 25 years, research techniques, technology, and the tax system itself have all changed dramatically. Efforts to "improve" TCMP are

⁹ We are aware of the January 1994 study showing that noncompliance levels are improving but remain rather high. In our view, that study suffers from the same flaw as all TCMP data -- it reflects the IRS position on audit, not a final determination. It also illustrates the danger of targeted "research" studies that are neither well designed nor well executed (e.g., a small sample of returns filed during two weeks in January). Compliance research projects should not be a hasty response to external pressure; they should be the result of well-conceived research strategies.

¹⁰ See, note 9, supra.

a little like trying to reconfigure a battleship into a speed boat. It is better to start over. Among the steps that the IRS should consider are the following:

- More frequent (perhaps annual) audits that rely on far smaller sample sizes and different audit techniques to facilitate the scoring of returns and tax gap estimates.
- The emphasis should be on **thinking** about compliance issues. IRS needs to do compliance research -- far more than it does today -- but it needs to design targeted research programs to test hypotheses and provide data that can be used in formulating legislative, regulatory and administrative initiatives.
- Recognize that "compliance" is not the only (or necessarily most important) issue to address in designing research programs. Consider, for example, studying taxpayer compliance burdens and whether various tax laws are achieving their stated policy objectives.
- Develop and implement a long-term research strategy, but place a premium on reasonably quick responses and flexibility. Most research efforts should be completed in less than a year. IRS must accept the fact that projects on the drawing boards will often be replaced by new initiatives in response to changing conditions.

IV. A Word of Caution We believe that the IRS should not go forward with the 1994 TCMP for two reasons: (1) the anticipated benefits do not justify the costs; and (2) the IRS should revise its research strategies to meet the current needs of tax administration. But we are far less confident that the Congress should preclude the IRS from going forward.

It is certainly appropriate and important for this Committee to ask hard questions and impose a strict standard of accountability. However, the final decision regarding administration of the tax laws generally should be left to the IRS. In our experience, efforts to "micromanage" tax administration through specific legislation or the appropriations process often have been counter-productive. We are not suggesting that Congress should never intervene in administrative matters; rather, we urge this Committee and the Congress to exercise great care when deciding whether to take that step.

Chairman JOHNSON. Thank you very much, Mr. Goldberg.
Mr. Gibbs.

STATEMENT OF LAWRENCE B. GIBBS, PARTNER, MILLER & CHEVALIER; AND FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. GIBBS. Madam Chairman, it is also a pleasure for me to be here with you today.

I will get right to the point. I rarely disagree with my good friend Fred Goldberg. On this issue, however, we are in disagreement. I would like to pinpoint, though, where we disagree.

I think the function that these hearings will perform is a good function. I think it is time that we take a hard look at TCMP. It has grown and changed over the last 30 years, and I think it is appropriate that it continue to do so. I would not suggest that we abandon TCMP, but I would suggest—and I agree with Fred in this regard—that there are problems, there are deficiencies, there are shortcomings.

The only thing that I would say is this. I would put it to you this way: While I was Commissioner from 1986 to 1989, there were two questions that I was asked by taxpayers, the media, and the Congress: No. 1, I was asked what is the level of taxpayer compliance with our tax law in this country? No. 2, how much are we losing in taxpayer noncompliance? I felt I had to have credible answers based on something that taxpayers and others would feel is credible in order to respond to those questions.

My point is that, with all of its faults and all of its shortcomings, TCMP is better than anything that has been suggested to replace it as an alternative. I would simply say that, in addition to Commissioners being asked those questions, I suspect you are asked those questions by your constituents. I know I was asked those questions by your predecessors, and it is important to have not only answers, but credible answers, answers that come from a comprehensive overall credible methodology to provide answers.

If we can change that methodology, if we can make it better, fine. But we had better not abandon the methodology until we have something else in place. To suggest that we do so before we have something else in place I think is inviting trouble that can lead to disrespect and lack of confidence—even more than is reported that we have at the present time.

So, for that reason, I would say improve TCMP and change it, change it drastically, but, for goodness sake, do not abandon it until we have an overall comprehensive credible system that will provide the results that TCMP is presently providing to the folks that are using those results.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. LAWRENCE B. GIBBS
PARTNER, MILLER & CHEVALIER

Madam Chairman and Members of the Subcommittee:

I appreciate the opportunity to submit this statement in connection with this hearing to examine the Taxpayer Compliance Measurement Program of the Internal Revenue Service. I served as Commissioner of Internal Revenue from 1986 until 1989, and I presently am a member of the law firm of Miller & Chevalier in Washington, D.C.

I add my congratulations to those of others on your decision to hold this hearing to examine the IRS' TCMP because I believe that it is timely and important to examine this program at the present time. Good questions are being asked about the program, and suggestions are being made to improve its effectiveness. In this process I believe the TCMP, taxpayer compliance, and our overall tax system will benefit.

The TCMP has been in effect for over thirty years. During that time it has grown and changed to accommodate the needs of the IRS, Treasury, Congress and others who have had an interest in improving tax administration and the compliance with our tax laws. Although TCMP has its drawbacks and its limitations, it is the only comprehensive and reliable method to determine taxpayer compliance that has been devised and has been able to withstand the test of time over the last thirty years. I urge you to encourage the IRS to continue to make improvements in TCMP where such are appropriate. But I also urge you not to abandon TCMP when no viable alternative has been suggested, tested and agreed upon by all of the interested parties who use its results.

When I served as Commissioner, I was asked repeatedly two questions by taxpayers, the media, and the Congress: (1) what is the level of taxpayer compliance with our tax laws, and (2) how much money are we losing to noncompliance? The ability to provide credible answers to these two questions, in my opinion, is a key to taxpayer confidence in our tax system, and that confidence is essential to the continued viability of our tax system.

For all their faults, the TCMP results permitted me to provide credible answers to those two questions. For one thing, taxpayers could identify with the method for obtaining those results, an IRS audit. The TCMP method was not some abstract statistical, economic or social science theory. Taxpayers could understand the idea of using a statistical sample of in-depth IRS audits to determine the levels of reported and unreported income, of appropriate and inappropriate deductions and credits. Taxpayers also could understand the concept of using the TCMP results to set standards for future selection of returns for audit and to estimate the dollar amount of tax noncompliance by individual taxpayers.

There are many shortcomings of the TCMP. They have been detailed in other testimony and will not be repeated by me here. However, no one has come up with a better overall, comprehensive, credible approach to provide answers to the above two important questions that everyone wants to know about our tax system. And make no mistake about it, your constituents will want answers to these questions, just as you and your colleagues in Congress will want answers.

From personal experience I can tell you that your predecessors wanted answers to these two questions from me while I was Commissioner. And your predecessors were not satisfied with anecdotal responses, partial results from new and unproven tests, theories about how to improve tax compliance, or promises about what new long-term research studies would eventually provide.

Also make no mistake in believing that your predecessors were unaware of the defects in the TCMP results. On the contrary, the defects were pointed out, often painfully so for me and others at IRS. Promises were made to improve the TCMP, and steps were taken to do so. However, we did not propose to abandon the "known devil" in favor of some "unknown devil."

Yes, the 1994 TCMP will be expensive for the government. In part, however, that is a function of the fact that the new TCMP will provide baseline data for the new approach to the new IRS compliance program called Market Segment Specialization Program, which I believe is the right approach for IRS to be taking in the compliance area. As I understand it, future TCMP-type data will be gathered less expensively.

In part the increased cost of the 1994 TCMP results from an attempt by the IRS to develop data to provide better answers to important questions previously raised by this Subcommittee and others in Congress about the extent of tax compliance under our present system. For example, this Subcommittee over the last several years has held several hearings to discuss the extent of compliance, or noncompliance, by subsidiaries of foreign corporations doing business in the United States. Part of the 1994 TCMP is designed to develop meaningful data to provide better answers to the important questions previously raised by the Subcommittee in that regard.

Yes, TCMP audits involve some additional taxpayer burden. But as a taxpayer who has undergone a TCMP audit previously, I believe the taxpayer burden arguments are overdone, particularly for compliant, well organized taxpayers. IRS takes steps at the beginning of a TCMP audit to minimize the cost and pain of the actual TCMP audit if taxpayers will prepare for the audit by initially organizing their tax information to permit them to more readily answer the auditor's questions. If taxpayers do not do so, or do not have the necessary data to support their income and deductions, then the process can be long and painful, as is usually the case in the normal audit for the same reasons.

Yes, TCMP results are imperfect in determining taxpayer compliance levels and the amount of tax being lost to noncompliance. TCMP certainly does not answer all of the important questions about how to improve taxpayer compliance and minimize noncompliance, and I continue to support the IRS requests for additional appropriated funds (or even the reallocation of existing compliance funds) to support more compliance research. Without a doubt, there is room for continued improvement in all of these areas.

Unless and until a better overall, comprehensive, and credible method to determine and measure tax compliance and the tax gap is developed and tested, I believe it would be a mistake to abandon the TCMP. We can, and should, use the current criticisms to improve the TCMP, but we ought not to abandon it. It may be fashionable at present to simply decide to "start over" when something does not meet our expectations. In the case of the TCMP, I believe to do so would be unwise.

Thank you for inviting me to testify. I will be happy to answer any questions.

Chairman JOHNSON. Thank you, Mr. Gibbs.
Dr. Sparrow, welcome.

**STATEMENT OF MALCOLM K. SPARROW, PH.D., LECTURER,
PUBLIC POLICY, JOHN F. KENNEDY SCHOOL OF GOVERN-
MENT, HARVARD UNIVERSITY, CAMBRIDGE, MASS.**

Mr. SPARROW. Thank you.

Madam Chairman and members of the subcommittee, I thank you for letting me be a part of this discussion this morning. In some ways, this discussion is part of a broader discussion about the policies of regulatory agencies, and the broader question would be should regulatory agencies be allowed to do random inspections of any kind? Should Customs be allowed to select passengers at random as they come through the airport in their attempts to understand patterns and methods of drug smuggling? Should OSHA inspectors be allowed to show up unannounced at a construction site where there has been no report of hazards, but they go on a random basis just to find out what kind of hazards are there?

I believe that regulatory agencies should be allowed to do random inspections and that it is vital, if they are going to understand patterns of noncompliance. For the last 6 years, I have been studying and writing about some of the changes in the strategies of American regulatory agencies, and there is a very significant movement under way and the IRS is party to that movement.

The movement I think is an attempt to discover a more intelligent, a more analytical approach to identifying patterns of noncompliance and then picking them apart, understanding where they come from and bringing a broad range of different tools to bear on identified patterns of noncompliance.

At its heart, this strategy is designed to be less coercive, to rely much less on traditional enforcement approaches and to consider, instead, a much broader range of intervention tools, including education, legislative changes, simplification, education programs of various kinds, as well as the normal ragbag of audit and enforcement tools.

Police departments call this problem-solving policing. Environmental protection agencies call it managing for environmental results. OSHA is now calling it the problem-solving approach to hazard mitigation. The IRS calls it their Compliance 2000 strategy.

Now, what is at the heart of the Compliance 2000 strategy, if I understand it correctly, is an intention to develop the capacity to identify important areas of tax noncompliance and then produce tailor-made surgical interventions aimed at producing higher levels of compliance, and to do that problem-area by problem-area. That is the heart of the strategy and it is still under development. It is certainly not fully implemented. It is a much more analytical, more intelligent, and less enforcement oriented approach to taxpayer compliance, which I think we should all recognize and welcome.

But such a strategy depends absolutely on the agency's ability to see clearly patterns of noncompliance and to recognize when they change, and to recognize it sooner, rather than later. An important question to ask is what apparatus is there available to the IRS to enable it to see changing or shifting patterns of noncompliance? I

believe that the TCMP instrument itself forms a vital and perhaps indispensable or irreplaceable part of that monitoring apparatus.

The danger the TCMP helps IRS avoid is one that is common to regulatory agencies and to intelligence agencies. Once you start focusing on a particular thing, your belief that that subject area, that problem area is important can become a self-fulfilling prophecy. If you are an intelligence agency and you believe that a particular individual is central in an organization, you then focus more surveillance on that individual. As you do so, you learn more and more about them, and the more you learn about them, the more they appear central in your thinking. It is a self-fulfilling and circular way of doing business.

The danger in regulation or compliance agencies is similar, that you can delude yourself into thinking that you know exactly what these noncompliance problems are, and if you have an idea about what they are, that is what you focus on. Those would be the audits and the examinations that the IRS would conduct. It is quite conceivable that over here on one side, far away from where your sights happen to be trained, new patterns of noncompliance are emerging of which you are completely oblivious.

Random audits are as unpopular within regulatory agencies as they are outside. Auditors will always tell you that they prefer to be allowed to focus and target their efforts, because they could raise more revenue that way. They are right, they certainly would raise more revenue that way.

But that is not the point. The whole purpose of random audits is that it gives you important information which allows you to do long-range planning and to adjust and redirect your resources over the long term. That is exactly the purpose of the TCMP data. It allows the IRS to adjust their audit selection formulas and target examination and audit resources, and to select enforcement actions that have the greatest impact.

Perhaps one way of looking at this is to remember that the IRS does more than 1 million audits per year which are focused. The critical question is whether those 1 million audits per year are well focused. If they are going to be well focused, what instrumentation and what data is that focusing based on? This is a relatively small number of random audits which helps to ensure that the bulk of the audits are in fact focused on the right people and the right patterns of behavior.

Thank you.

[The prepared statement follows:]

Testimony of: Dr. Malcolm K. Sparrow
John F. Kennedy School of Government
79 John F. Kennedy Street
Cambridge, MA 02138
(Tel: 617-495-8359)

Before: House Committee on Ways and Means
Subcommittee on Oversight

Date: Tuesday July 18th 1995

Thank you for the opportunity to address you this morning on the importance of the Taxpayer Compliance Monitoring Program.

For the last six years I have been studying and writing about some very significant changes in the way American regulatory and enforcement agencies approach their business. Many such agencies are rejecting their traditional dependence on predictable processes, procedures, and "coverage", and are developing new capacities for analyzing important patterns of noncompliance, prioritizing risks, and designing intelligent interventions using a much broader range of tools than traditional enforcement actions alone. Police Departments call this emerging strategy "problem-solving policing". Environmental agencies call it "managing for environmental results". OSHA now calls it "the problem-solving approach to hazard mitigation". The IRS calls it "Compliance 2000".

Under "Compliance 2000" the IRS proposes to develop its capacity for identifying important patterns of tax non-compliance and designing tailor-made, surgical interventions aimed at producing higher levels of compliance, problem area by problem area. That is the heart of their "Compliance 2000" strategy, which is still under development. It is a more analytical, more intelligent, less enforcement-oriented approach to taxpayer compliance; which I think we should all recognize and welcome.

Such a strategy relies absolutely on the agency's ability to recognize quickly, and to see clearly, new patterns of non-compliance as they emerge from time to time. The TCMP forms a vital and, I believe, indispensable part of the monitoring apparatus.

The danger that TCMP helps the IRS avoid is a common one, facing all "compliance" or "regulatory" agencies: namely the risk of assuming that you know about, and can see, all the important patterns of non-compliance. The way these agencies can delude themselves goes something like this. You focus on what you think are the central problems. As you do so, you learn more and more about those problems, and they become yet more central in your thinking. As time passes, you work on the non-compliance problems you know about; and you learn yet more about the non-compliance problems you work on. You can easily get caught in the circularity of this, focusing more and more carefully on things you always focused on before, just because those are the problems that happen to be in your sights. You fish in the same place, year after year, because that's where you caught fish

before.

Meanwhile new patterns of non-compliance emerge, some geographically concentrated, some peculiar to particular industries, some particular to certain tax-provisions; but all potentially out of your sights. If you have no system or machinery to help you spot new problems, you may not notice them for many years. TCMP is a piece of machinery designed specifically to help identify new areas of non-compliance, which the IRS might otherwise remain oblivious to.

TCMP's strength, I believe, lies in its random selection. (The IRS uses a stratified random sampling technique to make sure that the sample sizes in each area and industry segment are large enough to support proper statistical inferences). The whole point is that the selection is not focused on any existing problem, nor based on any existing IRS biases about where the important problems might be. It is designed as a statistically valid, scientific method of scanning the horizon for new problems. It reveals to the IRS what they don't currently know about patterns of non-compliance.

Random audits are usually as unpopular within a regulatory agency as they are outside. Auditors often think random audits (or "studies") are a waste of time, saying they could raise a lot more revenue if only they were allowed to focus on known problem areas. Which is true; they would raise more revenue that way.

But that argument misses the whole point. The principal value of random audits by the IRS (or--for that matter--random inspections by Customs, or random audits of health care claims) is that they provide information about types of non-compliance which existing targeting strategies might be missing. They provide the opportunity, over the long term, to redirect resources; to adjust audit selection formulas; to target examination and audit resources more effectively; and to select enforcement actions that have the greatest impact on significant areas of non-compliance.

Any cost-benefit analysis of such a program has to weigh the importance of the information about non-compliance trends, which will act as a basis for longer term planning and resource allocation, rather than focusing on the immediate and direct revenue implications.

I understand that undergoing a thorough, line-by-line IRS audit takes some time. I just went through one myself. The IRS plans, I believe, to audit roughly 92,000 individual returns in the proposed TCMP. Given that there are more than 100 million individual filers, and that TCMP comes around no more often than once every three years, this represents a risk of facing a random audit, per taxpayer, per year, of less than 1 in 3,000. This, I believe, is a very small price for taxpayers to pay in exchange for the assurance that the IRS will be able to devote its considerable public resources to the most important non-compliance issues.

I regard TCMP as an essential instrument for monitoring the shifting patterns of non-compliance. Taking it away would blind the IRS to changing patterns of non-compliance.

Chairman JOHNSON. Thank you.

Dr. Sparrow, those 1 million audits that the IRS does, what information did they turn up about deductions?

Mr. SPARROW. The focused audits do continually provide feedback to the IRS about different forms of noncompliance, as does any focused inspection by a regulatory agency. Whenever you go to delve into one matter believing that you knew what the problem was, you come away a little better educated, and sometimes you will see things that you were not looking for.

But the danger is that, in massive systems such as the IRS, you can completely miss some patterns of noncompliance. There is a feature of tax noncompliance and it is a feature shared with all kinds of other compliance areas that the problems do not reveal themselves automatically, unless somebody goes—

Chairman JOHNSON. I appreciate that, but I should think the problems like alimony reporting, like the deductions for children, it seems that those might have raised their heads in the million annual audits.

Mr. SPARROW. Yes.

Chairman JOHNSON. Why do they require such an extraordinary effort? First of all, do you know whether they did or did not?

Mr. SPARROW. They do undoubtedly.

Chairman JOHNSON. They come to the agency's attention through the normal audit course?

Mr. SPARROW. I think it is most unlikely that TCMP would show a form of noncompliance which was totally new and that nobody had ever seen. But I think perhaps its value is in helping you to understand the magnitude and relative importance of different problems.

I can provide an example of an issue that the IRS was well aware of, but did not really understand the magnitude of. I did some work for them on the electronic filing program and the frequency of fraud in that program. They knew that that was a problem and they were detecting a fair number of fraudulent returns coming through that system. But it was not until the 1994 filing season when they actually did a scientifically constructed and statistically valid random sample from which they were able to extrapolate to the whole population that they discovered the size of the problem.

Chairman JOHNSON. So your study of EITC, the earned income tax credit, would be an example of a targeted study that developed from the normal compliance process, would it not?

Mr. SPARROW. It was different from the TCMP in that it was focused on one particular kind of return.

Chairman JOHNSON. Last, so I do not keep my colleagues waiting too long, what is your response to the fact that the TCMP did not indicate the widespread abuse occurring under the shelter law?

Mr. SPARROW. I am not familiar with that particular form of non-compliance.

Chairman JOHNSON. Mr. Gibbs, would you like to comment on that?

Mr. GIBBS. I guess I would comment this way: I have said before that there are certainly shortcomings and there are certainly defi-

iciencies in any process or procedure. But, Madam Chairman, it is the best form that we have and I think it is credible.

One of the things that I said in my testimony that I would like to reiterate here, one of the things about the TCMP type approach is that taxpayers across the country can at least understand it. It is not an abstract statistical, it is not an abstract economic, it is not an abstract social science type of theory.

At least at the bottom of it, people can understand and relate to an audit. They can understand and relate to using a bunch of audits as statistical samples on a periodic basis to measure compliance and see how much we are losing. I think that is really important in terms of people understanding and, therefore, having a method that seems credible across the country.

So almost anything you come up with is going to have shortcomings. You can criticize various aspects of it. But if it has a basic ring of truth, until we come up with something that is better, my reaction is it is something that we ought to continue to refine and improve, but we ought not to abandon it. So I would respond to you by saying you may be able to pick at it and show one place where it did not work, one thing that is wrong with it or those types of things. But overall it is better than anything that anyone has proposed as an alternative.

Chairman JOHNSON. Mr. Goldberg.

Mr. GOLDBERG. I am tempted just to rest my case. Madam Chairman, I think that the problem we are having here is TCMP, to the extent what you are saying is random sampling is important, I absolutely agree. To the extent you are saying measures of the tax gap are important, I am not quite as convinced, but that is an OK thing to do.

My testimony is directed toward the proposed 1994 TCMP. I do not believe that the additional reliability, if any, with respect to tax gap estimates that will come out of that program is worth anything like \$550 million in taxpayer money, more than \$1 billion of out-of-pocket expenses by our citizens, and hundreds of millions of hours of time and torment. I do not think it is worth it. I believe that you can get approximately accurate tax gap estimates far more efficiently and far more effectively in other ways.

Dr. Sparrow referred to circularity. I believe he is describing an important phenomenon, but I believe the circularity is that the IRS for 35 years has been taking these enormous samples and running these so-called TCMP audits on intervals ranging from 3 to 10 years. The circularity is that the IRS is afraid to let go. We have always done this, so we know this is the only way to do it. That is the circularity.

The IRS, I am absolutely convinced, could accomplish its objectives, could deal with tax gap measures, could deal with detecting trends of noncompliance, could deal with coming up with responsive answers to Members of Congress who are considering anything from EITC compliance legislation to fundamental tax reform through a system that was designed in a fundamentally different fashion. At the end of the day, it will rely on random selection, but you can do a lot better for a lot less. Why not?

Chairman JOHNSON. Certainly the benefit of targeted studies is demonstrated by Dr. Sparrow's really excellent work on the EITC.

I understand the overall logic of the IRS' taxpayer compliance program. It is instructive that it does not touch on the biggest revenue loss area and that is unreported income.

Is there a program that the IRS could and should be developing to find out how they could better track all the cash economy that the current system is incapable of reaching? This is probably the most important issue that we face right now, because we are about to change our entire Tax Code in part to reach the unreported income.

One does have to question spending \$550 million to refine the structure we have, when one of the reasons for totally changing it is that so many are not complying, and this will not reach them. Now, is there any way we can design a program that might find out how people are avoiding reporting and what can we do about it?

Mr. GOLDBERG. Madam Chairman, with all due respect, I believe that you are going through exactly the process that the Internal Revenue Service should be going through. You have stated a hypothesis. It is correct, in my judgment. Unreported income is the biggest single problem in the system.

The next question, can we design a research program that will allow us, No. 1, to understand the magnitude of that problem, and, No. 2, design the research program in a way that will give you answers you care about, give you answers that you can do something with. I believe the answer to that question is unambiguously yes, I believe that could be accomplished. I believe it could be both accomplished and educated in a fraction of the time required for TCMP, and I believe that the information you would derive would be far more reliable.

Mr. GIBBONS. Madam Chairman, I would like to respond. It is interesting that you raise that. You are going to have another witness later on in this testimony, Dr. Kent Smith, that was responsible for the largest study I know of on noncompliance in the tax area. It was sponsored by the American Bar Association.

There have been proposals. There have been a lot of proposals over the last 20 years as to how we detect, what we do to measure, and how we prevent the problems that are going on in the cash economy. This gets back to my fundamental point: To tell me that you will promise me that if I will agree to give up something, you will find something for me that will do this, my reaction is why not give it to me now and let me compare it against what I have before I give it up. Because for the last 20 years, we have not done a very good job. We have known the problem was out there, it has been studied and we still do not have something that people can agree on a broad basis will be appropriate to measure, detect, and prevent the problems in the cash economy.

Mr. GOLDBERG. Madam Chairman, I would just like to point out—and I have not discussed this with Dr. Smith, and I could be mischaracterizing his testimony—I believe his recommendations in essence, at least as I read it, that it may well be prudent to move to far smaller sample sizes and to conduct TCMP examinations on an annual basis. I believe that is also Dr. Scheuren's recommendation, and it is my recommendation, as well.

Chairman JOHNSON. Thank you.

Mr. GIBBS. Again, Madam Chairman, I just want to make the point that if we can get a consensus, a broad-based consensus about something that is comprehensive and credible, fine. But until we have that, we should not abandon what we have in favor of the pig in the poke.

Chairman JOHNSON. I appreciate your comments, Mr. Gibbs.

Dr. Sparrow.

Mr. SPARROW. Madam Chairman, I think you raise a very important question on the subject of the cash-based businesses, the underground economy, and particularly nonfilers. Central to the Compliance 2000 philosophy is certainly the idea that every kind of noncompliance would be systematically and intelligently studied and then remedies sought. So certainly the IRS should be paying an awful lot of attention to problems that they cannot see through their own internal data.

Now, the specific area that you raise is a very peculiar kind of noncompliance problem. I think nonfilers have always been for many years the IRS' No. 1 compliance problem. If the IRS asked itself what program do we have in place to deal with nonfilers, the answers for many years has been "virtually nothing" because we deal with what comes to us. What data do we have about nonfilers in our data base? Absolutely nothing, not one bit or byte, because they did not file. So this particular problem is an extremely difficult one to get at and to study and requires you to go to outside sources, rather than inside sources.

In looking for signs of concentrations of a cash economy or undeclared income, divide that into two categories: undeclared income and unreported income for people that file and undeclared income for nonfilers. The nonfilers really does require the IRS to go to outside sources of data, just as they would, for instance, have to look at the Yellow Pages of the telephone directory and see which of these businesses that are advertising have not filed and compare that with their own records.

The TCMP data in some sense could help with that form of analysis, though. Suppose you are interested to know what proportion of the jewelry trade in the Los Angeles area did not appear to file tax returns. One way of doing that is to have a representative sample of the ones that did file, to be able to extrapolate by some guess as to how many of them you think there are, and to compare that with external economic indications as to how much revenue this business generates. But it would necessarily have to involve the comparison of internal TCMP data to some other external source which is less traditional for IRS to rely on.

With respect to filers who do not declare their revenue, I just went through a line-by-line IRS audit and was actually quite impressed with the way that it was approached. I had my pile of records on the table, and for at least the first 1½ hours the examiner was not the least bit interested in those. Instead, it was an asset-based approach. She was asking me what I earned, would I show her and tell her about any houses or cars. Then she worked back from that to see whether it appeared to match the income that I had reported.

Even though what she ended up doing was a line-by-line—she wanted to know how I arrived at every figure—there was also room

in the audit for her to notice that my living style might not match what I had declared, and there is that possibility, I believe, even within the line-by-line direction of the TCMP audits.

Chairman JOHNSON. Thank you. I am sorry that I must excuse myself. I am going to recognize Mr. Laughlin and turn over the gavel to my colleague, Mr. Hancock.

Mr. HANCOCK [presiding]. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Goldberg, in your testimony here today, you said there were other far less costly and intrusive ways to develop estimates of at least equal reliability. I first want to ask you what are the intrusive ways that concern you about the TCMP?

Mr. GOLDBERG. Mr. Laughlin, we are selecting 153,000 citizens, taxpayers, businesses and asking them to provide a line-by-line justification of every item on their return. I can tell you, as a former IRS Commissioner, I can tell you as a practicing attorney, and I can tell you as a citizen, I guarantee you that is very intrusive. That is a miserable experience.

I think that because the government does not have to pay the freight—

Mr. LAUGHLIN. Because the government does not have to what?

Mr. GOLDBERG. Because the government does not have to pay the freight, it is pretty easy to forget what we are doing to the citizen, and that bothers me. It is an intrusive process and I do not think anyone would dispute that.

Mr. LAUGHLIN. I want to ask you from that same testimony if you could identify some less costly methods and intrusive methods for obtaining the information that is sought.

Mr. GOLDBERG. It depends on which objective. If you are talking about tax gap estimates, people can make tax gap estimates relying on many different data sources. TCMP is a piece of that, but there are other ways to make those estimates.

I am not a statistician, but, as I mentioned, Dr. Scheuren is, I believe that Dr. Smith is. The experts I talked to when I was the Commissioner led me to conclude that on an all-in basis, the system would be far better served through far smaller samples, orders of magnitude smaller with annual kinds of examinations being conducted. I believe that would be a far more effective approach. The \$550 million of taxpayers' money is a lot, and I am not convinced that the additional accuracy of any TCMP tax gap estimate is worth the cost.

Mr. LAUGHLIN. The reason I ask about the intrusive ways, I have those concerns, too. You stated that you estimate out-of-pocket cost to the taxpayer to be in the \$5,000 to \$10,000 range. My question is what expenses were used in reaching these estimates that you made?

Mr. GOLDBERG. It was like that. There is no data. All I can tell you is that 60,000 of these audits are going to involve partnerships and corporations, another 50,000 to 60,000 are going to involve taxpayers with schedules C, F, D, and at least in my—I believe those numbers are probably low. But one of the things that I find rather striking is that, in light of all this discussion, I do not believe that the TCMP audit itself even gets information on how much taxpayers spend in the process.

Mr. LAUGHLIN. Certainly, if it gets beyond \$1,000 or so, it certainly takes on the approach of an unfunded mandate that has been on the minds of a lot of Americans the last few years in just dealing with their real property and other activities, so I share the concern that you mention there.

Would you have such a concern on the intrusion to obtain the information, if the IRS were paying the taxpayer for his or her time to come and sit through the compliance audit to determine where the gaps are?

Mr. GOLDBERG. Well, that would recompense the taxpayer for the out-of-pocket costs. I am not sure it recompenses the taxpayer for the time, the pain, and the suffering. But I think that that would be an important first step to take.

Mr. LAUGHLIN. You have also indicated that nothing new would be learned about the overall tax gap and its major components. The TCMP design calls for measurement of the compliance by market segments. Do you not think that a knowledge of which groups of taxpayers are contributing to the tax gap would be valuable?

Mr. GOLDBERG. I believe that the market segment approach to tax administration is the single most promising development in a decade. I think Dr. Sparrow's reference to Compliance 2000 was an issue I had some involvement with. I think that is breakthrough progress in tax administration.

What I am saying is that the 1994 TCMP as designed in my judgment is trying to retrofit something to deal with these new issues. I believe you could deal with those new issues far more effectively if you simply say I want to design a program to deal with those new issues. I think we are trying to make something that used to be useful serve a very different purpose, and I do not think they are going to get there as well as they should get there. I agree with market segments, absolutely.

Mr. LAUGHLIN. Thank you very much. Thank you, Mr. Chairman.

Mr. HANCOCK. That was an interesting comment you made, compensating the taxpayer for the pain and suffering. I do not know whether that could be done or not.

Is it possible—and I would like to ask all three this question—we were seriously considering major changes in the tax law in this country, the possibility of a consumption tax or a flat tax. Can we justify the TCMP on a basis of what we do maybe here in the U.S. Congress in the 105th Congress for at least data information, the compliance information on how the existing tax law ought to be changed, or what we need to do if in fact we change it?

Mr. SPARROW. Certainly, if there is a looming and major change in the tax law, then it makes this less attractive at this time right now, but I would make two qualifying points.

Even if change is coming, then somebody is going to be doing an awful lot of thinking about sensible changes in tax policy, what are the areas of tax administration that cause taxpayers difficulty, which are the areas that are poorly understood, what are the principal forms of noncompliance under the existing system. I do not believe that the IRS, having not done a TCMP survey since 1988, really has up-to-date information of that kind on which it could soundly base recommendations as to tax policy changes.

On the other hand, if there is any doubt at all that major tax changes are coming, if there is a possibility that the tax system remains much as it is for a few more years, then TCMP is urgent. It has not been done since 1988. It is long overdue. It was canceled in 1991, I understand, because of a variety of internal and external objections to it, the normal objections that come any time any regulatory agency does a random inspection of any kind.

All such inspections are intrusive by their nature. Regulatory agencies depend on them absolutely. The fundamental issue here is should regulatory agencies be required to compensate individuals for that necessary intrusion, and should random basis be permitted as a basis of selection.

Mr. GOLDBERG. Mr. Hancock, as the unnamed Commissioner who was responsible for that heinous act in 1991, I would like to comment, since I was the one responsible for the decision to allegedly cancel the TCMP.

Once again, I believe that random selection of individuals and enterprise for a thorough examination is a necessary component of the tax system. You have got to do it, if you are going to get the right answers. So I do not dispute that point.

It was not a question of canceling TCMP, shoving our heads in the sand and making light know-nothings. It was saying you can redesign the system, late 20th century statistical techniques, sampling techniques, research techniques, saying that we can do a better job of getting done what we need to get done at the IRS, and it was not a question of doing nothing.

It was saying go rethink the system, come up with a better design and get it done. I believe the suggestions again of Dr. Scheuren and others who have said far smaller, far more frequent TCMP-like examinations will be less intrusive at the end of the day and provide the government with far more reliable and far more useful information. This program, by its own design, is not going to be materially finished until 1998. If the Congress goes forward with tax reform in 1997, it is a day late and a dollar short.

To the extent, for example, the chairman suggests, issues of cash economy and the underground economy are relevant and that maybe some type of national sales tax or some other low rate of tax would improve compliance, those are important questions. You can only answer those questions through well-designed research programs. Those research programs will necessarily entail as a component some random selection of taxpayer for examination.

But it is not a one-shot 153,000 returns that you are going to do starting for tax year 1994. They are going to be done in 1999, at which point somebody is going to say are we going to do another TCMP, and we are going to say, well, we do not have anything better, we do not know what to do yet, we are dealing with a different system now, we had better do a TCMP, and I suggest that more annual, more focused, far smaller efforts at the end of the day are a better use of the taxpayer's dollar, and by definition less intrusive.

Mr. GIBBS. Mr. Hancock, I would like to respond to this one. For 30 years, we have measured taxpayer noncompliance and compliance in this country and we have estimated the tax gap based on a methodology. That methodology is TCMP. It has grown, it has

changed, it has evolved over that 30-year period. I believe generally, as a methodology for those two purposes, it is accepted by the American public. They understand it and they accept the results.

Now, there are a lot of criticisms that you can raise, and here is my point. My point is, if you are going to postpone it, then before you start saying what we are going to do, we should come up with an alternative. Let us get the alternative and be sure that we have the buy-in from the various constituencies out there that this is going to be as good as or better than what it is that we are abandoning.

I think your tie between tax reform that is going to be discussed and this program is an interesting one, because, in effect, what I am suggesting is that we should do the very thing that I applaud the Congress for doing at the present time. We are going to be discussing what the alternative tax systems are. We have proposals up on the table. People are going to know what they are, and then we will see in the final analysis, whether the country agrees to abandon what we have and go to something else or modify it in some way.

If I could answer that, I guess I could answer your question with respect to the cost benefit of the current TCMP. I would make just a practical suggestion to you. I would suggest to you that as we go about talking about something that is going to be far more complex than TCMP, namely a potentially alternative tax system, if we get an awful lot of things held up, not right now, but since 1991, and you put those chips on the table, you are putting an awful lot of pressure on yourselves and on the system in terms of making what seems to me to be a more important choice.

Some have said if you want to drive tax reform, let the TCMP go forward. With all the media publicity and the wailing over the 153,000 taxpayers, maybe that will drive tax reform. My reaction is I would do it for another reason. I would let the system go forward until we make the conscious decision in this country to change it. That would be my response.

Mr. HANCOCK. Mr. Gibbs, I agree that the principle of the TCMP has probably operated for about 30 years. Thirty years ago, we did not have anything close to the gray areas that we have got now in compliance. When you read in Money Magazine that 50 accountants came up with 50 different conclusions and nobody got it right, you have got a real problem of compliance with the law. Even people who want to comply with it have a problem. What do you do, say I will not take the gray area? Well, you are nuts if you do not take the gray area. Frankly, I think that there are a lot of changes to be made in the internal revenue law without having to completely redo it. However, I am in favor of getting rid of it completely.

Mr. GIBBS. I would simply comment to you that 30 years ago I think this same discussion was held and that was the reason they came up with TCMP. It does give us good data about what we do know. Maybe there are other methods that we should use for things we do not know. But I would not abandon the method for measuring what we do know simply because it is not fulfilling all

of the purposes. Change it, adapt it, make it better, but I would not abandon it.

Mr. HANCOCK. But is it not true that the TCMP only deals with filed returns? It does not take care of the question of nonfilers, and we do not even know what that is. We do not have the vaguest idea of what that is.

Mr. GIBBS. My point 1 minute ago was that we have known about the nonfiling problem for 20 years. What we have not been able to get is a consensus about what type of system is right to measure it, detect it, and then try to do something about it. There have been folks outside the Internal Revenue Service, as well as inside the Internal Revenue Service, working on it.

My only point is do not abandon something that is working for filed returns until you tell me what it is you are going to come up with to deal with the unfiled returns or the unreported income.

Mr. SPARROW. I share your concern about the nonfilers and the failure of TCMP to get at that issue. But nonfilers are at the end of the day only one of scores of identified noncompliance issues, and disbanding with TCMP loses your instrumentation on all of those others. It would be a mistake to do that simply because it did not address one. Rather, I would raise the question, if we have TCMP and that does not address the nonfiler issue, what else do we need to make sure that that particular critical noncompliance area is not forgotten and is properly addressed?

Mr. HANCOCK. Does any witness have any other comment you would like to make?

Mr. SPARROW. It has been very interesting for me to hear Mr. Goldberg's objections to this. He has stated repeatedly that there are alternatives to the random methodology for scanning the horizon for problems that you do not know about. It is true, there are. You can use focus groups and surveys and you can guarantee people anonymity. A lot of researchers at different times have tried to use those tools to get valid and unbiased views of taxpayer behavior. They are notoriously unreliable.

So I am relieved when my friend acknowledges that there is no substitute for randomly selected returns, and that is a fundamental piece of measurement machinery that all regulatory agencies have to have available to them, if they are going to see clearly what issues they are dealing with. That does leave open, though, the question of how big, how often, and whether now is the right time. I understand that those are important critical issues and they are separate from the underlying question of should we allow random audits.

On the question of how big and how often, I would just say in terms of having a sensible data base from which to work, there is now an accumulated deficit of 7 years, with no randomly generated data, and it is urgent that that gap be filled.

Thank you.

Mr. HANCOCK. We just got a call for two 15-minute votes, so we are going to recess this panel and invite the next panel back at 1 o'clock or thereabouts.

[Recess.]

Mr. HANCOCK. Welcome to the subcommittee. Thank you for appearing to testify to the subcommittee on a very important subject.

We will dispense with the preliminaries and get right on to Ms. Smith.

STATEMENT OF VERENDA SMITH, ALEXANDRIA, VA.

Ms. SMITH. Mr. Hancock and subcommittee members, my name is Verenda Smith and I live in Alexandria, Va. I have been asked to share my experience with what I now know is called a TCMP audit.

I have developed a personal definition of adventure. It is something that you wonder if you are going to survive. A TCMP audit is unquestionably an adventure. To understand how the audit affected my life, you have to know about my circumstances at the time.

In the early eighties, I was working as a sports columnist at the Jackson Clarion-Ledger in Jackson, Miss. I earned around \$25,000. I had a few stocks, and I owned a house. My tax situation was fairly simple, but I used a CPA to prepare my return because he had helped me in the year that I had sold a house.

In 1982 I was transferred to Virginia to help launch a new publication called USA Today. I was moving into a 400-square-foot apartment, so most of my belongings went into a storage shed in Jackson.

Now we jump ahead to January 28, 1983. I remember the date clearly, because that was my birthday. Among my birthday cards was a letter from the Internal Revenue Service telling me that I had been selected for an audit which would be at my house in Jackson in about 10 days time.

At that point, I did not know anything about the nature of the audit. I thought all audits were the same, and that if your return was chosen, everything was scrutinized. I thought it was strange that they would want to look at a simple return like mine, especially since I was anything but rich. One thing was clear, though, this was a very extensive audit.

The letter told me that I would need bank statements, documentation to show the source of all my bank deposits, documents to back up every item on the return, and, if I could, would I please supply a copy of the return itself.

Thankfully, the letter also supplied the name and phone number of my IRS auditor. I called immediately. I am pleased to report that the auditor was great. He seemed to anticipate that I would be confused, surprised and facing difficulties, and he was prepared to help. The reason I can tell this story today and smile is because he understood that I would need my hand held. He used humor and judgment, and he did not treat me like a tax cheat, but, rather, like a taxpayer.

He filled out his questionnaire while we were on the phone, and there were dozens of questions, like what kind of car did I drive and how much cash do I typically carry, questions that seem geared toward determining whether my lifestyle fit my \$25,000 salary. None of the questions were very personal, but some of them were humorous.

We rescheduled the audit and arranged to have it at his office. My employer invented a business trip to Jackson so I could gather

my papers. Had my company been less helpful, that would have been a most painful expense.

I clearly remember standing outside that storage room looking at a floor-to-ceiling collection of boxes, and I think every one of them was labeled "household stuff." I dug in and eventually toward the back found the box with my old personal records.

That was the easy part. My W-2 and interest statements and so forth were there with the return. But I cannot estimate how many hours I spent pulling together the bank records. I remember the IRS wanted more than 12 months of bank statements. I recall it covered at least parts of 3 years.

So I had to sort through my checking account records to see how many statements I had in hand. Then I had to go to the bank and order reprints of those I was missing. I had to pay a small fee for each of the statements. Then I had to go through the bank statements and make sure I could defend or explain each deposit. I did not worry over the small \$5 ones, but my travel reimbursements were sometimes substantial. Also, sportswriters often freelance, and I knew I had to show that I declared all my earnings.

I spent at least one afternoon at the newspaper getting copies of my reimbursement records. Eventually, I had everything explained except for one \$1,500 deposit. I could not find any record of where the money had come from. I finally told my accountant that I was worried about it, and he pointed out that it was my tax refund from the previous year.

I did not have to go to the audit myself. The auditor said my accountant could probably answer all his questions, and this saved me a trip to Jackson. I do not believe I paid the accountant extra. I had paid him to prepare the return, and also I had done all the work in gathering the documentation. But I would have paid him, if necessary, just so I would not have to sit and watch while my financial life was strip-searched.

My accountant called later that day to say that the auditor had seemed pleased with all the documentation and did not think there would be any change to my return. My accountant said this was probably the best audit he had ever participated in. He said the auditor was professional and pleasant and covered the ground quickly.

A few weeks later, I received this letter in the mail. It said: "We are pleased to tell you that our examination of your tax returns for the above periods shows no change is necessary in your reported tax." Suddenly the whole experience was worth the trouble. I had survived the adventure. But more importantly to me, I had done my part as a citizen of this country. I had filed my return, I had paid the lawful amount of tax and I could prove it.

There have to be audits, and this means that citizens get singled out even if they have done nothing wrong, not unlike jury duty. I hope I never have to do it again. It cost me quite a bit of time and a small amount of money. But I have never been sorry that the computer spit out my name.

Thank you.

Mr. HANCOCK. Thank you.

Mr. Lane.

**STATEMENT OF JOSEPH F. LANE, ENROLLED AGENT, ON
BEHALF OF THE NATIONAL ASSOCIATION OF ENROLLED
AGENTS**

Mr. LANE. Mr. Chairman, my name is Joseph Lane and I am an enrolled agent in private practice in Menlo Park, Calif.

Thank you for inviting me to testify here today on behalf of the National Association of Enrolled Agents. We have a written statement which we have submitted and I assume it will be in the record. A lot of information has been given already about the historical basis for TCMP, and I will not bother going over that again.

I will go over another taxpayer's reaction to the TCMP which was a little different than Ms. Smith's here today. I had a medical doctor who was a client who went through the last TCMP in 1988. His definition of the process was "an autopsy without benefit of dying." He had his personal income tax returns, his corporate income tax returns, his pension plan returns, and the returns of his children's trust all examined as part of the TCMP.

He was still amazed about the sheer volume of data that the auditor required and the cost of having representation through the process well exceeded his annual costs. The result of his audit was that all the returns were accepted as filed, but that is scant solace for his lost income for the time away from his practice, the months of responding to ever-increasing demands for more and different information, the stress of being subjected to an IRS probe into all of his financial affairs, and the necessity of having to explain many nontax related transactions to the satisfaction of the examining agent. That last point was particularly vexing to him.

He questioned why he had to explain to the examiner why he refinanced his ski house. He had never deducted any portion of the ski house for his business. It was for the sole use and enjoyment of his family and he felt that it was none of the agent's business.

My explanation that the agent had to account for all deposits into his bank accounts during the period under examination to ensure all income was properly reported merely served to further enrage him that his honesty should be questioned about reporting his business income.

When I recently told him the IRS would be conducting another TCMP this fall his reaction was, in the words of the old Irish ballad, "in the language that the clergy does not know."

I think basically what you have at issue today, is should we conduct TCMPs the way they have been done for the last 30 years or is there a better way? IRS has made a big point over the last 4 or 5 years of reinventing the IRS, and they have reevaluated a lot of the processes they have used over the years and they have modified a substantial number of them.

Our argument is that it might be time to take a look at a different way of looking at this data. There is a cultural change underway within the Service. They have begun to reemphasize traditional methods of auditing with their recent training programs, focusing on economic reality, and they have begun to question the income more than the deductions on tax returns.

While there are legitimate concerns that have been voiced about the wholesale implementation of this economic reality program, you can hardly fault tax administrators for trying to find undisclosed

income. It is precisely with respect to identifying undisclosed income where we see the greatest weakness in TCMP.

In a rudimentary sense, conducting a TCMP is akin to "preaching to the choir." It provides data about what taxpayers are deducting. It provides little in the way of identifying income never reflected on the return, and it provides nothing about taxpayers who never file. It is precisely the problem of underreporting and non-reporting of income that so fuels the average taxpayers' frustrations with the current tax system.

Any voluntary compliance system depends on the perception that everyone is paying their fair share. When it becomes common knowledge that there are many members of society not participating, it undermines the support for the system among those who do comply.

The Service has begun to focus on those segments who are not complying through the use of the market segment specialization program. We believe this approach is a wise one and believe that compliance will result from approaching taxpayers on an industry-specific basis.

Using a market-driven approach also permits taxpayer education when appropriate, and identifies legislative changes which could increase compliance. The Service clearly recognizes these factors and more and more returns are being selected based on market segment data and not the DIF score.

We think the DIF score will continue to decline as a primary selection mode for the Service, so we question why they have to go through the traditional way of running a TCMP.

There are many commercial data bases now available which will permit the Service to develop profiles of specific industries and will allow them to target taxpayers who do not meet industry ratios for examination. These external data sources contain management, tax, and financial data which could be factored into a model developed by local DORAs, the District Office Research and Analysis, and lead to more productive audit leads than random selection.

Another example of technology appeared in last Monday's Wall Street Journal where they report that a Halifax, Nova Scotia, accounting professor used something called Benford's Law to identify fraudulent financial transactions by scoring the deviation from a random selection of when numbers appear in a given sequence. The story in the Wall Street Journal indicated that the District Attorney's Office in New York has used this to prosecute fraud. We are not recommending that the IRS adopt this, but it is just an example of where they could take another technique and apply technology a little more efficiently to the process.

We would like to see a cost benefit analysis done of this whole program. I heard today that this is going to cost \$2.1 billion and some 30 or 40 percent of the people selected are going to be innocent bystanders. I think \$2.1 billion could be spent in a much more effective way.

We also would like to see taxpayers compensated for the amount of time it takes and for the cost of representation. I think Mr. Goldberg's projection of \$5,000 to \$10,000 is on the low side for the cost of representation if you are a corporation or a partnership going through this, this type of audit this year.

We would be happy to take any additional questions you have.
[The prepared statement follows:]

**STATEMENT OF JOSEPH F. LANE, ENROLLED AGENT
ON BEHALF OF THE NATIONAL ASSOCIATION OF ENROLLED AGENTS**

Madam Chair Johnson, Ranking Member Matsui, members of the Subcommittee on Oversight, my name is Joseph F. Lane and I am an Enrolled Agent in private practice in Menlo Park, California. I thank you for your invitation to testify on behalf of the National Association of Enrolled Agents regarding the Taxpayer Compliance Measurement Programs conducted by the Internal Revenue Service.

I am testifying today on behalf of the 9,000 plus Members of the National Association of Enrolled Agents (NAEA). As the members of the Subcommittee well know, Enrolled Agents are the only tax professionals possessing a Federal license to represent taxpayers before the Internal Revenue Service and our Members represent more than four million (4,000,000) individual and small business taxpayers annually. NAEA is especially appreciative of the interest this Subcommittee has taken in the matter of Internal Revenue Service practices and procedures, and their impact on taxpayers and we pledge our support to further assist the Subcommittee in the future on issues which affect the general taxpaying public.

TCMP: The Historical Perspective

The historical justification for the conduct of Taxpayer Compliance Measurement Programs has been to permit the Internal Revenue Service to hone its selection criteria for tax returns in need of examination. Decades ago when the TCMP was first employed there was ample proof it was needed - the IRS was experiencing a non-change rate between 30% and 40% of returns audited. This, all agreed, was a waste of both the taxpayer's and the Service's time and resources. Over the years the repeated cycle of TCMPs has enabled the Service to increase its ability to forecast which tax returns are more likely to produce a change if examined and they now achieve a no-change rate of approximately 11%.

In addition to reducing non-productive audits another result of using the data gleaned from TCMPs was the fact that the Service could insure some degree of uniformity in the application of enforcement efforts across the country. I remember sitting in the peanut gallery in this very room some twenty-three years ago when I was working at the IRS National Office and listening to then Assistant Commissioner for Examination, Singleton B. Wolfe, state to the Ways and Means Committee that it didn't matter if the taxpayer lived in Augusta, Maine or Augusta, Georgia; they had the same chance of getting audited because of the DIF score process. At that time it was important to reassure taxpayers, and their elected representatives, that there was a uniform application of enforcement across the nation.

It also was a recognition of the fact that there was no other way of approaching the task. The technology to permit more sophisticated data searches was still in its nascent stage. Alternative data bases did not exist to permit the Service to consider other means of devising an audit selection criteria. The computing power of the Service even then was woefully deficient. In short, there was no means other than an intensive, line by line probe into tax returns selected at random. This entailed a great expenditure of staff years on the part of the Service and an uncalculable amount of time, cost and lost opportunities on the part of the taxpayers unlucky enough to get swept up in the TCMP net.

Taxpayer Reaction

Ask any taxpayer who has ever been subjected to a TCMP examination about their experience. I had one client, a medical doctor, define it as "an autopsy without the benefit of dying." He had his personal income tax returns, his corporate income tax returns, his pension plan returns, and the returns of his children's trusts all examined as a part of the last TCMP. He is still amazed about the sheer volume of data the auditor required and the cost of having representation throughout the process well exceeded his usual annual costs for tax and accounting assistance. The result of his audit was that all returns were accepted as filed. But that is scant solace for his lost income for the time away from his practice, the months of responding to ever increasing demands for more and different

information, the stress of being subjected to an IRS probe into all of his financial affairs and the necessity of having to explain many non-tax related transactions to the satisfaction of the examining agent. That last point was particularly vexing to my client. He questioned why he had to explain to the examiner why he refinanced his ski house. He never deducted any portion of the ski house for his business. It was for the sole use and enjoyment of his family and he felt it was none of the agent's business. My explanation that the agent had to account for all deposits into his bank accounts during the period under examination to insure that all income was properly reported merely served to further enrage him that his honesty should be questioned about reporting his business income. When I recently told him that the IRS will be conducting another TCMP this Fall his reaction was, in the words of an old Irish ballad, "in a language that the clergy does not know."

The Issue Before Us Today

The issue before us today is to consider if the traditional means of conducting TCMPs are necessary in today's business environment. Do we really need to single out 153,000 taxpayers later this year and subject them to such an invasive process? Are we certain that we can't "reinvent" the TCMP process like so many other processes the IRS has overhauled in the past few years?

There is a cultural change underway within the Internal Revenue Service. They have begun to re-emphasize the traditional methods of auditing with their recent training programs focusing on the economic reality of the taxpayer's lifestyle if it is inconsistent with the income level reflected on the tax return. This reflects the effort to question not only deductions the taxpayer has taken but the income received and reported. While there have been legitimate concerns raised about any wholesale implementation of this approach, one can hardly fault tax administrators for attempting to identify taxpayers with undisclosed income.

It is precisely with respect to this last point, identifying undisclosed income, where we see the greatest weakness of the TCMP process. In a rudimentary sense, conducting a TCMP is akin to "preaching to the choir." It provides data about what compliant taxpayers are deducting. It provides little in the way of identifying income never reflected on the return and it provides nothing about taxpayers who never file. It is precisely the problem of under-reporting and non-reporting of income that so fuels the average taxpayer's frustration with the current tax system. Any voluntary compliance system depends on the perception that everyone is paying their fair share. When it becomes common knowledge that there are many members of the society not participating in the system, it undermines the support for the system among those who do comply.

The Service has begun to focus on those segments who are not complying through the use of the Market Segment Specialization Program. We believe this approach is a wise one and believe that compliance will result from approaching taxpayers on an industry specific basis. Using a market driven approach also permits taxpayer education when appropriate and identifies legislative changes which could increase compliance. The Service clearly recognizes these factors and therefore an increasing number of returns selected for examination are not being selected based on DIF formulas but because the taxpayer is in a particular industry or fits a market segment profile. The Service has seen the dramatic results of many of these market segment audit programs in the form of higher deficiency amounts and increasing market sector compliance levels.

We believe that the DIF score will continue to decline as the primary selection mode as the Service develops more market segment data and begins to reprogram its resources into more productive examination areas. It is less and less important to maintain consistency in examination approaches throughout the country as our business environment and enterprises are increasingly specialized and dispersed geographically. For example, what does it matter to the Gulf States District headquartered in New Orleans if the Los Angeles District has a team assigned to the entertainment industry?

There are many commercial data bases now available which would permit the Service to develop macro-economic profiles of specific industries for purposes of targeting taxpayers who do not meet industry ratios for examination. These external data sources contain management, tax and financial data which could be factored into a model developed by the local District Office Research and Analysis (DORA) teams and lead to much more productive audit leads than random selection. In addition, the benefit of not putting taxpayers who are complying through the agony of the process needlessly would accrue to the Service's credit.

We believe that additional focus should be given to using technology in identifying targets for examination. By way of illustration, an article appeared in the *Wall Street Journal* on July 10, 1995 (page B1) which discussed the process an accounting professor in Halifax, Nova Scotia is using to help identify tax cheating and other financial fraud. He uses an obscure numerology theory known as Benford's Law, which lays out the statistical frequency with which the numbers 1 through 9 appear in any set of random numbers. The law is applied to suspicious checks or tax returns to see if the numbers are truly random or invented. This process has been employed by the District Attorney in Brooklyn, NY in prosecuting check fraud in seven companies and the professor consults with Canadian and other taxing authorities. I discussed the applicability of this law to tax auditing with an accounting professor colleague this past week and he agreed that for certain tax schedules, like Schedules C or F or E, the theory should be predictive. He pointed out however, that wage data and charitable contributions would not work because one is more likely to find numbers ending in 0 or 5 in these two categories than a random sample would have predicted. We are not recommending that the Service adopt this procedure but use it merely to illustrate that there are alternative ways of approaching issues we used to depend on manual processes to accomplish.

Recommendations

We would like to see a true cost benefit analysis of the current plan for the upcoming TCMP. It should include some approximation of the cost to taxpayers to participate in this statistical-gathering exercise as well as the staff years and resources of the Service. The true cost should then be compared with alternative ways of gathering data using commercially available business resources, such as Dun & Bradstreet, SRI's Values and Lifestyles Studies, etc.

We would like to see taxpayers who are subjected to a TCMP compensated for the cost of their participation. We are aware that this has been discussed before and that some Service officials have expressed some support for compensating taxpayers who emerge from the process with a no-change. We are concerned that this would provide incentive for agents to find some issue to disagree on just to escape the reimbursement process. In principle, we would like to see all taxpayers receive some compensation for their involvement since their inclusion was based on a random selection and not the result of any indication that they deserved to be audited. Of course, we can understand the Service's position that this would have to be balanced against the results of the examination. We can well imagine the Service balking at the prospect of compensating someone who they are in the process of criminally prosecuting. Perhaps the remedy is to compensate up to a certain level of proposed deficiency only. We would like to see further study of this proposal.

Closing

We appreciate the opportunity to offer our comments about the Taxpayer Compliance Measurement Program. We offer our assistance to provide any additional information raised by these comments or other areas of concern.

Mr. HANCOCK. Thank you for your testimony. All three of your written statements will be entered into the record.

Mr. Keating.

STATEMENT OF DAVID L. KEATING, PRESIDENT, NATIONAL TAXPAYERS UNION FOUNDATION

Mr. KEATING. I appreciate the opportunity to testify today. I represent the National Taxpayers Union Foundation. My name is David Keating. I would like to touch on something not yet heard in today's hearing that I picked up from our advisors when I canvassed them for suggestions about this program. That is, does the TCMP have a garbage-in/garbage-out problem, and how serious is it?

A recent article in Tax Notes, by George Guttman—who I believe is in the audience—says TCMP data reflects selected audit results only, and no subsequent change is made when a taxpayer successfully contests an adjustment with the IRS appeals office or through litigation. Overall, the maintenance rate for issues that go to appeals and litigation is no more than 50 cents on the dollar.

Something else that I learned that was quite disturbing to me is that the people in the appeals office have, I think, different standards that they are held to than the tax auditors. If you look at rule one, governing practice before the appeals office, it says, "It shall be his or her duty"—meaning an appeals officer—"to determine the correct amount of tax with strict impartiality as between the taxpayer and the government and without favoritism or discrimination as between taxpayers."

Now, given the enormous amount of criticism of tax auditors by GAO and others, and the discrepancy between findings at the auditing level and the appeals level, I wonder how much statistical noise we are introducing into the TCMP data by not holding these auditors to the guidelines or professional standards we expect for employees of the appeals office.

I also picked up concerns about the timing of this TCMP. You would have to have your head buried in the sand not to realize that politically a lot of changes have happened in the last few months, and I think there is probably the best chance we have ever seen since the adoption of the income tax, over 80 years ago, to actually replace it with something brand new.

The IRS is essentially proposing to put all its statistical eggs in one basket, meaning the 1994 return, which may be one of the last returns under the current income tax law. I would think they would want to put their eggs in more baskets.

Another thing that is very important to our members and others is that it can be extremely expensive to face a TCMP audit. For a small businessperson, the cost can be quite punitive. I notice that in some of the stratifications of the samples, it would not be uncommon for 1 in 100 or even 1 in 200 taxpayers in some small business areas to be selected for audit under TCMP. That is a rather large number of people, especially when you compare it to other auditing rates in the population.

Now, the IRS in designing this TCMP project is pretending there is no cost for the taxpayer's time and expense in hiring a professional. That is uneconomic for the country. The IRS has little in-

centive to make the TCMP process more efficient because it has ignored the value of the taxpayer's time and expense in designing this program.

It should be of little surprise that the IRS has not given proper weight to those costs in designing this particular TCMP. When public opinion pollsters, when they want to go into a lengthy examination—and one of the big problems public opinion pollsters are finding today is getting people to cooperate—where they want to do more detailed multihour focus group they have to pay people in order to get them to attend.

What we have here is the IRS is going to conduct the Nation's most tedious and expensive focus group, but instead of paying the people to participate they are actually going to force them to pay hundreds or thousands or tens of thousands of dollars for the ordeal, and that does not even count the potential tax that may be collected.

We believe that if the IRS thinks that gathering this data is so important, then it should pay taxpayers for the time and expense of submitting to such a TCMP audit. This will give the agency an incentive to design a TCMP survey that efficiently considers the use of all national resources, not just the agency funds.

I would also like to briefly express some concern about the use of the TCMP data by the IRS and the Congress. We cannot think of a single instance since 1986 where the IRS has made a single legislative proposal based on the last TCMP survey.

Even though everyone knows there is a problem with EITC, the IRS actually sent out EITC refunds to taxpayers who did not even qualify for the program.

In conclusion, we think that before undertaking another TCMP, especially the one that is going to be the largest ever, the IRS should be required to study other less intrusive alternatives. The TCMP, as it presently exists, is overly burdensome on taxpayers and arbitrary in the selection process.

By the time meaningful results can be derived from this program, the information that will be gathered may well be obsolete or irrelevant by the passage of comprehensive tax reform.

Thank you very much.

[The prepared statement follows:]

Statement of
 David L. Keating
 President
 National Taxpayers Union Foundation
 on the
 Taxpayer Compliance Measurement Program
 before the
 Subcommittee on Oversight
 Committee on Ways & Means
 U.S. House of Representatives
 July 18, 1995

Thank you for the opportunity to testify on the Taxpayer Compliance Measurement Program (TCMP). National Taxpayers Union Foundation represents 300,000 members who are concerned about the fairness of the tax audit and collection process.

Representative Johnson, we commend you for scheduling this hearing to examine the proposed 1994 Taxpayer Compliance Measurement Program. As you know, the upcoming TCMP is scheduled to review 153,000 returns, substantially more than previous TCMP surveys.

As I worked to prepare this statement, I sought comments from several professional tax practitioners who are informal advisors to our organization. I am especially indebted to Kip Dellinger, who is a partner at Dellinger & O'Connell, a Los Angeles based CPA firm.

Writing in the June 5, 1995 *Tax Notes*, George Guttman reports that the next "TCMP is expected to cost approximately \$280 million in FY 1996 and require 4,388 staff years. This will break down to 4,248 revenue agent staff years, or 26 percent of agent resources, and 140 tax auditor staff years, or 5 percent of auditor resources." Not counted in the IRS' cost estimates, of course, is the value of the time spent by taxpayers and their tax professionals. Given the rigorous nature of a TCMP audit, these costs are likely to be even larger for the taxpayer.

Please keep in mind how arduous a TCMP audit is. How many of the married members of this subcommittee can quickly locate their marriage license? Remember, that is just the first item on the tax return, and is one of the easiest to document. If the IRS reviews all the deposits made in your various banking, checking, or mutual fund accounts, how easy would it be for you to document the source of all funds deposited and transferred?

Does TCMP have a garbage-in, garbage-out problem?

Guttman notes that "TCMP data reflects selected audit results only. No subsequent TCMP change is made when a taxpayer successfully contests an adjustment with the IRS Appeals Office or through litigation. Overall, the suspension rate for issues that go to Appeals or Litigation is no more than 50 cents or less on the dollar."

Essentially this means that the TCMP data can be used to flag tax returns where the IRS can claim a tax adjustment, not whether it can win such an adjustment. Given recent GAO criticisms of the knowledge of tax laws by tax auditors, this would seem to call into question the reliability of the raw TCMP data.

A recent paper by Dan Pilla for the Cato Institute notes the different standards between the auditing process and the cases reviewed by the Appeals Division. He notes that "of the cases received by the Appeals Division in 1993, nearly 97 percent were settled by agreement. That is to say, while the taxpayer was unable to reach a satisfactory settlement with the tax auditor, he could with an Appeals officer 97 percent of the time." Pilla says the reason why taxpayers often come to an agreement with an Appeals officer "is found in the rules governing practice before the Appeals office." Pilla quotes the language of Rule 1:

"An exaction by the U.S. Government which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the U.S. Constitution.

Accordingly, an Appeals representative in his conclusion of fact or suppositions of the law, shall hew to the law and the recognized standards of legal construction. It shall be his or her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers."

Pilla notes that "incredibly, no similar guidelines exist for tax auditors." In other words, the people who will be compiling data for the TCMP are not operating under rules requiring the type of strict impartiality that is the standard for the Appeals Division.

The timing of this TCMP is poor.

We believe that there is a very good chance that the next Congress will pass fundamental reform of the current income tax law. The current income tax may be replaced altogether by a national sales or flat rate tax. Both the House Majority and Minority leaders have proposed a fundamental restructuring of the tax laws as have the chairmen of the Ways & Means and Senate Budget committees. With the likelihood that the tax laws will be fundamentally restructured, and soon, the timing of this TCMP is questionable at best.

TCMP is overly burdensome on and costly for arbitrarily selected taxpayers.

As described by the IRS, taxpayers are selected for TCMP audits on a random basis within stratified taxpayer filing groups. Yet these taxpayers are subjected to what can become an enormously time consuming and costly audit process. It takes an enormous amount of time to assemble the documentation of every line item on a tax return. In many cases, it is necessary for the taxpayer to retain a professional for representation. In other instances, taxpayers do so simply out of fear, or in response to the overwhelming and intimidating information requests that accompany TCMP examinations.

Because of the nature and extent of TCMP examinations, professional fees can be extremely expensive and will generally exceed the cost of preparation of the returns themselves several fold. While a \$280 million program is, by federal government standards, a paltry expense — the costs of a TCMP to individual taxpayers or small businesses can become almost punitive.

When so many other methods, resource, and tools are available in the IRS arsenal of weapons to be used against errant taxpayers, it is patently unfair to put a random group of taxpayers through the rigorous, sometimes ridiculous and very expensive process that TCMP entails for statistical purposes.

TCMP design should account for all costs, and taxpayers should be compensated.

To the extent that the IRS is allowed to proceed with the presently contemplated TCMP program — the government should be required to compensate both taxpayers and any professional representatives they engage for their time and effort. Care should be taken to advise taxpayers selected for a TCMP that they will be compensated for their time and that if they choose to retain a professional representative they will be reimbursed for reasonable professional advisors' fees.

In designing this TCMP and projecting its cost, the IRS is pretending that there is no cost for the taxpayer's time and the expense of hiring a professional. That is unwise and uneconomic for the country.

Guttman's article notes that statistician Amir Aczel "contends that the DIF [discriminate function] analysis has been superseded by more powerful statistical methods, such as 'logistic regression,' which requires less data. Aczel claims 20,000 audits can provide the same type of information that the IRS will get from the 153,000 plan for the 1994 TCMP." Guttman reports that "Aczel says the IRS' plan for the next TCMP is like doing exploratory surgery with stone-age tools."

Guttman also cites "Don Rubin, chairman of the Statistics Department at Harvard University [who] argues that nobody knows whether Aczel is right." He writes that Rubin believes "the best that an outside statistician can say is that the IRS approach can be made more efficient."

Yet the IRS has little incentive to make the process more efficient because it has ignored the value of taxpayers' time and expense. It should come as no surprise that the IRS has developed a TCMP that statisticians think can be made more efficient, since most of the expense would be borne by the unlucky taxpayers who will be selected for this arduous audit.

When public opinion pollsters wish to conduct a lengthy examination of public attitudes, they rely on focus groups. In order to get people to attend focus groups they pay them. This enables the public opinion professional to secure a representative sample of people who are willing to give up several hours of their time to answer questions and react to proposals.

The IRS is proposing to conduct perhaps the nation's most tedious and expensive focus group. But instead of the IRS paying the survey participants, the subject must participate at no charge. Indeed most will probably pay a tax professional hundreds or thousands of dollars for assistance with this ordeal. And don't forget that the taxpayer may have to fork over even more taxes or spend thousands of dollars to appeal a decision by a tax auditor who is unfamiliar with the tax law and has recommended an incorrect claim for additional tax.

If the IRS believes gathering this data is so important, it should pay taxpayers for their time and expense of submitting to the audit. This will give the agency an incentive to design a TCMP survey that efficiently considers the use of all national resources, not just agency funds.

Reimbursement should not be based on the results of the examination; it should be based on some multiple of the hours spent by the IRS in completing the TCMP exam (including pre-audit, review and supervisory time). For example, for every hour spent by the IRS, the taxpayer and representative should be reimbursed for two hours. The "rate" of reimbursement could be based on the prevailing rate in the local area for professional representation.

While some may argue that taxpayers whose exams render a sizable deficiency and substantial non-compliance should bear the cost of their examinations, this will only serve to encourage some at the IRS to assume overly aggressive positions with respect to potential adjustments.

The Service's Arsenal of Weapons has vastly expanded.

When originally conceived, the TCMP was likely the only method realistically available to determine the level of taxpayer compliance that the program was designed to assess. At the time it was initially developed and implemented, the collective resources available to the Internal Revenue Service to obtain the type of information with respect to various categories of taxpayers and their varying degrees of compliance with our income tax laws were far more limited than the resources available today. Moreover, compliance with the overwhelming technical and mechanical requirements of the tax law was far less burdensome than that faced by taxpayers today and, consequently, the time and effort — as well as likely professional fees — were less than what faces potential TCMP targets today.

Today, the IRS has access to a wealth of information -- over a billion information documents per year -- that can lend itself to the kind of statistical analysis that is developed by the TCMP. This includes the ability to more thoroughly analyze (both quantitatively and qualitatively) the results of the ongoing, regular examination process. And it becomes readily apparent when one examines the characteristics, methods and objectives of the IRS's "economic reality" audit approach.

We have previously expressed our concern about privacy issues related to the "economic reality" examination approach. Nonetheless, the mere fact this information is available, that the IRS has access to data bases and taxpayer information infinitely greater than when the TCMP was conceived, should have reduced the need for an arbitrary examination process as intrusive as TCMP. In addition, the IRS has and can continue to focus on particular types of deductions or other tax information on a targeted basis. This information is often developed by region and income level and probably provides more significant and timely information than what results following the years of accumulation and interpretation of TCMP results.

We also call the Committee's attention to the increased specialized knowledge that the IRS has developed largely without use of TCMP results as evidenced by the Market Segment Specialization and Industry Specialization Programs.

Relevance of the data obtained in TCMP is questionable.

We cannot think of a single instance since 1986 where the IRS has made a legislative proposal based on the most recent TCMP survey. There is clearly an enormous problem with earned income tax credit (EITC) compliance, yet after the latest TCMP, the IRS sent out EITC refunds to taxpayers who didn't qualify for the program! The IRS made no attempt to recover this money. EITC has also been an area rife with fraud.

The Administration and the IRS have failed to identify legislative initiatives to improve EITC compliance, and the Administration pushed through legislative changes in 1993 to make the program more generous.

IRS spokesman, Steve Pyrek, has stated that the TCMP is "... only done sporadically because it's very expensive and time-consuming ... People are doing things now and living in ways they weren't five years ago ... As economic life changes we need to keep up with those changes and with what's going on in society."

Mr. Pyrek has a point. But based on experience, we doubt that the TCMP will accomplish what he describes as the IRS goals and objectives for the TCMP.

First, the economic and lifestyle changes that Mr. Pyrek describes — particularly with regard to monetary matters — are accelerating as electronic information technology plays a more important role in our economic system.

This Committee's own Press Release announcing this Hearing highlights the fact that Congress has not yet received reports on the findings of overall compliance from the 1985 and 1988 TCMP surveys. Clearly, delays of any measurable time period in obtaining whatever results derive from the proposed 1994 TCMP audits would render those results, at best, of diminished usefulness and, perhaps ... meaningless. This is further magnified by the obvious overwhelming public support and Congressional interest in a very significant revision of our national tax structure. To arbitrarily subject 153,000 taxpayers or entities to the costs and burdens of this program seems on the whole, misplaced.

Second, the use of 280 million dollars of IRS resources to derive detailed information from a population of Americans that do — in fact — file income tax returns when much of that information is available by other means appears to be a colossal misuse of taxpayer dollars.

Third, before undertaking another TCMP, the IRS should be required to study other, less intrusive, alternatives that will provide more timely information. There remains the unanswered question whether yet another TCMP is underway because of a bureaucratic mindset that says — "that's the way we've always done things." For example, the IRS should consider looking at fewer items on more returns, rather than every single item on every return selected for a TCMP audit. By looking at fewer items on more returns, this would at least spread out the burden somewhat so that the TCMP compliance burden is allocated somewhat more fairly.

Also, some members of the practitioner community believe that the IRS sees the TCMP program and its attendant publicity as a form of deterrent. We do not believe that to be the case.

Conclusion.

The TCMP program, as it presently exists, is overly burdensome on taxpayers and arbitrary in the selection process. Much of the information the program attempts to garner can be secured by alternative means. Moreover, by the time meaningful results can be derived from the program, the information will almost surely be rendered obsolete or irrelevant by today's rapidly changing information society or passage of comprehensive tax reform. We hope that the IRS uses its resources on projects more likely to improve taxpayer service.

Mr. HANCOCK. Thank you all for your testimony. There are a few questions that we would like to get in the record, and I have got a lot of questions about this. But in the interest of time, Ms. Smith, from your testimony I kind of get the impression that you feel that this just basically is the price of citizenship.

Ms. SMITH. Very much so. That is how I was raised and it is a theory that I have come to embrace myself. That is not to say that I did not think it was the audit from hell or that I want to do it again. [Laughter.]

Mr. HANCOCK. Kind of like a root canal?

Ms. SMITH. I, given a choice between this and a root canal, I would take the root canal, I think. I have had one of each.

But, yes, it is important to me to pay my taxes, to do it correctly as best I can and to participate in the system. It was not my judgment and nobody asked me in 1981 if this was the best way for the IRS to do its business, they just said this is what we are doing and you are in it, and I was glad to participate.

Mr. HANCOCK. Well, do you think that you should have been reimbursed for your expenses?

Ms. SMITH. I do not think there is enough money to reimburse anybody for the kind of time and stress that it puts you through. But having thought about this question in the past week, I think it would have been nice if I had had, for instance, a voucher that would have given me one-half hour of some CPA's time for a consultation, something like that. Perhaps, even something to show appreciation like a method of filing electronically for free for the next 5 years, would have been nice. Not unlike what Nielsen did when they asked me to write down a television log for a week.

Mr. HANCOCK. Well, what would have been your attitude if, in fact, they had said, yes, you got a trip back to Jackson for this audit.

Ms. SMITH. I do not believe I was given any choice. The records were my responsibility and it had been my decision to leave the records. I never thought about going into an audit. I just was moving and left the records behind because I did not think I would ever need them again. I did have the forethought to keep them, thank goodness.

If I had had to make some arrangements to go back and get them I would probably have had friends of mine dig out the boxes and try to do something that I could afford to do.

Mr. HANCOCK. It could have been a little bit different, though, if, in fact, you had been out several thousand dollars?

Ms. SMITH. Oh, yes. Everybody's circumstances would be different. If this had happened to my mother it would have been a disaster.

Mr. HANCOCK. Mr. Lane, you indicate, in your testimony, that there is value in focusing on the economic reality of the taxpayer's lifestyle if it is inconsistent with the income, the level reflected on the return.

Does this not raise your concern that the TCMP process does little to identify income not reflected on the return?

Mr. LANE. Yes. It does address our concern. We are concerned that since TCMP just applies to taxpayers who file, there ought to be better systems devised to identify taxpayers who are not filing

at all. There are data bases out there that the Service could access, commercial data bases which would give them participants in given industries.

For example, what they are doing in the market segments approach is a much more realistic and much more profitable approach in terms of the use of their resources than to go out and spend \$2.1 billion on this TCMP that is going to drag 40 percent of taxpayers in and result in refunds, or no changes.

In addition, the cost to the taxpayers and small businesspeople to comply with this TCMP is just enormous. The testimony we had this morning by Mr. Brand of about 1 hour or 1½ hours per audit, that may be what the national office thinks happens, but in reality what happens in the field is different. The taxpayer that Mr. Zimmer described that would be assigned to a fairly low-graded auditor and the fact that the TCMP is given such an emphasis within the Service—plus the fact that they have all gone through this economic reality training this year, that taxpayer who walked in and refused to turn over the records of a noninterest bearing account would be treated like Al Capone.

There is no question that the auditor would get a summons issued for the checking account data and there is no way, under any circumstances, that it would be a 1½-hour audit. I can assure you of that.

It would turn into a major controversy with that taxpayer. There is no way, in a TCMP especially that you are going to tell some tax auditor you are not going to give him the information on the bank account. The first request the taxpayer got notifying him would have told him to bring in all of his bank statements for the year.

That is just the reality. So I do not know what the national office thinks is happening out there, but what is actually happening on the street is that they would treat that a lot differently. It would be a much more thorough audit if the taxpayer did not provide all of the data that was requested in the information document request.

Mr. HANCOCK. Well, do you think that even on the TCMP you did not get the idea of assumption there, the assumption of guilt, something being wrong. But in your judgment, especially with the way some of these audits have been handled that you are familiar with, that there is an assumption on the part of the auditor that, in fact, there has been something wrong, rather than just saying, look we are running a compliance check here.

Mr. LANE. TCMP gets two reactions in the field. The experienced revenue agents generally consider it a nuisance because it is a random sample and they know, therefore, that some of these people are going to be refunds or no changes. Their attitude is it is a waste of time. We ought to audit people that we know we can identify through some other vehicle that are a lot more likely to result in audit changes, higher DIF scores for example.

Newer agents, and there are a lot of new agents out there, have not been through a TCMP before and they see the emphasis the Service gives it. They see things like congressional hearings and newspaper articles on it and they take away a frame of reference that this is a really hot issue. They get special reports they have

to fill out and there are special detailed forms, so the impression it creates for the newer agents is that this is a very highly rated and important program. So they tend to approach it much less flexibly than a normal audit.

They are given marching orders by their superiors that they have to audit every single line on the return and if there are any related entities, they have to consider which related entities will also be opened for exam. This is a much different environment than a normal audit where a fair amount is left to their discretion.

So it signals to the employees that this is a fairly important program and so they are less flexible with the taxpayer as a result.

Mr. HANCOCK. In the preparation of the cost benefit analysis, how would you recommend that they can reduce the cost to the taxpayers for a TCMP audit?

Mr. LANE. Well, one of our recommendations is that IRS take notice that there are a lot of commercial data bases available. Just to name a few, the Stanford Research Institute has a program called the Values and Lifestyle Study. They have been gathering data for 30 years now. If I am Procter & Gamble and I want to know households that have \$100,000 and more in income, and have a Cadillac in the garage that is less than 2 years old, I can buy a list of people that fit the criterion. I can custom design these lists for marketing.

Our analysis is that before we'd go and spend \$2.1 billion of the taxpayers' money which is the true cost of this TCMP—the lost opportunity costs of those agents in the field and \$559 million of the program, itself—I would want to take a look at whether there is alternative data that is already existing out there in Dun and Bradstreet, and every place else in the world that you can buy.

I think there is no argument from the Service officials, if there are any left in the room or the ones that were here this morning, that the market segment approach is one of the best things they have come up with in tax administration in the last 25 years.

They can prove it by two trends. No. 1, the average deficiency on a market-segment audit is significantly higher than the average deficiency in a general program audit. No. 2, statistics reflect increasing compliance levels in given market segments once they have been worked.

So why not focus your efforts, your money, and your resources on market segments and identify more and more of those people who are not complying and get those market segments into compliance.

I would try to buy these commercially available data bases. Now, someone earlier, when we were talking on the break, indicated that some of these companies would not sell the data to the IRS, and that may be the case, I do not know. I am not a statistician; nor do I go out and try to purchase these things. But I know they are available.

Mr. HANCOCK. Thank you.

Mr. Keating, you expressed in your testimony that the timing of this TCMP is poor as a result of possible major changes in the current income tax law. Do you believe that there are aspects of the current laws that may be important for the administration of future laws under tax reform, for instance the reporting of income or the timely payment of taxes?

Mr. KEATING. Well, I suppose it depends on what we ultimately come up with as a part of tax reform. But certainly it is quite possible, especially on the definition of income including how much income is reported and whether it is accurately reported, that the TCMP can provide information that is applicable for current or future tax administration.

Mr. HANCOCK. How would you recommend that this information be gathered on the current behavior pattern of taxpayers relevant to the existing law?

Mr. KEATING. I do not know enough about the statistical development of TCMP to say for sure, but I am sure of one thing. When you prepare your tax return or when someone is auditing the tax return, the law as it exists now is so complicated that there is a huge potential variation in what an expert would say is the proper amount of tax that is actually due.

You referred, earlier in the hearing, to the Money Magazine report, where they had 50 professionals look at the same theoretical tax return and they came up with 50 different answers. Those are the kinds of problems we are facing with the Tax Code today—an incredibly complex tax law that is difficult not only for the taxpayer to comply with but the Service to administer.

Those are problems that I would imagine the TCMP process has a great deal of difficulty with as well.

Mr. HANCOCK. Well, you spoke about the IRS having access to all kinds of information, data bases, Mr. Lane mentioned it, Dun and Bradstreet reports, and all that type of taxpayer information.

Do you support the idea of IRS using these external data bases, as Mr. Lane suggested? Would you support that?

Mr. KEATING. I doubt it. I think it is probably a nonissue anyway because the firms that compile these data bases, much of them are direct marketing oriented firms and they are not going to want this data being used for tax administration. If they do allow IRS access to the data, the people that compile it probably think that a lot of the data that they are able to get now on a voluntary basis from people will not be forthcoming, because they think it might be used for tax administration or auditing.

So I do not think the direct marketing community or industry would ever allow this data to be sold to the IRS. In fact, in previous times when the IRS tried to obtain samples of demographic data from the industry, I recall a great deal of resistance to this.

I think the industry will continue to resist and do so successfully.

Mr. HANCOCK. Thank you.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

First of all I want to apologize for not being here through your testimony. As our chairman has probably explained, our schedule is crazy these days. We have a lot of conflicting scheduling items, and I just apologize to those who are here today that we all cannot be here more.

I have read through the testimony. I have not read every word of it, but I have skimmed all the testimony that I received and I appreciated all of your views. Mr. Lane, it is good to have you back before the subcommittee again.

Mr. LANE. Thank you.

Mr. PORTMAN. I like your candid approach to this. I would agree with you on the market segment data, not just because Procter & Gamble is in my district, but because, in fact, as I tried to articulate earlier, I think there is a lot of new technology and new techniques to get at some of the same information the IRS is rightfully looking for in this latest program.

So I would hope, too, that perhaps we could utilize some of that private sector data that is already out there.

Let me ask you another question in your role as representing the enrolled agents. Perhaps it is something that the IRS officially must address, but do you understand how the burden of proof is going to work? Let us say that someone, like Ms. Smith, makes a claim about her lifestyle in connection with the economic reality approach. It cannot be sustained. Either you have lost your marriage license or you know you do not have a title for the riding lawnmower that you bought 2 years ago, or you got from a friend or traded with your neighbor, or whatever it is.

How does the burden of proof change, if at all, as compared to a normal audit? Do you understand how that is going to work?

Mr. LANE. Yes, I do. There is no change in the burden of proof in this instance because it is a civil examination and the burden of proof is with the taxpayer not with the Service.

Mr. PORTMAN. OK. So she has to prove that she did not do something, even if she does not have the information on hand. That sort of is a transition to the appeals process and you talked a little in your testimony, I think, about the fact that 97 percent of the cases that go to appeal are resolved. What happens to those? Are the adjustments made pursuant to the IRS or their estimate? When you say they are resolved, what is the typical outcome, do you know?

Mr. KEATING. Well, according to George Guttman's article in Tax Notes, the overall sustention rate for issues that go to appeals or litigation is more than 50 cents on the dollar. The taxpayers and the IRS are able to reach agreement in 97 percent of the cases that go to an appeals officer.

I think that is probably because No. 1, the level of standards and professionalism at the appeals process is probably higher than at the auditing process. No. 2, there is probably also better knowledge of the tax law and better understanding of the hazards of litigation, both for the IRS and the taxpayer at the appeals level.

But, certainly, from GAO reports and from what I have heard from our members who are tax professionals is that at the auditing level there is often a lack of knowledge about the proper amount due. There are positions taken. It is almost like a negotiation strategy rather than trying to figure out what is actually—

Mr. PORTMAN. Starting out high and ending up lower?

Mr. KEATING. Right, exactly. Now, I hope in the training for the TCMP that the auditors will not be dealing with these types of audits in the same way. They have to take a view that if the IRS is going to have accurate data, the TCMP audit is not something that is a negotiating technique with the taxpayer to find the highest amount that they think they can squeeze out of the taxpayer, but something that is the actual correct amount due.

Mr. PORTMAN. The inference I draw from what you said earlier about the 97 percent is that a great many of those cases are re-

solved in a sense, in the taxpayer's favor and that the auditor's adjustment is not the final figure. In fact, it is a figure that is a compromise between where the taxpayer might have been and where the auditor was. Is that what you are saying?

Mr. KEATING. Yes.

Mr. PORTMAN. In other words, the fact that 97 percent of them are worked out I suppose would indicate that folks understand the litigation costs, as you said, or they can understand the cost benefit analysis and they are willing to work on resolving it by going to another level than where the audit had been?

Mr. KEATING. Well, certainly that is a factor but also I have heard a number of reports from our members that it is simply that there is a better level of understanding at the appeals process and more willingness to consider things that you do not see considered at the auditing level.

Mr. LANE. Could I add something here?

Mr. PORTMAN. Sure, please.

Mr. LANE. I do a fair amount of appeals work myself. I do not know how valid that number is.

Mr. PORTMAN. The 97-percent number or the—

Mr. LANE. Oh, I believe 97 percent settle, but I do not think it is all settled at less than the tax auditor or the revenue agent proposed. There are a number of ways that cases get to appeals. The important difference with appeals as opposed to a tax auditor in the office or a revenue agent in the field is that the Service has given the appeals office settlement authority in cases.

The people on the street do not have settlement authority. Their job is to make the substantially correct tax liability based on their understanding of the law. They are not allowed to consider the hazards of litigation and for good reason. You would not want to have 25,000 employees across the United States all having their own view of what is the hazard of litigation. It is a lot easier to control 1,900 appeals officers.

Because settlement authority is not provided to those employees and it is provided to the appeals office, they have more flexibility in resolving cases.

An awful lot of stuff that goes to appeals gets there by default. For example, the taxpayer may have moved and did not get the audit notice and the next thing they know they get a statutory notice of deficiency, or they have a deficiency assessment and they go in and say, well, I really have got proof of my home mortgage interest and my charitable contributions, so appeals opens that case up and resolves it.

Other appeals cases may be Tax Court cases never really intended to go to Tax Court. They are filed to preserve the taxpayer's ability to appeal the audit process. So a lot of "junk," that is, substantiation and documentation cases, get into appeals for resolution which should have been closed further down in the process.

Clearly, the better people in IRS, in terms of their technical knowledge, are in the appeals function. For one thing the grades are higher, the work is better. You do not have an inventory to carry that is the size of the field inventories, and it is a nicer environment to work in. So the better people that have settlement in mind tend to gravitate toward that work.

Mr. PORTMAN. The question, I guess, for us today is what does all this mean for TCMP? Will it be any different? I do not understand what the differences might be. I think you are still going to have a number of these kinds of cases. Although I suppose change of address would not be as big a problem because someone will have sat down face to face with an auditor.

Mr. LANE. Yes. I do not know that anybody keeps separate data on what percentage of TCMPs settle out in appeals. I would imagine that it is going to be fairly consistent with regular audits.

Mr. PORTMAN. Ms. Smith, a couple of quick questions for you since you have been through the process, I understand. I am sorry I missed hearing your testimony firsthand, but you said that you had pretty good records when you went through this process and you were able to provide the information perhaps better than some of us who are not as good at recordkeeping.

If you had come upon a situation where you did know factually that you had properly done something and yet, you did not have the marriage license or you did not have the title to the riding lawnmower or whatever it was. You had the choice of fighting it, meaning going out and hiring a professional advisor, probably an accountant, or just going along with it. What would have gone through your mind?

I mean what I am trying to get at is the problem I think which would occur in many cases where someone would say, do I go out and hire an accountant for \$500 or \$1,000 to try to resolve this thing, or do I just pay the \$700 or \$800?

Ms. SMITH. I went through much that same process a few months ago when I got a speeding ticket and I had to decide how much I wanted to spend. Whether I wanted to just pay the fine, it was not a big speeding ticket, or hire a lawyer and go to court and try to get the record erased or reduced in some way.

I think I would use the same standards for this. It would depend upon the circumstances and I think it would come down to a dollar amount, in large part. I am a stubborn person and if I knew I was right and if I thought I had some way of showing I was right, I would probably go forward more than a lot of people would choose to do.

If there were very much money involved, I would feel the need to go forward. If it were a minor point, like the argument I am having with an insurance company now for \$58, the stress is not worth it. I am going to give up after about 1 hour.

Mr. PORTMAN. You might throw in the towel. Well, that is something that is an interesting part of the whole calculation of what the cost is and the burden is on the taxpayer. I appreciate your testimony.

I have one final question for Mr. Lane. This just goes to a projection of what the total cost to the taxpayer would be, by that, I mean the Federal Government. I had heard some figures earlier, and I think I had mentioned in my questioning that it seemed like it was \$300 to \$500 million. You have talked about \$2.1 billion which includes kind of the lost opportunity costs, plus the actual costs. Is that something that there is a consensus on among your colleagues and those who understand the system pretty well?

Mr. LANE. I took that from the testimony, the printed transcripts of Mr. Brand's testimony today.

Mr. PORTMAN. Just adding it up?

Mr. LANE. He said it is \$559 million direct costs and \$1.5 lost opportunity costs. That adds up to about \$2.1 billion. There are some interesting things in the testimony this morning, and that was one of them that just caught my eye.

Mr. PORTMAN. It is a big number when you compare that to other things we are trying to do with tax modernization or any of the other programs we have ongoing to try to make the system work better and more efficiently. That is a substantial part of what we have available to try to make ours work better. So that is interesting.

Mr. LANE. I guess I look at that and look at the success they have gotten from the market segment program and think boy, the \$2.1 billion could be better spent on other things in the market segment area in terms of taxpayer compliance.

I think the key thing with any of these things we try to do in tax administration—and having spent 10 years in the Service in the beginning of my career and now 15 years in private practice—I feel qualified to comment that I think the key thing the Service needs to focus on is the impact. In an ideal environment they would only be working cases that deserve to be audited, enforcing against people who deserve to be seized, and the taxpayers who complied basically would be left alone.

That would be an ideal environment. The taxpayer who never needed to be audited, never got audited. There are imperfections in the system—as Fred Goldberg talked about; for example, the circularity issue. Just to keep doing it because we have always done it that way, when we have got new tools available is wrong. I mean what have we spent on technology in the last 5 years in IRS? We should be able to come up with a better way of constructing a method of sorting tax returns than to go back to a model of something we used in 1963.

I am also concerned about some of the assumptions that IRS draws from the data. For example, in Mr. Brand's testimony today, there is an assumption about what impact they had in compliance as a result of the child care issue.

You have a chance to review that. Our take on that is 180 degrees the other way. I do not believe, as he points out in his testimony, that they identified a problem with people overstating the credit and so they required the tax ID number of the child care provider. As a result, 2.7 million taxpayers stopped claiming the credit which gave them an additional \$1.2 billion in revenues, and credits that to the TCMP process.

I do tax returns, folks. There is no way that 2.7 million people were claiming a fraudulent credit and stopped taking it because now they had to put the tax ID number of the child care provider down. That is not what happened here. Rather, what happened is because they had to put the tax ID number of the child care provider down, they had to make a decision: "Was it worth turning grandma in for the \$480 credit?"

The 2.7 million people made the decision that for \$40 a month, it was not worth disrupting their baby sitting situation. That is

what happened. I do not draw the same conclusion IRS does—I draw a conclusion that says the credit is too low. If the credit were \$2,500, they all would have thrown grandma from the train. [Laughter.]

But for \$40 a month, it is not worth it.

Mr. PORTMAN. Are they not throwing themselves from the train, too? Because it raises the whole issue of the Social Security tax.

Mr. LANE. Well, no, they may not even have grandma doing the baby sitting in the house. They may be taking them to a next door neighbor. But for \$40 a month, if you talk to most working couples, the biggest problem they have is this child care hassle and the last thing they are going to do is disrupt one that is working for a \$40 a month tax credit to play “rat fink” on the baby sitter. So the bottom line is that the credit was too low and a lot of people looked at that and said, no, I am not going to do that. I had people say, “I am not going to give you that number, just take the credit off the return.”

So to turn around and draw the conclusion afterward that oh, our great TCMP provided this dramatic \$1.2 billion additional revenue because we got all of these tax cheaters off the rolls, is absolute nonsense.

I am not accusing them of being disingenuous with the subcommittee. I am just saying, this is an example of the myopia the organization has. They take these backward looks at situations and say, oh, well, our TCMP suggested this is a problem.

The primary reason they wanted this tax law change for the TIN was that they only had 260,000 people in the country file tax returns indicating they derived income from child care. There are probably 260,000 in the city of Washington that are making child care income. So they knew they had a problem and they knew that they would get better compliance if you asked for the tax ID number. I do not think that it had anything to do with TCMP.

Mr. PORTMAN. Well, that just goes to the difficulty of making some of these estimates, not just looking back but looking forward, which is even more problematic as Mr. Keating has said, 3 years from now when we have the data available we may well have an entirely different tax system to be working with.

Thank you, Mr. Chairman, I appreciate the testimony.

Mr. HANCOCK. Thank you.

Well, thank you, very much, to the panel. We most likely have another vote on so we will recess temporarily and the next panel will be seated and we will be back in about 15 minutes.

[Recess.]

Mr. HANCOCK. I want to welcome the next panel. I am not going to make formal introductions. Your written testimony will be made a part of the record. I would appreciate it if you would try to be as concise as possible and maybe we can wind this up by about 3 p.m., and maybe before we get another vote over there.

Would you please proceed, Dr. Scheuren.

**STATEMENT OF FREDERICK (FRITZ) SCHEUREN, PH.D.,
VISITING PROFESSOR OF STATISTICS, GEORGE
WASHINGTON UNIVERSITY, WASHINGTON, D.C.; AND
FORMER DIRECTOR, STATISTICS OF INCOME DIVISION,
INTERNAL REVENUE SERVICE**

Mr. SCHEUREN. I am a former IRS employee, but I have been out of the Service now for a few months and I am teaching at George Washington University. I am not going to cover my testimony in any depth, except I would like to talk about possible alternatives to the specific 1994 proposal that you heard about this morning.

I feel that there are a number of issues around that proposal, organizational issues around the way the Service is planning to do it—considering the way it has done it traditionally.

There are also some operational concerns with such a large endeavor, and I have recommended in the testimony that the Service conduct a “dress rehearsal” this year, instead of a full-scale study. This is a very large undertaking and dress rehearsals are typical in large statistical efforts. The Census Bureau, for example, typically conducts one or more dress rehearsals before each census. We are talking about something that is on that order of magnitude. This is a very large undertaking, and I think it deserves a dress rehearsal, especially given the things I heard this morning about the computer system.

I also want to comment about the sample design, since that is my business. In general, the work done on the sample design was extremely good, although it is constrained by some assumptions that were made. I think that there are some issues around the data available to do the sampling with—given the antiquated nature of the IRS processing system.

I would recommend a change in the way that the sampling is going to be carried out for 1994, if a pilot or a dress rehearsal were taken. My approach would be quite simple. Just take the existing sample that has been drawn, which as I say is quite good, given the constraints, and subsample it to deal with some of the burden issues and with some of the targeting issues and with the point that we really need a dress rehearsal. Then field a sample of, perhaps, 15,000.

Now, admittedly 15,000 is a number that I pulled out of the air; but it is a significantly smaller number, an order of magnitude smaller than 150,000. You cannot settle these questions, at least in my business, without doing some empirical work. I am not sitting here saying I have done this empirical work. It requires a lot of study. But I think a small, but not too small, version of what is planned is what is appropriate.

I think there are some issues about sample estimation and Fred Goldberg made some of these points this morning in a general way and I will make them again. I think things have moved, in my profession, in the last 30 years a great deal, and I think there are ways that we can more efficiently make estimates from a sample. That efficiency could lead to a smaller sample.

I do not want to overpromise here. I know a great many of these new methods are worth trying and some of them have actually worked. A TCMP study that I was slightly involved in (form

990-T) was one in which an efficient estimation procedure really made some big payoffs.

I am concerned about the study analysis issues. But I think I will pass over that right now. A lot of people have talked about those issues already and others that are sitting here with me may as well.

So what am I proposing? For the immediate short run, first, one thing that I have not said here but that is in my testimony—I think the TCMP is irreplaceable and there must be a TCMP. I am not saying anything to disagree with that.

On the other hand, I think a smaller, targeted, better planned, more carefully developed TCMP, in terms of the dress rehearsal idea, is essential for the fall.

What would I recommend that we do afterward? Again, I have seen it in the testimony of others today. I would recommend that TCMP become an annual study, that it be smaller annually. Certainly a lot smaller annually than it is for 1994. It could become more efficient over time. One of the things that we need to learn from the Japanese is “just-in-time” procedures and short cycle times. If we do TCMP the right way, we can learn how to do it better and better; reduce the burden on the taxpayer by making TCMP smaller and smaller; and the burden on the resources of IRS would be a lot less as well.

That’s my recommendation. Since many of you here are in the political world, you understand the nature of rolling samples, of tracking polls. This is the way to do business—quite different than doing a measurement every few years. I think this approach should be taken in TCMP. Furthermore, I think it is consistent with the Service’s desire to modernize itself.

Thank you.

[The prepared statement follows:]

Testimony

To
Committee on Ways and Means
U.S. House of Representatives
Subcommittee on Oversight

By
Frederick (Fritz) J. Scheuren
Visiting Professor of Statistics
The George Washington University

Tuesday, July 18, 1995

My statement today on the Taxpayer Compliance Measurement Program (TCMP) will cover --

- How TCMP data differ from data produced in the Statistics of Income (SOI) program,
 - The value and use of TCMP data, and
 - The benefits and shortcomings of the current TCMP design.
- In addition, I would like to discuss some alternatives to the current approach that the IRS is intending to take.

Disclaimer and General Perspective

First, a disclaimer may be in order. I am here solely as a private citizen. However, at present I am a part-time consultant to the Treasury Task Force on Tax Refund Fraud; also, I have travelled to Russia for the Treasury Department to consult on tax matters. Indeed, I'll be going to Moscow again next week; this is partly under Treasury auspices and partly for The George Washington University, where I am employed full-time as a visiting professor of statistics.

Second, my overall perspective may be worth noting. Over the years my involvement with TCMP has been both professional and personal. In fact, I worked as an apprentice statistician to help draw the first TCMP samples back in the 1960's -- just after I came to Washington to "serve my country" as an IRS employee. My recent knowledge of TCMP is nothing like as detailed now as it was then. I will, therefore, speak quite generally, posing questions more than offering answers. Much of what I have to say is very supportive of what TCMP is all about. On the other hand, I have some questions on the approach being taken. In my view, there are places where a wiser course may be open to the IRS.

TCMP and SOI Data

Let me begin now with a discussion contrasting TCMP and SOI data -- the kind of data each program collects, with what frequency and focus:

- Large-scale, usually annual studies are mounted of tax returns and information documents as part of the Statistics of Income (SOI) program. This is the program, incidentally, which I led for many years when I was at the IRS. These SOI data are taken from the unaudited reports of taxpayers and third party filers.
- Taxpayer Compliance Measurement Program (TCMP) data, in contrast, have historically been periodic in nature, rather than annual. Furthermore, the data collected have been audited.

In no real sense are TCMP and SOI data substitutes for one another. Both are needed. For some 80 years, SOI data have been made available to study who pays the taxes, to benchmark measures of the National economy (like GDP), and to study the effect on reported taxpayer behavior of changes in tax laws. TCMP data, available periodically over the last 30 years, obviously have always had a compliance focus.

The main uses of TCMP in connection with SOI have been to provide correction factors for the underreporting of SOI income amounts and the overreporting of SOI deductions. What has not happened is to develop a unified design embracing both of these important IRS statistical programs. The usually much larger (and considerably less expensive) SOI samples could improve TCMP estimates -- perhaps greatly. I will return to this point later.

Value and Uses of TCMP Data

There are many others whom you will or have heard from on the value and uses of

TCMP data; therefore, I will be brief.

Unquestionably, TCMP data have considerable value -- notably for policy makers and for the economists who maintain the U.S. National Income and Product Accounts. Uses, of course, by the IRS over the years have been many, including such statistical measures as the tax gap; even so, the operational application of TCMP data can be frustrating. Among the reasons I have heard for this are --

- TCMP's (perceived) lateness and the fact that, in the meantime,
- Legislative or other changes may have intervened -- making it hard to know how to employ the results.

Documentation issues may exist too, as I have learned personally, if one wishes to make comparisons over prior TCMP studies on topics not looked at earlier.

A strength of TCMP is that it is comprehensive in scope. This makes it possible to rank by importance the compliance issues IRS faces -- even to use the rankings to help the agency set priorities for employing its scarce resources. On the flip side, sample sizes for some compliance areas of concern may be insufficient to provide enough detail to inform action. Even when the samples are large enough, they may not be frequent enough to decide whether legislative or administrative changes had the desired effect. The alternatives implicitly here are either more frequent TCMP studies or a series of single issue studies. Both probably are needed -- I will return to this point later.

Benefits and Shortcomings of Current Design

The complexity of mounting such a large statistical effort as TCMP within an operating environment is daunting. That it has been done and done well over the years is a real achievement. Nothing I have to say below should be interpreted as contradicting this; nonetheless, many improvements may be possible. I will mention a few here.

Organizational Issues. -- Historically, each TCMP has had an *ad hoc* structure, with many new individuals involved in a temporary endeavor. Though carefully trained, each study's workers have mainly been first-timers. It is, moreover, a commonplace within the IRS that TCMP is seen as interfering with the real work of the agency. Issues of organizational learning, therefore, exist in this environment; the process of trying to make continuous improvements may have slowed (even suffered) as a consequence.

Operational Concerns. -- The upcoming TCMP is particularly vulnerable to concerns about the likely quality of the work to be done, given the long time between studies. Typically, in statistical projects of this size a full scale "dress rehearsal" would be carried out before fielding such an ambitious effort. I have not seen all the extra management controls IRS will put in place to carry out its ambitious goals. Maybe if I had, I would not feel the way I do; but at this point **I strongly recommend the IRS not go forward as planned with a full study.** A sizable pilot makes sense instead (perhaps on the order of 10% or so of the current planned effort).

Sample Design. -- Some time ago, I saw the TCMP sample design and talked to the statisticians who developed it. Incidentally, I was still an IRS employee at that point; my "need to know" involved work I was then doing to manage the statistical aspects of the 1993 EITC Studies (which you have heard about at various points over the last year). While I questioned then, and still question, some of the 1994 TCMP planning assumptions, my impressions of the sample design work done are that it is of an exceedingly high calibre. My recommendation above that a pilot be conducted would allow time to test some of these design assumptions. The idea of market segment stratification, for example, is an inspired one but not fully tested--more a hunch than a scientific conclusion.

Sample Selection. -- Because of the antiquated nature of IRS computer processing, the TCMP sample, as well done as it is, still may not be adequately targeted. A two-stage design might be a better approach:

- The current TCMP sample would continue to be selected as now. Once drawn, case files would be built (adding information documents, etc.) -- again as is now underway.
- From this initial large sample a subsample would be selected, presumably better targeted because more information could be employed in its selection. (This subsample might be the pilot sample mentioned earlier.)

Sample Estimation. -- Issues have been raised about the size of the TCMP sample. Does it need to be so large? My answer to this is I do not know; but I suspect that more looking at modern ways to make survey estimates could pay off in (at least somewhat) reduced sample

sizes. Work which I initiated some years ago on a TCMP sample of Form 990-T filers showed some of this promise from improved estimation methods. This too would be something to study, if a pilot were conducted.

Study Analysis -- At one point the upcoming 1994 TCMP was supposed to be the last traditional TCMP. New measures based on operational data were to replace the program. Frankly I have not followed this particular possibility, since it was discussed some years ago. If this is still seriously being considered, it raises many concerns. What is needed is not a TCMP effort divorced from these operational measures but a blend of the two over several years. Under such a proposed scenario, it is conceivable that TCMP could be reduced in scope as the newer methods are seen to be working. It is unlikely, though, that TCMP should end altogether, even then.

Summary and Possible Alternatives

Let me summarize my comments about TCMP briefly and then look at some possible alternatives. So far I have made two main points:

- First, TCMP is an irreplaceable technique for understanding a whole host of economic and tax compliance issues.
- Second, I have raised a number of specific questions about the 1994 TCMP that may be worth further study. My main point throughout is that the current 1994 plans be scaled down to be simply a "dress rehearsal."

Implicit in my discussion has been the idea that everything be done to reduce the burden on individual taxpayers of TCMP. This should be a major consideration in framing alternatives.

What about possible alternatives, then? A key question not addressed by me is what should happen after the 1994 "rehearsal" that I have recommended. Basically, I would suggest --

- TCMP become a continuous program,
- Much smaller annually than the 1994 sample,
- Carried out by a permanent cadre of employees,
- With an adaptive statistical design that could be responsive to new conditions and to what was being learned from previous studies.

To give TCMP some completely new thinking, the IRS should seek help from the National Academy of Sciences -- a practice it has followed with some success in the past. One issue for the National Academy to look at would be how to integrate the SOI and TCMP designs so each can be strengthened; also the Academy might be asked to consider how to integrate special compliance studies into a general framework, like that provided by TCMP.

Concluding Comments

Allow me two last comments and then I will be happy to answer any questions that the Committee may have:

- First, I have tried to express some very technical ideas in non-technical language. My apologies for what I fear are the many points at which I may have failed.
- Second, I hesitate to use this analogy but it may fit. Alvin and Heidi Toffler have been talking about building third wave systems to replace second wave ones. My criticisms of the current TCMP plans are consistent with the Tofflers' ideas. What I am recommending is a third wave approach to TCMP. At present, the IRS has taken largely a second wave one.

I am done now. My thanks to the Subcommittee for inviting me to participate. Also, I wish my former colleagues at the IRS the very best in their work on TCMP. However much we may differ on approach, the work IRS is trying to do is important and valuable; I have no doubt it will be carried out with professionalism throughout.

Mr. HANCOCK. Thank you, and now we will hear from Ms. Long.

STATEMENT OF SUSAN B. LONG, PH.D., DIRECTOR, CENTER FOR TAX STUDIES, SYRACUSE UNIVERSITY, SYRACUSE, N.Y.

Ms. LONG. I will summarize my statement that I have submitted. I basically have three points. No. 1, that I think TCMP is tremendously important and should be continued.

No. 2, that I think we could get a lot more mileage out of TCMP if we had broader public access to the data, and hence, more people looking at it.

No. 3, I have some specific suggestions as to how we might use TCMP creatively to reduce overall taxpayer burdens.

My acquaintance with TCMP goes back a lot longer than I would like to remember. When I was a graduate student 25 years ago, I first sought access to TCMP data from the IRS for my research on taxpayer compliance and IRS operations. At that time, no TCMP information was made available publicly by the IRS and indeed, the GAO complained because it could not get aggregate statistics from TCMP.

Because IRS did not voluntarily release it, my husband and I ultimately filed suit in 1975 under the Freedom of Information Act and we were, after very lengthy litigation, ultimately successful and forced the release of over 1 million pages of TCMP statistics reports as well as some microdata files.

My first point is that I really think that after all of this time, while I have often been viewed as a critic of IRS, I think TCMP is a tremendously important program and should be continued. I go into this, in some depth, in my written testimony and many of those points were already covered and I will not emphasize them here. But basically the bottom line is we really do not have a substitute yet for the idea of random selection. TCMP may be able to be improved but the basic concept of TCMP remains and should be continued.

I also want to point up something that was not in my written testimony but came up in earlier questions in other panels as to the underground economy. The TCMP that these hearings are focusing on concerns individual and corporate returns that are filed. But TCMP has also been used to go after the nonfiler program. The last survey on that topic was in 1988. So it is possible for this mechanism of random selection to be used to examine the problem of nonfilers.

Now, the second point that I want to make is how we might get more out of TCMP. While I view TCMP as an essential tool for good government, one question must be examined, Have we gotten the most mileage from it? I do not think we have. It would be surprising if there was not room for improvement in any government program.

One very simple, but obvious point, is that for the information to have value it must be distributed and used. Because IRS, for far too long, sought to restrict access to this data, society has not reaped the benefits from TCMP that are possible. Even within the agency, itself, the insights provided by TCMP data have not been sufficiently exploited.

In these tight budgetary times, I believe that one way that more could be gotten out of TCMP is by making TCMP microdata files available for analysis outside the agency. This would in no way impinge on individual taxpayer privacy.

For many years IRS has sanitized microdata files from its statistics of income programs and made them publicly available. Although IRS has argued that access to TCMP microdata would somehow impair its collections strategies, these fears are largely misplaced.

There is no reason not to release historical files. For more current data there are numerous approaches that could be adopted to meet IRS concerns while still allowing broad access.

The third and final point I wanted to turn to is the issue of taxpayer burdens. It has been suggested in some quarters that TCMP is a burden for the taxpayers that are selected for this special audit. Of course, this is true. In a similar way serving on a jury is a burden, sometimes a big one, but being judged by a jury of one's peers improves the chances of a fair system for all. So it is with TCMP, the existence of which can lead to a more equitable and efficient tax system for all.

Historically TCMP has been used mostly for identifying ways to modify the behavior of taxpayers. An equally important but underutilized purpose should be to identify ways that the tax system can be modified to help taxpayers meet their obligations with the minimum administrative hassle.

Let us face it, a great deal of burden is imposed by our tax system on all taxpayers. We should think creatively as to how we could use information to eliminate some of these unnecessary hassles.

Two of these areas that occur to me are in the area of complexity of tax laws. First, we could use TCMP to assess just how much complexity leads to noncompliance. My written testimony goes into that, and hopefully would allow Congress to better confront that problem with real figures.

Second, we could use TCMP to provide us a window on IRS audits and, therefore, to pinpoint areas where IRS auditors are raising inconsistent or unnecessary claims. I have a number of suggestions as to how that might be achieved and, thereby, get the maximum leverage out of TCMP and in the long run reduce taxpayer burdens.

Thank you.

[The prepared statement follows:]

**STATEMENT OF SUSAN B. LONG
DIRECTOR, CENTER FOR TAX STUDIES
SYRACUSE UNIVERSITY, SYRACUSE, N.Y.**

Madam Chair and members of the subcommittee, thank you for requesting my testimony. The fair and efficient operation of our federal tax laws is a matter of central concern to every American. I very much appreciate the opportunity to present my views on what I consider a vital component in this system: the Internal Revenue Service's Taxpayer Compliance Measurement Program (TCMP). My testimony is divided into three areas: (1) the fundamental importance of TCMP in efforts to improve the fairness and efficiency of the federal tax system, (2) the need for improved access to TCMP data in reaching these goals, and (3) specific suggestions for how TCMP could be used to help reduce unnecessary taxpayer burdens.

My acquaintance with TCMP goes back longer than I like to remember. Twenty-five years ago, when I was a graduate student at the University of Washington, I first sought access to TCMP data from the Internal Revenue Service for my research on taxpayer compliance and IRS operations. At that time, no TCMP information was publicly released by the IRS. Indeed, the General Accounting Office complained that it could not obtain access to even aggregate TCMP statistics. Because IRS did not voluntarily release TCMP data when I requested it, my husband and I ultimately filed suit in 1975 against the IRS under the Freedom of Information Act. This suit eventually was successful in forcing the public release of over a million pages of TCMP statistics, agency internal reports and analyses, details on the sample designs, and computer tapes containing the underlying checksheets (after deleting taxpayer identities) made out by IRS auditors on many of the returns covered by TCMP studies.

While I have long been viewed as a critic of the IRS, after years of research I remain convinced that TCMP is one of the most important government initiatives aimed at making our tax system work in a more efficient, fair and less intrusive manner.

WHY IS TCMP SO IMPORTANT

The Taxpayer Compliance Measurement Program is essential because without it the IRS, Congress, and the public would be flying blind about the operation of the government's central function -- tax collection.

"The revenue of the state is the state," wrote Edmund Burke, the eighteenth-century statesman and historian. Put another way, without the legal authority to collect taxes and the compliance of citizenry to these laws, government is a sham. It is this fact -- that taxes are profoundly essential to the existence of all successful states -- that makes information about the functioning of our tax system essential. Without reliable and valid information, tax collectors' actions may be misguided and ineffective, citizens may be unduly burdened or unfairly treated, and the citizens' elected representatives will be hampered in their attempts to correct these failings. Without the continued and systematic monitoring of how our tax system is working, we will not recognize problems until they have become festering social and economic problems. Without solid grounding in the facts, actions designed to improve our tax system and its administration are less likely to produce their intended results.

How can we obtain reliable and valid information about the true functioning of our tax system? Congress has long recognized the need for such information. Encountering difficulties in getting the information it desired out of the Treasury Department after federal income tax laws were instituted following approval of the Sixteenth Amendment to the Constitution in 1913, Congress mandated that government prepare and publish annual statistics about the operations of the federal income tax laws. The Statistics of Income (SOI) program was born in response to this

mandate, and the "Tax Model" files and related SOI reports which continue to this day are relied upon by IRS, the Treasury Department, Congress, scholars, and the public at large.

The SOI data, however, reflect the information that is reported on tax returns. Not all taxpayers file required returns, and the information reported on returns that are filed is often incorrect. This is where TCMP comes in. It examines the tax compliance behavior of 120 million business and nonbusiness taxpayers by looking at the behavior of a relatively small scientifically valid "random sample." This program and its predecessors¹ dates back to at least the 1940s -- almost fifty years.

There are countless examples of how TCMP has provided indispensable information that could not be obtained in any other way. Specific legislative and administrative improvements taken as a result of TCMP findings are well-known and have saved taxpayers many, many times the cost of the program.²

The plain fact is that there are no known substitutes for this approach that will produce comparable information. In the late 70s, for example, the Justice Department commissioned a comprehensive study on measuring white collar crime. This study, which I worked on, singled out IRS's TCMP program as the model which offered the only generic approach for measuring most regulatory and white collar offenses.³ I am unaware of any magic breakthrough that changes this assessment today which would offer a substitute for the TCMP approach.

GETTING THE MOST OUT OF TCMP

While I view TCMP as an essential tool for good government, one question must be examined: Have we gotten the most mileage from it? In my opinion, the answer is no. It would be a surprising government program, of course, where there was no room for improvement. One very simple but obvious point is that for information to have value it has to be distributed and used. Because IRS for far too long sought to restrict access to these data, society has not reaped the benefits from TCMP that are possible. Even within the agency itself, the insights provided by TCMP data have not been sufficiently exploited.

I believe TCMP data are as essential to the nation as Commerce and Labor Department information on the economy and even Census data on the population. This is because TCMP provides powerful facts and insights that could lead to improvements in the tax law and its administration. The potential impact here is hard

¹ The Bureau of Internal Revenue (as the IRS was then called) launched the Audit Control Program right after World War II using audits of random samples of taxpayers to measure taxpayer compliance. TCMP as we know it was formally launched in 1962.

² For examples of TCMP uses see Internal Revenue Service, Taxpayer Compliance Measurement Program: Sample Design Documentation, Document 9293 (Volume I (1993) and Volume II (1994)); Internal Revenue Service, Taxpayer Compliance Measurement Program Handbook, Document 6457 (Revised Edition, 1989); General Accounting Office, Taxpayer Compliance: Status of the Tax Year 1994 Compliance Measurement Program, GAO/GGD-95-39 (December 1994); George Guttman, "Taxpayer Compliance Measurement Program: Is It Necessary?" Tax Notes, June 5, 1995, pp. 1282-1288.

³ Susan B. Long, The Internal Revenue Service: Measuring Tax Offenses and Enforcement Response. Washington, D.C.: U.S. Government Printing Office (1980).

to exaggerate. Because taxes are a vital component in our economy, improvements necessarily will have wide ramifications for everyone's pocketbook. Beyond the immediate functioning of the economy, the way taxes are collected strongly influence public attitudes towards government and our laws.

Since my FOIA litigation, IRS has taken some steps to make TCMP more accessible to the public. They now routinely release tabulations and analyses they prepare from TCMP. For a time the IRS had a program which allowed researchers, with IRS assistance, to undertake their own studies. The agency also sponsored annual conferences where IRS staff, tax professionals and academics shared research findings. This cross-fertilization reduced the insularity that had long plagued IRS. In recent years, however, agency TCMP analyses have sharply declined and collaborative research has diminished.

In these tight budgetary times I believe that one way that TCMP research can be increased is by making TCMP micro-data files available for analysis outside the agency. This would no way impinge on individual taxpayer privacy. For many years, IRS has sanitized micro-data files from its Statistics of Income program and made them publicly available. Although IRS has argued that access to TCMP micro-data would somehow impair its collection strategies, these fears are largely misplaced. There is no reason not to release historical files. For more current data, there are numerous approaches that could be adopted to meet IRS concerns while still allowing broad access.

REDUCING TAXPAYER BURDENS

It has been suggested in some quarters that TCMP is a burden for the taxpayers who are selected for this special audit. Of course this is true. In a similar way, serving on a jury is a burden -- sometimes a big one. But being judged by a jury of one's peers improves the chances of a fairer system for all. So it is with TCMP, the existence of which can lead to a more equitable and efficient tax system for all.

Historically, TCMP has been mostly used for identifying ways to modify the *behavior of taxpayers*. An equally important, but under-utilized purpose, should be to identify ways the tax system can be modified to help taxpayers meet their obligations with the minimum administrative hassle. I am not limiting this to only changing IRS procedures. It is also essential that TCMP be used to identify problems in the way Congress has written the tax laws that impose unwarranted complexity or regulatory burdens. Two examples of what I am talking about come to mind.

Everyone bemoans the many burdens imposed by the complexity of tax requirements. But partly because the costs of these burdens have not been quantified and the specific problem areas identified, we have failed to confront this very grave problem. This did not have to be the case. Past TCMP data, if properly analyzed, could have provided detailed information about components of noncompliance arising from unnecessarily complex tax provisions.⁴

⁴ The Center for Tax Studies at Syracuse University has pioneered additional ways of measuring components of tax complexity keyed to line items on tax returns filed by individuals. Research studies show that tax complexity appears to be a major cause of the differences between taxpayer reports and IRS TCMP auditor findings. See Susan B. Long and Judyth A. Swingen, "The Impact of the Tax Reform Act of 1986 on Compliance Burdens: National Survey Results," in The Impact of the Tax Reform Act of 1986: Did It Improve Fairness and Simplicity? Internal Revenue Service Publication 7302 (1989); Susan B. Long and Judyth A. Swingen, "The

In response in part to suggestions from Congress and the academic community, the current TCMP survey has added specific questions designed to help identify trouble-spots where complexity is the primary source of audit adjustments, along with very detailed issue coding to pinpoint specific sections of the tax law where this occurs. More attention needs to be focused upon pretesting this part of the survey, the selection of categories, and the proper training and instruction of the auditors. Although I thus have some reservations about aspects of TCMP's planned implementation, the potential of identifying problem laws and measuring their compliance costs could be enormous. Armed with detailed information about the true costs of complexity, Congress, tax professionals, and the IRS could mount genuine reform. With the better understanding of the actual costs of compliance, Congress could confront and debate these issues before it passes new tax legislation.

Second, TCMP could also play a vital role in identifying correctable administrative failures which make taxpayers' lives difficult. TCMP provides a unique window on IRS auditor behavior. There is a variety of evidence suggesting that there are gross inconsistencies in how individual auditors, Service Center personnel and collection officers treat taxpayers. Data analyses at my center have repeatedly shown enormous and inexplicable variation in audit and collection practices from one district to the next.⁵ Internal IRS studies, backed by GAO reports, have discovered that inappropriate advice and collection claims occur all too often. When contested, initial IRS auditor findings are frequently abandoned. A recent GAO study, for example, showed that only 22 percent of taxes recommended by IRS's audits under the Coordinated Examination Program between fiscal years 1983 and 1991 were eventually collected after any appeals or litigation.⁶ My analyses using TCMP data matched with IRS Master File records showed significant differences between TCMP noncompliance estimates and final assessments after a taxpayer appeal.⁷ Studies by other tax authorities have found striking inconsistencies in auditor judgments on the same return.⁸

Role of Legal Complexity in Shaping Taxpayer Compliance," in Van Koppen, Hessing, and Van Den Heuvel (eds.), Lawyers on Psychology and Psychologists on Law. Amsterdam: Swets & Seitlinger (1988), Susan B. Long and Judyth A. Swingen, "An Approach to the Measurement of Tax Law Complexity," Journal of the American Taxation Association, Spring 1988.

5 See, for example, David Burnham, A Law unto Itself: Power, Politics and the IRS. New York: Random House (1990, Appendix, pp. 377-395).

6 Tax Policy and Administration: 1994 Annual Report on GAO's Tax-Related Work, GAO/GGD-95-66 (February 1995), p. 44. See also GAO/GGD-94-70; Susan B. Long and David Burnham, "Solving The Nation's Budget Deficit With A Bigger, Tougher IRS: What Are The Realities?" Tax Notes, August 6, 1990, pp. 741-757.

7 Susan B. Long and Judyth A. Swingen, "Taxpayer Compliance: Setting New Agendas for Research," Law and Society Review, volume 25, number 3 (1991), pp. 658-660.

8 See, for example, Henk Elffers, Income Tax Evasion: Theory and Measurement. Denventer: Kluwer (1991); Henk Elffers, Henry S. J. Robben, and Dick J. Hessing, "Under-Reporting Income: Who Is the Best Judge--Taxpayer or Tax Inspector?" 154 Journal of the Royal Statistical Society (1991 Ser. A), Part 1, 125; Henk Elffers, Henry S. J. Robben, and Dick J. Hessing, "Reliability and Validity of Tax Audits: Can We Have Confidence in the Opinion of the Dutch IRS on Noncompliance?" Working Paper, Erasmus Centre for

These unwarranted inconsistencies impose a hidden and vast burden on millions of taxpayers each year. This burden is unnecessary. With the proper design of TCMP research and its sincere application to problems not only of taxpayers but tax administrators, a large step could be taken in reducing these destructive enforcement deficiencies.

How could this be achieved? First, TCMP surveys should not stop with the initial finding of the auditor. While these can continue to provide valuable information, TCMP noncompliance estimates should include the revisions that occur in tax assessments after taxpayer appeals.

Studies have found, however, that taxpayers frequently do not contest auditor claims they disagree with because such appeals are costly and painful.⁹ This fact means that more is required to obtain a comprehensive picture of wrongful auditor claims. TCMP should be used directly to assess the consistency of auditor judgments. In pretesting the TCMP survey auditor judgments on the same hypothetical taxpayer situation should be compared to identify and correct inconsistency problems. Further, during the TCMP audits themselves, the consistency of auditor judgments should be continually monitored. This approach has been successfully used by the Dutch tax authorities. (See footnote 8 above.)

This would not only provide a truer picture of tax compliance, but help pinpoint those areas where IRS training and supervision needs to be improved so that taxpayers do not face unfounded auditor claims as often occurs during routine tax examinations. While it is impossible to estimate the proportion of taxpayers who confront wrongful government claims, there is fairly persuasive evidence that they represent a lot of people.

CONCLUSION

In conclusion, TCMP is an extraordinarily valuable resource that needs to be continued. Second, while TCMP is admittedly a burden on the few, its product is an essential tool for reducing the considerable burdens on all of the nation's taxpayers. Third, although TCMP is valuable now, it can be improved. A key to such improvement, in my view, is to provide much wider access to TCMP data so that a much larger community can contribute to the essential task of identifying and correcting the shortcomings in our tax system.

Sociolegal Research (1989).

⁹ General Accounting Office, Audit of Individual Income Tax Returns by the Internal Revenue Service, GGD-76-54, (1976); L. Hart Wright, Needed Changes in IRS Conflict Resolution Procedures, American Bar Foundation (1970); Susan B. Long, Measuring Tax Offenses and Enforcement Response, Washington, D.C.: U.S. Government Printing Office (1980).

Mr. HANCOCK. Thank you, Ms. Long.
Mr. Feinstein.

STATEMENT OF JONATHAN S. FEINSTEIN, PH.D., PROFESSOR OF ECONOMICS, YALE SCHOOL OF MANAGEMENT, NEW HAVEN, CONN.

Mr. FEINSTEIN. Thank you, very much. I would like to also loosely follow my written comments, omitting some things that have already been discussed today and adding a few remarks that might be useful.

I am a professor of economics at the Yale School of Management and I have studied noncompliance and tax enforcement for the past 8 years, working with both TCMP data and ordinary IRS audit data and I will say a little bit about both of those. I have written a series of research papers during that time, served on committees overseeing IRS research programs, and worked with several State tax authorities.

I am going to talk a little bit about my own experience with TCMP and then comment on the usefulness of TCMP. I have worked extensively with both the 1982 and 1985 TCMPs. I have found TCMP data to be very clean with few, if any, missing values or obvious miscodings, and I say that by way of contrast with some other government data sets I might have worked with.

I have used TCMP to study three issues. First, I have investigated the relationship between household characteristics such as marital status and self-employment, and the underpayment of taxes. Second, I have calculated detection rates for individual IRS tax examiners, demonstrating how TCMP can be used to help the IRS evaluate the performance of its examiners. Third, I have estimated the tax gap. If you extrapolate forward, my estimates would suggest that the tax gap presently is at least \$120 billion. I would consider that to be a conservative estimate. I would not be surprised if it was quite a bit more than that.

The magnitude of the tax gap, I think, illustrates the importance of IRS audit programs. I wanted to make one further comment about that. If you look at other countries, the proportion of taxes unpaid, that is the tax gap, compared to government revenues is substantially higher. One important difference between those countries and the United States is that the IRS has a TCMP, I believe.

Now, the primary reason for conducting a TCMP is to help the IRS develop audit selection guidelines. In the remainder of my testimony I would just like to address whether TCMP is essential for these audit programs or whether it could be replaced by cheaper alternatives. I would like to say a bit about if it is essential, how large should it be?

I just wanted to also begin by noting that IRS audit selection is of a very high quality. IRS audit productivity, as measured by the average audit assessment, has increased fourfold during the past 30 years controlling both for inflation and for the increase in tax burden that has occurred during this time period. That is a very high level of productivity increase.

If the IRS simply selected household returns for audit at random, it would collect far less than \$1,000 on each audit. Because it has sophisticated methods to select households for audit, it currently

collects, on average, well more than \$5,000 on each audit. Those numbers are useful in saying something about what the costs of the TCMP are in terms of the opportunity costs to examiners. Every time a TCMP audit is done, at least \$4,000 is given up because some more productive audit could have been done.

So, for example, if 50,000 households are selected for TCMP audit, that would be approximately \$200 million given up of Federal revenues to do those TCMP audits.

IRS audit programs not only generate direct audit assessments but also generate additional indirect revenues to the deterrent effect they exert on potential cheaters. Although indirect audit revenues are difficult to measure, most experts agree that they are substantially larger than direct assessments.

Now, in my view, a considerable body of evidence indicates that TCMP is critical for the design and implementation of IRS audit selection guidelines. One of the most important uses of TCMP is in the development of DIF. During the past 3 years, Brian Erard, who is at Carlton University, and I have investigated IRS audit programs in the Oregon district in considerable detail. Our analysis is based on a large data set we have assembled and includes most of IRS audits of Oregon households for tax year 1987.

What we find when we look at the data is that nearly one-half of all IRS audits are based on DIF. Further, we find that these DIF audits generate significantly larger assessments, on average, than are generated by the remaining non-DIF audits. These findings, I think, strongly suggest that DIF and, hence, TCMP is, in indeed, a critical factor in audit selection.

I wanted to remark parenthetically, by the way, that Brian has also helped the IRS on a recent study of nonfilers, an issue that came up earlier today. I just wanted the subcommittee to know that there has been a recent study of nonfilers which you might want to take a look at, although, in fact, nonfilers are a pretty small amount of the total noncompliance tax gap that we have in the country.

TCMP is also useful in helping IRS researchers discover patterns of noncompliance that have been overlooked by existing audit programs. A good example of this is the discovery a few years ago, based on an analysis of TCMP data, of the fictitious dependents problem which has already been discussed today, so I will not talk about it further.

What are the main alternatives to TCMP? I think probably the clearest alternative would be to rely on ordinary audit data instead of TCMP data to come up with audit selection guidelines. In fact, ordinary audit data is not an adequate substitute for TCMP data. TCMP is a random sample and provides an accurate picture of the entire taxpayer population. Ordinary audit data does not and we could talk about that further if we need to, but I have worked with both kinds of data and see some clear differences between them.

A second alternative would be survey data. Unfortunately, survey data is extremely unreliable in this area. The third alternative would be to abandon statistical analyses and instead rely on examiner expert judgments. I did want to note that currently the examiner judgments are used in combination with DIF very effectively, but I do not think that they could serve as an adequate substitute

for DIF. I think they are better in combination with something like DIF.

I do think TCMP is essential for the IRS in some form. I think a question still remains as to how big TCMP should be. I just wanted to say a bit about the household component. In the past, TCMP sampled about 50,000 households. The proposed TCMP would sample 90,000 households.

Expanding the sample would surely allow the IRS to get greater sampling densities in certain subpopulations. It is my experience that some population subgroups are very thin in existing TCMPs down to say a few dozen taxpayers which can make it difficult to determine what kind of tax audit systems to use. I do not think I would want to reduce that very far. But I have to say that based on what I know, I am not convinced that the substantial cost involved in expanding the TCMP would be worth the benefits to be gained, which seem to me to be uncertain.

I will say I have not seen all the evidence about that, but I am not convinced at the moment of what the benefits would be.

Thank you for the invitation to testify, and I hope my testimony is useful for you.

[The prepared statement follows:]

TESTIMONY

To
Committee on Ways and Means
U.S. House of Representatives
Subcommittee on Oversight

By
Jonathan S. Feinstein
Professor of Economics
Yale School of Management

Tuesday, July 18, 1995

I have studied tax noncompliance and tax enforcement for the past eight years. I will begin my testimony by briefly describing my own experience with TCMP. In the remainder of my testimony I will comment on the usefulness of TCMP for IRS audit programs, first reviewing some facts about IRS audit programs, and then discussing the way TCMP is currently used, possible alternatives to TCMP, and the proposed expansion of TCMP.

I have worked extensively with both the 1982 and 1985 TCMPs (Exhibits 1, 2, and 3). I have found TCMP data to be very clean, with few if any missing values or obvious miscodings. I have used TCMP to study three issues. First, I have investigated the relationship between household characteristics, such as marital status and self-employment, and the underpayment of taxes. Second, I have calculated detection rates for individual IRS tax examiners, demonstrating how TCMP can be used to help the IRS evaluate the performance of its examiners. Third, I have constructed estimates of the tax gap for 1982 and 1985. My estimates suggest that the tax gap is presently \$120 billion or more. The magnitude of the tax gap illustrates the importance of maintaining and improving IRS audit programs. A number of other economic researchers have also made use of TCMP, including Daniel Nagin (Carnegie-Mellon University), James Poterba (Massachusetts Institute of Technology), and Joel Slemrod (University of Michigan).

The primary reason for conducting a TCMP is to help the IRS develop audit selection guidelines. Is TCMP essential for IRS audit programs, or could it be replaced by cheaper alternatives? If TCMP is essential, how large should it be? In the remainder of my testimony I will address these questions.

Let me begin by noting that IRS audit selection is of high quality and has a significant impact on federal tax collections. IRS audit productivity, as measured by the average audit assessment, has increased fourfold during the past 30 years, controlling both for inflation and the increase in tax burden that has occurred over this time period. That is a level of productivity increase matched by few other Government programs. If the IRS simply selected household returns for audit randomly, its examiners would assess on average less than \$1,000 on each audit. Instead, the IRS relies on sophisticated methods to select households for audit, and its examiners currently assess on average approximately \$5,000 on each audit. The large difference between these numbers shows how good the IRS has become at audit selection. IRS audit programs not only generate direct audit assessments, but also generate additional indirect revenues through the deterrent effect they exert on potential cheaters. Although indirect audit revenues are difficult to measure, most experts agree that they are substantially larger than direct assessments. Currently, IRS examiners annually recommend approximately \$7 billion in direct assessments based on audits of households. Including indirect revenues, the total impact of the IRS's household audit program on federal tax collections is likely to be substantially more than \$15 billion per year.

Most observers are likely to agree that IRS audit programs play an important role in safeguarding federal tax collections. There may be less consensus, however, about the importance of TCMP for these programs. In fact, a considerable body of evidence indicates that TCMP is critical for the design and implementation of IRS audit selection guidelines. I will discuss two ways in which TCMP is useful for audit selection.

First, one of the most important uses of TCMP is in the development of DIF, a computer-based rating system that assigns a number to each return, predicting the likely yield from auditing the household that filed the return. During the past three years Brian Erard (Carleton University) and I have investigated IRS audit programs in the Oregon district (Exhibit 4). Our analysis is based on a large dataset we have assembled that includes most IRS audits of Oregon households for tax year 1987. In our data we find that nearly one-half of all IRS audits are based on DIF.

Further, we find that these DIF audits generate significantly larger assessments on average than are generated by the remaining non-DIF audits. Our findings strongly suggest that DIF, and hence TCMP, is indeed a critical factor in audit selection.

Second, TCMP is also useful in helping IRS researchers discover patterns of noncompliance that have been overlooked by existing audit programs. A good example of this is the discovery a few years ago, based on an analysis of TCMP data, that households were claiming millions of fictitious dependents. The elimination of this tax scam has saved the federal government billions of dollars.

I will now discuss what I consider to be the three main alternatives to TCMP. One alternative is to rely on ordinary IRS audit data instead of TCMP data in the development of audit selection guidelines. In fact ordinary audit data is not an adequate substitute for TCMP data. TCMP is a random sample and therefore provides an accurate picture of the entire taxpayer population. In contrast, ordinary audit data includes information only about households whose returns looked sufficiently suspicious, according to existing audit selection criteria, to trigger an audit. Households that discover a new way to evade taxes and elude existing selection criteria are not represented in ordinary audit data. As a result, the analysis of ordinary audit data cannot readily detect such new forms of evasion, whereas an analysis based on TCMP might.

The discovery of the fictitious dependents scam is a good example of the difference between TCMP and ordinary audit data and shows how important TCMP is for discovering new or previously neglected forms of evasion. The problem of fictitious dependents was never apparent in ordinary audit data, because existing audit selection criteria ignored this issue, and, because of this, few of the households selected for an ordinary audit were found to have claimed an excessive number of dependents. The problem only became apparent after a careful analysis of TCMP data, which revealed that a significant fraction of households were claiming too many dependents. Of course, once the problem of fictitious dependents was discovered, audit selection guidelines were modified to address the problem. Let me summarize my view of the uses of ordinary audit data. Ordinary audit data is good for evaluating existing audit programs, as Brian Erard and I have done. It is not well-suited, however, to the development of new audit selection criteria, because it does not keep the IRS abreast of changing evasion patterns.

A second alternative to TCMP is survey data. Unfortunately, survey data is extremely unreliable. Typically, 70% or more of respondents on surveys claim that they pay their full tax obligation, even though the hard facts from TCMP show that in most years more than half of all households underpay their taxes to some degree.

Finally, a third alternative is to abandon statistical analyses based on TCMP and instead rely solely on examiner expert judgments in the development of audit selection guidelines. While such expert judgments are currently used effectively in combination with DIF, they are unlikely to be a good substitute for DIF. Further, even if expert systems are used more in the future than they are at present, TCMP is likely to provide a good training ground for experts, exposing them to the full range of cheating strategies.

Supposing that TCMP is essential for IRS audit programs, a question still remains as to how big TCMP should be. I will conclude my testimony by briefly addressing this issue, confining my remarks to the household component of TCMP, which I know best. Previous TCMPs sampled approximately 50,000 households, whereas the proposed TCMP would sample 90,000 households. In my experience the previous TCMPs are thin in their coverage of certain taxpayer groups and locales, so I do not think it would be wise to shrink the sample below 50,000. Enlarging the sample would allow the IRS to increase its sample size for some of these groups, which might lead to a substantial payoff in the long run. However, these benefits are uncertain and might turn out to be relatively modest. I am not familiar with all of the arguments being made in support of enlarging the TCMP. Based on what I do know, however, I am not convinced that the benefits to be earned from expanding the program are worth the substantial cost involved.

In conclusion, based on my extensive study of tax compliance and tax enforcement programs, I believe that TCMP is important and productive and should continue. I am not convinced, however, that it needs to be expanded.

I thank you for the invitation to testify. I hope my testimony is useful to you.

Mr. HANCOCK. Thank you, Dr. Feinstein.
Mr. Smith.

STATEMENT OF KENT W. SMITH, PH.D., SENIOR RESEARCH FELLOW, AMERICAN BAR FOUNDATION, CHICAGO, ILL.; AND FORMER MEMBER, COMMISSIONER'S ADVISORY GROUP, INTERNAL REVENUE SERVICE

Mr. SMITH. Mr. Chairman, and members of the subcommittee, first let me note that I am speaking as an individual social scientist researcher and my comments do not necessarily reflect the views of the American Bar Foundation.

In my research on tax compliance administration since 1983, I have used the TCMP data in both tabular form and by special runs that the IRS research staff did for me. My comments are also informed by other research we have done on taxpayers' views and on research on State individual income tax audits that my colleagues and I have done in cooperation with the Oregon Department of Revenue, but at the State level this time.

Let me summarize most of my comments that are in the written testimony and highlight a few of the points. First, as others have argued, the TCMP detailed line item data for a statistically representative sample of tax returns has permitted a wide range of analyses by the Service, by many other administrative and legislative offices that have not been represented in the testimony today and by academic social scientists. As others have said, many of these analyses could not have been done with other types of data.

Two essential characteristics of the TCMP are that it, No. 1, includes a statistically sound sampling of returns that is at some level of stratification independent of the expected levels of non-compliance.

In the current form, there is an oversampling of the strata of taxpayers where there is the highest amount of noncompliance so there is a weighting toward an expectation of primarily picking up noncompliance or a heavier amount of that. It is not just simply a random sampling of the entire population of taxpayers.

No. 2, the other essential characteristic is that the audits are broad ones, examining all relevant aspects of the taxpayer's financial and tax situations. Without those characteristics, the data from the TCMP would be statistically biased and the conclusions could very well be misleading.

Several issues are frequently raised about the design efficiency and burden of the TCMP. About timeliness. For several reasons I believe it is probably unavoidable that it will take 2½ to 3 years, at a minimum, from the end of a tax year to a time when one can have clean data and compliance estimates from an accurate high-quality, TCMP data cycle. That is built into the nature of the tax filing process and the timing of when taxpayers file and the auditing process. One has to be concerned about the taxpayers and the time and social and business obligations they have. You cannot rush an audit because that increases the burden on the taxpayers. If she had not had the time, if Ms. Smith had not had the time to get her records together, it would have been much more burdensome for her, for instance.

So a 3-year lag may be an inevitable consequence of this process. What concerns me more is the amount of time between the TCMP cycles. If there is, say, 4 years between samples of a particular type of return, then the tax policy and administrative analyses and audit selection models have to rely on data that is up to 7 years old, given that unavoidable 3-year lag.

Before I make comments about burden, let me note that many returns selected through the sampling process end up with taxes owed, even though there was no indication ahead of time that there would be noncompliance. The TCMP audits are better at discovering unreported income than what would appear by just looking at the returns. Also many taxpayers end up with refunds that they did not expect to be getting because they had overcomplied.

Audits undertaken, for whatever reason, are burdensome and anxious experiences which taxpayers would like to avoid. Is the burden, in principle, excessive or unreasonable? Here I think my analyses of Oregon State audits is relevant. Most of the audits I studied were general audits that were not unlike TCMP audits by the IRS. The taxpayers in Oregon considered them to be burdensome, yes, but the vast majority we interviewed did not consider them unreasonably burdensome, and by and large the taxpayers came out of the audits feeling satisfied with the process and satisfied with the outcomes. If we focus on the fairness of the procedures and the quality of the audits, many of the concerns about burden, I think, will be met.

As has been anecdotally noted, many auditors, at least in the past, resent doing TCMP audits. The normal criteria for evaluating performance and allocating work in the examinations reinforces the feeling that TCMP audits are an unreasonable burden on both auditors and taxpayers.

In improving TCMP, attention needs to be placed on assuring that auditors are positively motivated to produce quality audits and quality data. They are the linchpin of the program and they have to be committed team members. The Service, I think, is for the next round taking solid steps in this direction.

Some suggestions have been made by others, including a National Academy of Sciences Panel, as to how to improve the TCMP. First, I think there should be an increasing of the capability for analyzing TCMP data within the Service, probably through the DORA sites. Second, we need to develop a team of TCMP audit specialists which may overcome some of the problems of the alienation of the auditors from the process.

Third, we should seriously consider conducting annual TCMP audits with smaller samples. Doing so would allow new patterns of compliance to be identified and analyzed sooner and the data would be available on a more timely basis. You could still group the annual audit data into 3- and 4-year groups for the more detailed kinds of analyses.

Whether or not one should do that now, this round, I am not entirely convinced because we have a lot of catchup, for instance, since 1981 for partnerships, and can we afford a small sample at this point?

Finally, even if fundamental tax reform occurs, there will still be a need to monitor and analyze compliance with something like a TCMP involving statistical samples of taxpayers and general audits. I also think current TCMP data could be used far more than what it currently is to evaluate the compliance implications of the various reform proposals.

That concludes my statement, and I will be happy to answer any questions.

[The prepared statement follows.]

**Hearing on
The Taxpayer Compliance Measurement Program**

**Subcommittee on Oversight
Committee on Ways and Means
House of Representative**

**Statement of Kent W. Smith
American Bar Foundation
July 18, 1995**

Madam Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Internal Revenue Service's Taxpayer Compliance Measurement Program (TCMP). I am speaking as an individual social science researcher, and my comments do not necessarily reflect the views of the American Bar Foundation. In my research on tax compliance and administration, I have used TCMP data both in the tabular form made publicly available by the Service and through special computer analyses prepared for me by the staff of the IRS Research Division. My comments are also informed by research on state individual income tax audits that I and my colleagues at the American Bar Foundation and Oregon State University have done in cooperation with the Oregon Department of Revenue (DOR). Many of the audits conducted by the Oregon DOR are general audits whose coverage and thoroughness is similar to that for TCMP audits. For a sample of these audits I have read hundreds of the auditors' working papers, and we have interviewed taxpayers about their responses to the audit process.¹

The TCMP is an invaluable tool for identifying and analyzing patterns of noncompliance and for evaluating administrative and legislative responses. While I will later outline some of the ways that I think TCMP could be improved, I begin by providing some examples of how the TCMP data have been successfully used in analyses of tax compliance. I will then detail some of the essential characteristics of the TCMP that contribute to its utility. My examples are illustrative rather than exhaustive, and others testifying today have extensively used TCMP data and can provide additional examples of the utility and limitations of the data. In his recent article on the TCMP, George Guttman has described several other successful uses of the TCMP data by the Service and other government offices.²

Some Examples of TCMP Analyses

One of the particular strengths of TCMP data is that they provide a detailed picture of patterns of compliance and noncompliance within a return. Rather than characterizing taxpayers as simply compliant or noncompliant, the detail reveals on which aspects of the tax return various types of taxpayers are more or less compliant. For instance, in our research for the American Bar Association's Commission on Taxpayer Compliance, we used TCMP data to obtain distributional information about compliance with line items. What aspects of tax reporting are particularly problematic? For a particular line item, are there many taxpayers in noncompliance by small amounts, or are there a few with large levels of noncompliance? Either a lot of little fish or a few big ones could produce the same aggregate level of dollar noncompliance, but the difference between the two patterns has large implications for resource allocation and compliance strategies. As Susan Long has also pointed out, the detailed picture of *over*-compliance also provides a very useful window into the level of unintentional

1. Two relevant papers are Stalans, Loretta J., and Karyl A. Kinsey (1994), "Self-Presentation and Legal Socialization in Society: Available Messages about Personal Tax Audits," *Law & Society Review* 28: 859-95; and Smith, Kent W. (1995), "The Cultural Grounding of Tax Issues: Insights from Tax Audits," *Law & Society Review* 29: 201-38.

2. Guttman, George (1995), "Taxpayer Compliance Measurement Program: Is it Necessary?" *Tax Notes*, June 5, pages 1282-88.

noncompliance. No other source can provide this key distributional information as accurately as can the TCMP.³

Steven Klepper and Daniel Nagin at Carnegie Mellon University have also used compliance patterns at the line-item level to analyze how the likelihood of detection and the severity of penalties affect compliance levels.⁴ Moreover, because the TCMP data allowed them to compare line items, they could explore the possibility of substitutions effects. Do taxpayers with opportunity for noncompliance on some aspects of their returns tend to be noncompliant in other areas, or does the opportunity for noncompliance, for instance on income reporting, "substitute" for noncompliance in other aspects, for instance the overstating of deductions? Interestingly, they found evidence for such substitutions effects, an analysis that could best be done with TCMP data. In general, there is not a high positive correlation between compliance on one part of a return and compliance on other unrelated parts. As they note, "We believe our analysis demonstrates that disaggregating noncompliance to the level of the line item on the tax return can be very revealing."⁵

Several researchers have also used TCMP data to explore the roles various types of tax preparers and practitioners play in tax compliance patterns.⁶ Klepper and Nagin again used the detailed line-item patterns of compliance to determine that practitioners tend to increase compliance with relatively unambiguous aspects of returns where noncompliance is likely to be detected and adjusted by the IRS, while they seem to increase the likelihood of more aggressive positions in ambiguous areas with low likelihoods of detection. In our own analyses we found that the apparent relationship between practitioners and overall noncompliance is misleading. Individuals with complex financial and tax situations are both more likely to be noncompliant (either intentionally or unintentionally) and more likely to use tax practitioners. When one uses the detailed data in the TCMP to control for the complexity of the tax situation, one finds that the *net* effect of practitioners is to *decrease* overall noncompliance. In far more detailed and sophisticated analyses, Michael Udell has found similar patterns.

The Research Division of the IRS and the General Accounting Office have occasionally used the working papers from TCMP audits to obtain a fuller understanding of the problems with areas of high noncompliance. For instance, the working papers have been used to trace why exemptions for dependents were being disallowed (e.g., generally inadequate documentation and record-keeping or misinterpretation of the law) and to examine the problems with capital gains and losses (e.g., inadequate documentation for the basis, incorrect calculation of the basis, misinterpretation of the laws for carry forwards and carry backs, etc.). Such analyses can be extremely valuable in planning administrative and legislative responses to problems, but drawing the information from working papers is inefficient and labor intensive. From my work with Oregon state auditors, I know that similar information can be obtained much more efficiently through check sheets completed by the auditors for targeted issues—if the analysts and auditors cooperate in designing the check sheets and if the auditors understand and are committed to the utility of the information. This is an extension of the TCMP audits that I think should be used more often.

3. American Bar Association Commission on Taxpayer Compliance (1987), "Report and Recommendations on Taxpayer Compliance," *Tax Lawyer* 41: 329-92.

4. Klepper, Steven, and Daniel Nagin (1989), "The Anatomy of Tax Evasion," *Journal of Law, Economics, and Organization* 5:1-24.

5. *Ibid.*, p. 23.

6. For example, Graetz, Michael, Jennifer Reinganum, and Louis Wilde (1989), "Expert Opinions and Taxpayer Compliance: A Strategic Analysis." Social Science Working Paper No. 710. Pasadena: California Institute of Technology. Klepper, Steven, and Daniel Nagin (1989), "The Role of Tax Practitioners in Tax Compliance," *Policy Sciences* 22: 167-92. Udell, Michael A. (1991), *The Effects of Tax Preparer Use on Non-Compliance with the Federal Individual Income Tax* (dissertation). Pasadena: California Institute of Technology, Division of the Humanities and Social Sciences. Smith, Kent W. (1988), "Tax Practitioners and Taxpayer Compliance: A View from Intensive Tax Audits," at the Annual Conference of the Socio-Legal Group, Oxford, England, March 23.

These are just some of the many examples of the valuable analyses that can be done with TCMP's detailed data on a statistically sound sample of taxpayers—analyses that could not be done as well with other types of data. The TCMP potentially offers answers to far more questions than the IRS's Research Division can explore. But the analyses can now be distributed more widely within with Service. During the first 20 years of the TCMP, analysis involved specialized programming on a mainframe computer, and the primary emphasis was on producing a general purpose set of tables. The output literally stood several feet, and retrieval experts were needed to find the relevant information in the tables, and then the general purpose tables often did not provide direct answers to one's questions. With today's powerful micro computers and statistical programs, analyses tailored to specific questions take just a matter of minutes. They can be done by staff members with training in data analysis and the special problems of working with audit data. With the promising development of DORA sites, I hope that the Service will distribute more widely the facility for analyzing the data and thereby take much fuller advantage of the rich TCMP data than it has been able to in the past. For this distributed analysis to be effective and efficient, however, researchers in the National Office will have to expand their functions to also be consultants on TCMP analyses, and there will need to be some mechanism for sharing analysis plans and results among DORA sites.

Two Essential Characteristics of with TCMP

The plans for the 1994 TCMP involve many improvements over previous cycles, and the program can be improved even more. However, in evaluating and modifying the TCMP, I think there are two essential characteristics that must be retained if it is to remain a useful tool for identifying and analyzing compliance patterns. These same characteristics are probably also critical for an efficient and accurate data base for developing statistical models for audit selection, such as DIF; but my focus is on the other administrative and legislative uses of TCMP.

1. Probability Sample of Taxpayers. To draw valid inferences about noncompliance, the TCMP data must include a statistically representative and sufficiently large sample of taxpayers who are compliant on a particular item so that their characteristics can be contrasted with those of a sample of taxpayers who are not compliant. Therefore, the program must involve a probability sampling of taxpayers that at some level of stratification is independent of the likelihood of noncompliance.

2. General Audits of Taxpayers' Finances. The starting point for TCMP audits must be the total financial and tax situations of the taxpayers during the tax year being audited. The TCMP auditors should not be given the latitude to focus on just those items that they think may be relevant. If they do, there will be a selection bias at the level of the line item even though it may be a statistical unbiased sample of returns.

There are several interrelated reasons why these essential characteristics should be retained.

- First, adequate pictures of the incidence of noncompliance and of the factors related to noncompliance have to be based on the contrast between statistically sound samples of cases of noncompliance and of cases of compliance. One cannot determine how noncompliance differs from compliance by only or primarily looking at cases of noncompliance. Without a probability sampling and general audits, TCMP would provide a biased and misleading picture, both of the relative amount of noncompliance and, perhaps more importantly, of the factors affecting the noncompliance.
- Not all under and over compliance is reflected in the returns as filed and in third-party reports. Using only this information to select returns and issues will give an incomplete and misleading picture. To give some examples, evidence from TCMP and survey data indicates that there are appreciable numbers of individuals with small business on the side but who file 1040s without Schedule C and even 1040As or 1040EZs. Understatements of income by amounts too small to show up in expenses or living standards is widespread and, in the aggregate, a significant source of noncompliance. Individuals and businesses, for one reason or another, often do not list relevant expenses, but an accurate picture of compliance patterns should include such over compliance.

- Patterns of noncompliance are continuing changing, and basing TCMP selection and auditing on past auditing experience is likely to miss some of these changing patterns, at least in a timely manner. As someone once observed, tax compliance is like a leaky hose. As soon as one hole is patched, another one springs out, often in direct response. Looking where the old leaks were is not the best way to find the new ones: the entire hose must be inspected.⁷
- There is also an important compliance reason for probability samples and general audits. Because opportunities for noncompliance come and go, all taxpayers should have the perception that there is some probability, however small, that their returns might be audited, even if they think they have prepared them so that they will be beyond suspicion. That audit presence for everyone is a deterrent factor, but I and others feel that it is also an important contributor to the normative support for trying to comply with tax laws. "If the government doesn't take my compliance seriously enough to be concerned about it, why should I?" Even though the TCMP sample is a minuscule percentage of returns, it helps to provide this deterrence and normative underpinning for compliance.

Concerns about TCMP Audits: Some Observations

Several issues are frequently raised about the design, efficiency, and burden of the TCMP. My comments about these issues are based on my own experience with TCMP data, discussions with IRS staff, and my analyses of Oregon state individual income tax audits.

Timeliness. For several reasons it is probably unavoidable that it will take two and a half to three years from the end of the tax year to obtain clean data and compliance estimates from an accurate, high quality TCMP cycle. Taxpayers who file late have different financial situations and taxpaying orientations than those who file early. The TCMP sampling must include both, so it cannot be completed until at least 6 months after the filing date. Once an audit begins, it often takes considerable time to obtain documents from third parties, and good auditors need to respect the many other business and personal obligations of the taxpayers being audited. Even with perfectly clean data, it still takes time to create the data base, double check for inconsistencies, and conduct the initial analyses. Thus, a 3-year lag may be an inevitable consequence of the nature of tax filing and auditing.

The data entry and checking procedures planned for the 1994 TCMP should decrease the time needed for cleaning and organizing the data, but I suspect more could be done to speed up this part of the process, especially by improving the accuracy of the initial data input by the auditors—"getting it right the first time" in the parlance of Total Quality Management. What concerns me more, however, is the amount of time between TCMP cycles. If there are three years between samples of a particular type of return, then tax policy and administrative analyses and audit selection models have to rely on data that are up to 6 years old, given the unavoidable 3-year lag.

Sample Size. Others today can address the issue of sample size more authoritatively than I can, but I doubt that the sample can be decreased very much if we are still to have statistically sound data. The stratified sampling design, especially as improved for the 1994 TCMP, is already allowing considerably smaller samples than would an unstratified random sample of audits. As I noted before, compliance on one line item is generally not highly correlated with compliance on other line items, so an adequate sample of compliance and noncompliance on each line item requires quite large overall samples. Also, some types of important noncompliance are rare and unpredictable from available data: large samples are needed to increase the probability of including these often large but rare cases of noncompliance. Moreover, the factors related to various types of noncompliance vary considerable across categories of tax-

7. Lest the analogy be misunderstood, let me note that the primary reason why the compliance hose is leaky is *not* that the tax system is old or brittle. More fundamentally, the leaks occur because the financial and social situations of tax entities are complex and forever changing, resulting in both intentional and unintentional noncompliance; because some entities will try to take a "free ride" when the opportunity exists; and because for some the utility and satisfaction of keeping a dollar away from the government is worth more than a dollar.

payers. As a consequence, we must have adequate samples within these categories to permit stable estimates at the level of detail needed for audit selection models and other types of analyses. The added focus on geographically specific analyses by the DORA sites is in many respects a significant improvement, but it does add another cross-cutting dimension for stratifying the population of returns and may increase the total sample size needed.

Burden on Taxpayers. Audits, undertaken for whatever reasons, are burdensome and anxious experiences which taxpayers would like to avoid. TCMP audits differ from other general audits because there is a higher probability that the audit will result in no change or a refund. On the other hand, many returns selected through the sampling process end up with taxes owed even though there was no indication ahead of time that there would be noncompliance. In that respect, all TCMP audits are enforcement audits.

Is the burden in principle excessive or unreasonable? Here I think my analysis of Oregon state audits is relevant. Most of the audits I studied were general audits that routinely included deposit analyses or other indirect methods for checking income. In many cases, taxpayers were also asked to complete a form with estimates of their annual personal and household expenses. Audits that began with one focus frequently expanded to other issues and to other years' returns. Not unlike TCMP audits by the IRS. Did taxpayers in Oregon consider them to be burdensome? Yes. But the vast majority we interviewed did not consider them *unreasonably* burdensome and, by and large, the taxpayers came out of the audits feeling satisfied with the process and how they were treated and satisfied with the outcomes.

From this analysis and other research on citizens' responses to enforcement experiences, I am convinced that the primary focus in improving taxpayers' responses to TCMP audits should be on assuring that the auditors appear competent, efficient, and reasonable; treat the taxpayers with respect and dignity; keep the taxpayers informed on the progress of the audit; and explain both the process and the decisions in clear and understandable terms. Without assuring the quality of these fundamental fairness aspects of the process, some taxpayers are going to continue to be alienated and resentful, even if they are paid. In short, I am not persuaded that paying taxpayers is necessary, and I am concerned that payment without assuring quality may have unexpected and not necessarily beneficial consequences.

Yes, there are cases of excessive and unreasonable requests from auditors doing TCMP audits. For instance, even in a general audit focusing on all relevant aspects of a taxpayer's financial situation, there seldom is a need for a wedding certificate to verify that a couple with children and grandchildren can be filing a joint return. But I think thoroughness and a focus on the finances of a taxpayer, not just on what appears problematic on the return, is reasonable in any audit—*provided* the audit is done responsibly and with respect and consideration for the taxpayer.

As is well known at least anecdotally, many auditors resent doing TCMP audits, and the normal criteria for evaluating performance and allocating work in Examinations reinforce the feeling that TCMP audits are also an unreasonable burden on auditors. I suspect that many of the horror stories about taxpayers' experiences can be traced to what can be called "over-conformity" and excessively going by the book on the part of resentful and alienated auditors. In social science and medical research, there is always a concern about the quality of data one can obtain from "hired-hand help" who do not understand and are not committed to the goals and procedures of the research. In improving TCMP, more attention needs to be placed on assuring that auditors are not alienated, hired-hand help. They are the lynchpin of the program and have to be committed team participants.

Some Suggestions for Possible Improvements

In light of these observations about the issues surrounding TCMP, let me briefly suggest some possible improvements. All have been suggested before by experts inside and outside the Service, and I think they are worthy of a serious and open-minded appraisal of their possible advantages and disadvantages.

Specialists in TCMP Audits. Examinations is increasingly moving toward various types of specialists and specifically focused teams. These specialists often become resources for oth-

ers within Examination. Given the specialized nature of TCMP audits and their dual purposes of enforcement and research, there perhaps should also be TCMP specialists. These specialists could be affiliated with the DORA sites while still functioning within Examination, and they could serve as liaisons and research resources within Examination at the district or post-of-duty level. Correspondingly, the criteria for evaluating their performance and for advancement would have to be broader and somewhat different from the criteria for normal Examination staff. In the funding for these specialists, there probably should also be some recognition of their dual affiliation and multiple roles so that Examination would not, quite reasonably, feel it was paying out of its budget for services to other areas of the IRS and to other government offices. Without some such organizational change, there are going to be continuing structural and incentive pressures toward alienated, hired-hand work on TCMP audits.

Smaller Annual Samples. There are several arguments for moving from large samples drawn every few years to smaller samples drawn every year. The work loads of the TCMP specialists I just suggested would be evened, and there would be other efficiencies in avoiding cycles of starting up and closing down. Moreover, new patterns of noncompliance could be identified and analyzed sooner, and the data would be available on a more timely basis. For some broad stroke analyses and early warning systems, the annual data could be used. For audit selection models and most other detailed analyses, the annual data could be grouped into 3- or 4-year moving clusters. One difficulty with this design is that the data from some years would have to be adjusted for tax law changes before the analyses were performed, and there would inevitably be some additional estimation involved. However, under current procedures, the audit selection models are having to be adjusted after the fact for tax law changes, also with estimations, but with no data on how taxpayers are actually responding to the changes. With annual samples we would at least have some early evidence on these response changes.

TCMP and Basic Tax Reform

Finally, questions have been raised about how TCMP relates to some of the fundamental changes in our federal tax system that are currently being developed and debated. Regardless of the tax system, there will always be a need to monitor compliance, to analyze the factors affecting it, and to evaluate administrative and legislative changes in light of the compliance data. As many of us have argued, measuring and analyzing compliance effectively and accurately will require some sort of probability sampling that is independent of the expected level of compliance and general audits covering the relevant aspects of taxpayers' financial situation. In short, there will always be sound administrative and legislative need for something like TCMP.

Many of the tax reforms being suggested still involve the reporting of income. Currently, most noncompliance, both in terms of the number of taxpayers and the number of dollars, is on the income side, not on the subtraction side. These compliance problems will not completely disappear by eliminating the subtractions and simplifying the returns. Analyses of the current TCMP data about under reporting various types of income and the factors affecting it could be used to evaluate the compliance implications of the alternative reforms.

Those reforms focusing on consumption, especially those involving a VAT or other sales and transaction taxes, will rely upon the accurate reporting and collection of taxes by some sectors of the economy that are now among the least compliant (again, in many cases unintentionally so) and with some of the worst record keeping relative to business needs. Careful analyses with TCMP and other data about possible compliance problems with the reporting and collection of consumption and transaction taxes should be done before the federal government decides to rely primarily on such sources of revenue.

In summary, regardless of the shape of future tax reform, the concern with TCMP now and for the foreseeable future should be on how to improve the program and how to utilize its data more fully in planning and evaluating legislative and administrative reforms. The focus should not be on abandoning the program or its essential characteristics.

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

Mr. HANCOCK. Thank you, Dr. Smith.

The gentleman from Texas.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Scheuren, in your testimony you contended that the market segment stratification is a good idea, but not fully tested. Has there not been some market segment analysis of data from prior TCMP studies that supports the value of such data from a larger sample?

Mr. SCHEUREN. I think the market segment is a very good idea. The problem is at the point of sampling, how good a classification of the taxpayer can you do in terms of market segments? There are some real data quality problems on the tax returns that are being used to do the sampling.

It is a well-known problem. A problem I actually worked on when I was in the Service. At the point of sampling, there is a lot of possibility for misclassification.

That is one of the reasons why I recommended the additional work of drawing a subsample.

Mr. LAUGHLIN. Ms. Long, you have indicated that there are numerous approaches to address IRS concerns about the release of current TCMP microdata. Could you give some samples of the issues and the means of addressing them?

Ms. LONG. Well, for example, IRS does release TCMP to outsiders under contract with the IRS. You sign a disclosure agreement with some restrictions. They might consider, in the short run, such a proposal so that they could release data for purposes of research. Their concerns, as I understand them, which I think are somewhat misplaced, are that if you had the data you could recreate their discriminant function formulas.

I think if you gave the data to 10 statisticians, you would get 10 different sets of formulas. I do not think this is a real concern, but if that was a concern they could have contractual arrangements so that people agreed not to do certain things.

I also think that there are some statistical ways that the data could be sanitized that could provide protection against those kinds of concerns with some of the new modern techniques that are available. Right now, TCMP, although we invest a lot of money in it, the actual use of TCMP is disappointing. Also, IRS tends to be rather insular in its approach. We need, I think, a wider community looking at it.

Mr. LAUGHLIN. Dr. Long, and Dr. Scheuren, I apologize for not acknowledging your academic achievement. Dr. Feinstein, in your testimony you question the need to expand the household component of the TCMP. Yet, you describe prior TCMP as thin for certain groups and locales. Are there any differences in compliance based on different parts of the country and, if so, are you saying that the differences are not substantial enough to warrant the additional audits, or that the past number of audits provide reliable data for the selection of returns at the local level?

Mr. FEINSTEIN. In my experience, looking at the past data, you would find in narrow cells of taxpayers, for example, farmers in a particular State or lawyers in a particular State, perhaps 1 dozen or 2 dozen TCMP audits.

I would say that that is, as a statistician would tell you, just about at the level at which you can have some reliability in what

you do. I would never want to go below that but I would not necessarily see that the value of going above that would be as great as maintaining at that level.

Mr. LAUGHLIN. Dr. Smith, you indicated that the TCMP covers answers to more questions than the IRS research division can explore. Would you recommend that sanitized data be made available to outside researchers as well as to the district office research sites?

Mr. SMITH. I am an outside researcher, I would love to have the data, but I think that the initial focus probably is on getting up to speed more of the sites at the district level within the Service for taking advantage of the data.

I would say that institutionally that should be the focus because getting more people—

Mr. LAUGHLIN. Well, let me just interrupt you and ask on that point. You stated more needs to be done to get up to speed and I take it you are talking about the TCMP process. What are your recommendations, specific recommendations for doing that?

Mr. SMITH. I am thinking about the analysis of it. At the DORA level, the analyses could now be done with modern computers with a reasonable level of training and data analysis. Even more critical, perhaps, is also an understanding of the technical problems of analyzing data from audits. Presumably, IRS personnel have some of that sensitivity.

Getting that ability out, at the district level in the new DORA sites, could increase the understanding of approaching problems in an analytical way throughout the Service. That would have a major advantage.

Yes, there would be considerable advantage in getting more outside researchers interested in studying patterns of compliance and noncompliance by giving out sanitized data. To extend just a bit on what Dr. Long said, a recent study in last year's Research Bulletin from the IRS showed that a great deal of the ability of the DIF process to identify targeted taxpayers for auditing is on how the Service manipulates and prepares the data for the analyses. Outside researchers are not going to have that same skill. That skill is based upon decades of working with the data.

Mr. LAUGHLIN. Well, I certainly thank this distinguished panel of doctors for their appearance.

I yield back to the gentleman from Missouri, the chairman.

Mr. HANCOCK. The chairman would exercise his prerogative on this and that is, Mr. Feinstein, were you stating in your statement that the average return without the DIF assessment was \$1,000 or whether it was \$5,000? I do not know if that is a statement on how good the auditors are or how bad the tax law is. But this hearing is adjourned, thank you.

[Whereupon, at 2:52 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

WRITTEN STATEMENT OF ERIC J. TODER
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
SUBMITTED TO THE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE
IN CONNECTION WITH HEARING ON IRS'S TAXPAYER COMPLIANCE
MEASUREMENT PROGRAM
JULY 18, 1995

Dear Madame Chairman and Members of the Subcommittee:

I am happy to submit this statement at your request regarding the ways in which Treasury's Office of Tax Policy (OTP) relies on the data compiled in the Internal Revenue Service's (IRS's) Taxpayer Compliance Measurement Program (TCMP) audits. The principal purpose of the TCMP audits is to develop information that will enable the IRS to administer the tax laws more effectively. IRS is solely responsible for the timing, scope, and design of the TCMP audits. But the information the audits produce is also helpful to OTP for both policy analysis and revenue estimation.

From a policy perspective, TCMP audits provide OTP with valuable information on those aspects of the Federal tax system that create the greatest problems of compliance for taxpayers and administrative problems for the IRS. TCMP audits indicate which items of income, expense, deduction, or credit generate the greatest numbers of errors per response. Such errors can occur either because the specific tax provisions associated with those items are unduly complex and confusing for taxpayers, because they are difficult for the IRS to verify, or both. The TCMP data can thus be very helpful to OTP in suggesting policy changes that reduce taxpayer burden and improve compliance. From an estimating perspective, TCMP audits provide useful information on how proposed changes in information reporting or in the level of resources devoted to tax administration would affect future tax receipts.

Treasury's Office of Tax Analysis (OTA) evaluates numerous proposals to improve taxpayer compliance and the ability of IRS to enforce the tax laws. In estimating the revenue impact of these proposals, it is first necessary to establish a "baseline" of the level of non-compliance. The TCMP is the only source of data that provides sufficiently detailed information on the level of compliance associated with specific tax provisions. For example, the Energy Act of 1992 required buyers who deduct seller-financed mortgage interest to report the name and social security number of the seller. The revenue estimate for this proposal required two key pieces of information: (1) the degree of non-compliance in reporting home mortgage interest deductions associated with seller-financed mortgages and (2) the extent to which the IRS could expect to close this gap by requiring the additional information. TCMP data on the level of non-compliance for seller-financed mortgages and on the level of compliance for mortgages financed through financial institutions that currently required information reporting were used to estimate the revenue gain from the proposed increase in reporting requirements.

Another example of the use of the TCMP data in estimating the revenue effect of tax compliance initiatives is the provision of the Omnibus Budget Reconciliation Act of 1993 which required donors to obtain substantiation from donee organizations for charitable contributions of \$250 or more. The provision required a charitable organization to state the

size of the contribution made by the donor and provide a good faith estimate of any goods and services rendered in exchange for the contribution. Before this change in the tax law, the taxpayer needed only to have a cancelled check as validation for a charitable contribution deduction. The TCMP data showed that charitable contribution deductions are frequently and substantially overstated, and showed how the overstatement of charitable contribution deductions was distributed by size of contributions. These data proved crucial in estimating the effects of alternative proposals to detect overstatement of charitable contribution deductions, including the specific one that became law.

The TCMP data also were very helpful in estimating the revenue effects of requiring mortgage brokers to file information reports to the IRS on the proportion of property taxes paid by the buyer and the seller in the course of a home sale. Previously, it was possible for both the buyer and the seller of the house to claim a deduction for the entire amount of property taxes paid on the house in the year of the sale. While the TCMP data did not directly measure compliance for this specific type of deduction, compliance under this proposal could be inferred from examination of compliance in the reporting of the home mortgage interest deduction, an item whose compliance is measured by the TCMP. Thus, even if the revenue effects of a compliance proposal cannot be estimated directly from the TCMP data, it may be indirectly estimated by using a closely related TCMP compliance-measured income or deduction item.

These are just a few examples of how OTP uses TCMP audit data to determine where additional information reporting would be particularly helpful and in estimating the revenue consequences of such changes. To the extent the quality of the TCMP data is maintained at a level consistent with the primary objectives of the program -- the determination of taxpayer compliance levels, the appropriate allocation of IRS audit resources, and the selection by the IRS of specific tax returns for audit -- the TCMP data will continue to meet OTP's requirements. Conversely, if the TCMP program were reduced or compromised to the point where it no longer accomplishes these objectives of the IRS, OTP's ability to rely on the data would also be adversely affected. Were that to happen, our ability to propose improvements to the tax system and provide accurate revenue estimates would be reduced.

104TH CONGRESS, 1ST SESSION

HOUSE
 BILL ARCHER, TEXAS
 CHARLES W. STENBERG, CALIFORNIA
 PHILIP M. CRANE, ILLINOIS
 WILLIAM M. THOMAS, CALIFORNIA
 SAM M. GIBSON, FLORIDA
 CHARLES B. RANGEL, NEW YORK

SENATE
 BOB PACKWOOD, OREGON
 VICE CHAIRMAN
 WILLIAM V. ROYCE, JR., DELAWARE
 OFFICE OF MATCH, UTAH
 DANIEL P. PATRICK, MARYLAND, NEW YORK
 MAX BAUCUS, MONTANA

Congress of the United States

JOINT COMMITTEE ON TAXATION
 1015 LONGWORTH HOUSE OFFICE BUILDING
 WASHINGTON, DC 20515-6453
 (202) 225-3821

KENNETH J. GEL
 CHIEF OF STAFF
 MARY M. SCHWARTZ
 DEPUTY CHIEF OF STAFF
 LAW
 BERNARD A. SCHWARTZ
 DEPUTY CHIEF OF STAFF
 REVENUE ANALYSIS

AUG 01 1995

Honorable Nancy Johnson
 U.S. House of Representatives
 Washington, DC 20515

Dear Mrs. Johnson:

You have requested information relating to how the Joint Committee on Taxation ("Joint Committee") uses the Taxpayer Measurement Compliance Program ("TCMP") files of the Internal Revenue Service ("IRS") in preparing revenue estimates for many tax compliance proposals. This letter contains a brief description of the 1988 TCMP file followed by some examples of how the Joint Committee has used the TCMP data.

The 1988 Individual TCMP contains approximately 54,000 individual tax returns for 1988 that have been extensively audited. These returns were chosen to be a statistically representative sample of the 107 million individual returns filed for tax year 1988. The TCMP examination covers every line item of the tax return. In contrast, routine IRS examinations focus on specific, and generally predetermined, items on tax returns.

The resulting TCMP data set contains both the taxpayer-reported amounts and the IRS examination-recommended amounts. The data are particularly well suited to the analysis of information reporting proposals because amounts reported on information documents can be compared with amounts reported by taxpayers to measure taxpayer reporting compliance. Moreover, the data include verified occupation categories for each tax return. Taxpayer-reported occupation categories are accurately reported on only about one third of individual income tax returns. Verified occupation categories are quite useful for proposals that target specific types of taxpayers, such as independent contractors.

The IRS uses the TCMP information as a planning tool to determine its workload, to understand areas in which taxpayers do not accurately report amounts that the Service believes should be reported and to estimate how much individual income tax should have been paid. TCMP data are also used to develop the system that selects returns for audit. One result of the TCMP-developed audit selection system has been a dramatic decrease in the percentage of audited returns for which no change in tax liability was found.

Congress of the United States

JOINT COMMITTEE ON TAXATION
Washington, DC 20515-6453

AUG 01 1995

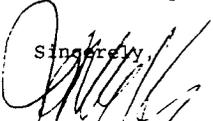
Honorable Nancy Johnson
U.S. House of Representatives

The Joint Committee uses the TCMP data in preparing revenue estimates. Some examples of these include:

- 1) To segregate the "Other Income" line item into the sources of income reported. The General Accounting Office performed this analysis for the Joint Committee and provided results that were used to estimate gambling reporting proposals.
- 2) To estimate excessive claims of charitable contributions for various information reporting proposals. In particular, TCMP data was used to estimate the charitable contribution substantiation and disclosure requirements included in OBRA 1993.
- 3) To analyze estimated tax payment relief proposals for individuals in disaster areas.
- 4) To estimate the reporting of disability income payments.
- 5) To estimate the reporting of unemployment income payments.
- 6) To estimate real estate and property tax reporting proposals.
- 7) To analyze information reporting of sole proprietor gross receipts, and sources of sole proprietor noncompliance, by line item and occupational category. This information was very useful in estimating both the Administration's Service Industry Noncompliance ("SINC") proposal in 1993 and, more recently, various independent contractor proposals.
- 8) To analyze the relative compliance of different classes of taxpayers for various tax reform proposals.

I hope that this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,



Kenneth J. Kries



1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

(202) 737-6600
Fax (202) 638-4512

O-1-226

August 1, 1995

Members of the House Ways and Means
Oversight Subcommittee
United States House of Representatives
1136 Longworth House Office Building
Washington, DC 20515

Dear Sir/Madame:

The AICPA appreciates the opportunity to comment on the value of the Taxpayer Compliance Measurement Program (TCMP). We believe that the TCMP is an essential element in the Internal Revenue Service's audit program and should be continued. A TCMP audit is a time-consuming process, both for the taxpayer and the agent, but its benefits outweigh the costs through more efficient tax administration. While these audits impose substantial added burdens on those taxpayers selected, they should help countless other taxpayers avoid an audit completely through the accumulation of statistically valid baseline data.

As you are aware, it has been six years since the last TCMP survey. The TCMP is one of the cornerstones of the voluntary compliance system. In a tax system that requires the filing of a return, and when less than 1% of those returns are audited, the enforcement authority (the IRS) must have a method by which to measure compliance and target enforcement efforts. The TCMP aids the IRS in this goal. With the data provided by detailed "random" audits of a statistical sampling of returns filed, the IRS can hone its enforcement efforts to select those returns for an audit which are most likely to be in noncompliance.

Any cost-benefit analysis of the TCMP audit is speculative, at best. The TCMP began with the examination of 92,000 individual tax returns from tax year 1963. The TCMP survey planned for the 1994 tax year is projected to examine 153,000 returns. For the first time, the sample will be drawn from 28 major market segments, enabling the IRS for the first time, to look at compliance within each market segment, regardless of the type of tax return filed. Of the 153,000 returns selected for an audit, 92,000 are intended to be individual tax returns and 61,000 are intended to be corporate and partnership tax returns. These 92,000 individual tax returns represent fewer than .03% of nonbusiness individual returns and fewer than 1% of business individual returns. Nonetheless, the IRS must take steps to ensure that taxpayer inconvenience is minimized for those selected and ensure that taxpayer selection is truly random. While the taxpaying public at large benefits, the incremental inconvenience to the audited taxpayer is severe, as can be the incremental costs.

Members of the House Ways and Means
Oversight Subcommittee

August 1, 1995

One subject of potential concern to us, as practitioners and tax representatives, is the role of "economic reality" or "financial status" questions to be used in the forthcoming round of TCMP audits. We have been in oral and written discussion with the IRS National Office about the potential conflict between information needed for an audit of a tax return and taxpayers' rights of privacy. Questions involving "financial status" that extend outside the four corners of the tax return are appropriate only when an examining agent has reason to believe that there may be unreported income on a return. In the absence of such belief or suspicion, we believe it appropriate to challenge when this line of questioning turns from being an audit tool to an improper invasion of taxpayer privacy. We acknowledge the IRS's need to probe for unreported income, but would urge that taxpayers not have to respond to questions that have at best only a tangential connection to that subject.

If you have any questions or wish to discuss the contents of this letter, please do not hesitate to contact one of the following:

Joseph Cammarata
Tax Practice and Procedures Committee Chair
(703) 352-3850

- or -

Anita L. Horn
AICPA Technical Manager
(202) 434-9231

Sincerely,



Deborah Walker
Chair
Tax Executive Committee

DW/ALH/kvk

cc: Joseph Cammarata, Tax Practice and Procedures Committee Chair
Jeffrey L. Raymon, Financial Status Audit Working Group Chair

**STATEMENT OF DANIEL J. PILLA
ST. PAUL, MINN.**

Madam Chairman and Members of the Subcommittee:

My name is Daniel J. Pilla. I am a tax litigation consultant from St. Paul, Minnesota. For nearly 20 years, I have been actively engaged in the defense of taxpayers' rights. My work focuses in the areas of IRS abuse prevention and cure, taxpayers' rights issues, and problems resolution. Over the years, I have been involved, directly or indirectly, with thousands of cases. I have seen every kind of tax case imaginable, and some that are not imaginable.

I am the author of eight (8) IRS self-help defense books. In addition, I am the editor of two nationally circulated newsletters. One is addressed to the general public. The other to tax professionals. In connection with my work as an author, I have appeared as a guest on more than 3,000 radio and TV talk shows, and currently conduct more than 500 interviews per year. In that capacity, coupled with my consulting work, I talk to about one hundred people per week who face difficulty with the IRS.

At present, I am the executive director of an organization known as the Tax Freedom Institute (TFI). TFI is a national association of tax professionals, including attorneys, accountants and enrolled agents who have dedicated a portion of their practice to defending taxpayers rights against abusive IRS practices. As the executive director of TFI, I am responsible for developing continuing professional education materials to train these tax pros in matters of tax law and procedure. I have taught courses in tax law and procedure having to do with taxpayers rights for numerous professional associations, including the prestigious Penn State Tax Institute.

This statement is submitted on behalf of myself in my individual capacity, on behalf of the Tax Freedom Institute, and on behalf of every American business and individual taxpayer.

One question before this subcommittee is whether the IRS' Taxpayer Compliance Measurement Program (TCMP) provides sufficient research value to the IRS and Congress in the areas of tax administration, taxpayer compliance with the tax laws, and policy analysis as to warrant continuation of the program. Another question is whether the program is overly burdensome to taxpayers selected for such audits.

For reasons I shall elaborate upon in detail, I submit the program should be discontinued. First, the program does not provide adequate, accurate or reliable data to either the IRS or Congress in any of the areas of concern. Second, even if the IRS were able to gather accurate data, history has shown the agency is unable to assimilate or utilize the data it has. And third, the program is so invasive and subject to abuse, taxpayers cannot be adequately compensated for being forced to participate in such a program.

1. The results of TCMP Audits are Unreliable.

The TCMP audit is a grueling line by line examination of the tax return selected. Taxpayers are called upon to prove their names, social security numbers, the names and births of their dependent children, and so on throughout the entire return.

The results of the audits are compiled into a sophisticated data base which has many uses. Results are used to determine patterns of non-compliance, to evaluate the IRS' policy and enforcement needs, and to assist Congress in the areas of legislative policy. Another primary use of TCMP data is to formulate the data base used in the Discriminate Function System (DIF).

DIF is a computer program which compares every line of one's tax return with national and regional statistical averages for a person in a given income bracket and profession. Such averages were previously ascertained through TCMP audits. If one's return is out of sync with those tolerances, that return is flagged for a potential face-to-face audit by a revenue agent.

TCMP data are unreliable simply because they are only as good as the audits themselves. The reality is the results of IRS audits are often wrong. For a number of reasons, when IRS examiners report that citizens have erred in the computation of tax liability, they have, quite simply, arrived at erroneous conclusions.

In my nearly 20 years of experience dealing with the IRS and audits, I have seen countless examples of examiner errors. In some cases, the errors are so basic, one must question whether they were in fact intentional. Erroneous audit results grow not only from auditor errors, but from overt acts of tax examiners to bluff and intimidate citizens into accepting audit results which are clearly erroneous. These are just a few examples:

1. Where examiners wrongfully claim a citizen has insufficient proof to support an otherwise legitimate deduction and therefore the deduction is disallowed.
2. Where examiners wrongfully give an incorrect statement of the law to a citizen regarding a particular tax deduction or tax treatment of an item, leading to the disallowance of such item.
3. Where amounts of money transferred from one of the citizen's bank accounts to another (transactions known as redeposits) are double and triple counted by examiners, and therefore a citizen is said to have earned income he did not report on his return.
4. Where tax examiners falsely claim that citizens have no, or limited appeal rights from the decision of tax examiners, and therefore have no choice but to accept audit results which are clearly in error.
5. Where tax examiners falsely claim that citizens will suffer other or greater penalties if they pursue their right of appeal, and therefore accept audit results which are clearly in error.
6. Where tax examiners explain to citizens that the avenue of appeal is lengthy, costly, time consuming and the IRS wins its cases anyway, all the while additional accumulations of interest and penalties stack up against the citizen.
7. Where, in certain unusual cases but nevertheless prevalent, tax examiners will claim a citizen can be put into jail if he does not sign and accept audit results which are clearly wrong.
8. Where, as very commonly happens, tax examiners will threaten citizens with lien, levy and seizure of bank accounts and property if they refuse to sign and accept audit results which are clearly wrong.
9. Probably the single most common reason erroneous audit assessments are recorded against citizens is most citizens are simply unaware of their right of appeal. Upon completion of a tax audit, the IRS mails to the citizen a so-called 30-day letter. The letter contains the Revenue Agent's Report (RAR) which details the changes proposed to the citizen's return.

Citizens commonly mistake the RAR for a bill, which it is not. They do not understand that it is a proposed change to their tax, which

they can appeal. But with lack of understanding of the appeal right or process, and lack of funds to hire a professional, many do nothing. This leads to the issuance of a notice of deficiency, which requires the filing of a petition in the Tax Court within 90 days. If the petition is not filed, the amount of tax claimed becomes assessed without further action necessary on the part of the IRS. In effect, the citizen loses his tax audit case by default.

This is certainly not an exhaustive list of the things that commonly happen to honest, perfectly law abiding citizens during the course of routine face-to-face examinations, such as a TCMP audit. They are, however, a few of the more common examples of what takes place on a daily basis within the realm of tax law administration.

Another very compelling reason why tax audits are often wrong is the fact that tax auditors are poorly trained in the law. We have a tax law that consists of 17,000 pages of law and regulation which was changed more than 100 times just during the decade of the 1980s alone. The pure size, scope and evolution of the law makes it physically impossible for any human to understand its full scope and application.

This problem is particularly troublesome in multi-year audits, which are becoming more and more common. A multi-year audit involves more than one tax year. The IRS may, for example, attempt to examine each of the three open years on one sitting. In fact, in the current TCMP model, IRS will provide its agents with three tax returns for the each TCMP subject. They will be, the return for the primary year, and returns for the two previous years.

Problems arise in such audits when the law treats a given transaction differently in one year than it does in the next. Very commonly, an examiner will treat the transaction the same for all years in question. This makes the resulting examination report correct as to one year, but incorrect as to the next. This despite the fact the it reads identically for both years.

The fact that IRS examiners are poorly trained yet are under pressure to produce results is confirmed by a recent General Accounting Office (GAO) report. In testimony to this subcommittee, Lynda D. Willis, associate director of tax policy at GAO described many problems businesses face in complying with the tax laws. Her testimony described the results of a survey GAO conducted to determine the compliance burden faced by small businesses. See: Tax System Burden, Tax Compliance Burden Faced by Business Taxpayers, GAO/T-GGD-95-42, December 9, 1994.

Among other things, Ms. Willis said:

"The complexity of the code has a direct impact on IRS' ability to administer the code. The volume and complexity of information in the code make it difficult for IRS to ensure that its tax auditors are knowledgeable about the tax code and that their knowledge is current. Some business officials and tax experts said that IRS auditors lack sufficient knowledge about federal tax requirements, and in their opinion this deficiency has caused IRS audits to take more time than they otherwise might.* * *" Ibid, page 3.

The audits not only take more time, leading to more cost for both the agency and the private sector, but they often result in

incorrect conclusions. This leads to the assessment of taxes, penalties, interest which are simply not owed.

Recently, the GAO released the result of a study of the IRS' Coordinated Examination Program (CEP). CEP is designed to audit the largest, most complex corporations. Despite having spent 1,700 staff years to examine 1,700 such corporations, GAO was able to confirm that only 22 percent of the amount of tax proposed through audit was ever collected. See: Tax Policy and Administration, Compliance Measures and Audits of Large Corporations Need Improvement, GAO/GGD-94-70, September 1, 1994.

GAO generally cited two reasons for the tremendous difference in the amounts of tax recommended by examination, versus that assessed and collected. First is the complexity of the tax laws. This factor gave rise to "opportunities for different interpretations" of complex tax law issues. Secondly, IRS encouraged CEP teams to "recommend more taxes in the shortest time possible." This not only makes it difficult to do a complete audit, it makes it impossible to do a correct audit.

While the above mentioned report dealt with complex corporate tax audits, the results are no different in the examination of individual taxpayers, or small business taxpayers. IRS examiners are under the same pressure to close cases, and deal with the same complex and ever changing tax law.

I recently completed my own detailed analysis of the accuracy of IRS' audit results. My study was published by the Cato Institute, on April 15, 1995. Drawing exclusively from IRS' annual reports of the Commissioner, I present data which shows that IRS' audit results are consistently wrong about 50 percent of the time. See: Cato Institute Policy Analysis No. 222, Why You Can't Trust the IRS, April 15, 1995. These findings are more generous than the 22 percent found by the GAO in above-cited report. However, they are deeply troublesome from the standpoint of individual citizens.

Individual citizens certainly cannot afford the kind of legal and accounting talent available to America's largest corporations. As a result, citizens are far more likely to fall victim to erroneous statements or out-right bluffs. They are far less likely to exercise their right of appeal, which almost always leads to a more accurate result than is reached by tax examiners.

The reason for this is Appeals officers are under strict guidelines to settle cases solely on the basis of the law and facts. Incredibly, tax auditors are under no such admonition. On the contrary, they are under pressure to recommend taxes and close cases, regardless of the law and the facts. See Revenue Regulation 601.106(f)(1) regarding appeals settlement rules; compare with Revenue Regulation 601.104(a)(1) - (a)(4), regarding examination of returns.

This reality leads to audit assessments which are plain wrong about half the time. The results of TCMP audits are no more accurate than any other type of IRS examination. In fact, given that every line the return is relentlessly examined, I believe TCMP audits are more susceptible to error.

Given the IRS' error rate in the conduct of audits, it is unreasonable to continue to subject the American people to the hassle, significant expense, time and anxiety of TCMP audits. The IRS is aware of the problems it faces with regard to examiner training. The agency recognizes that constant changes to an already confusing law makes it virtually impossible for examiners with the best of intentions to apply its countless facets correctly.

In the face of this reality, the only reasonable thing to do is discontinue TCMP audits and redirect the expense to examiner training.

2. The IRS is Unable to Assimilate or Use the Data it has.

Even assuming the IRS is able to obtain accurate data through the TCMP process, the facts indicate the agency is incapable of putting the information to good use.

Over the years, the GAO has uncovered deplorable deficiencies in the IRS' own internal system of recordkeeping and accounting. These are just a few of the facts:

a. Weaknesses, oversights and failures in the administration of the IRS information systems substantially increase the risk of fraud and seriously undercut the reliability of data used in management decisions. GAO/AIMD-93-34, September 22, 1993.

b. The IRS lacks any degree of accountability over its automated data processing equipment. Despite having spending billions on ADP equipment in the process of modernizing IRS computers, the agency cannot account for what it has, how the equipment is used, its value, etc. GAO/AIMD-93-24, August 5, 1993.

c. The first audit of the IRS' financial statements showed, among other things, the incredible fact that the agency was unable to account for 64 percent of its entire 1992 Congressional appropriation. The report also revealed numerous examples of fraud, malfeasance and nonfeasance on the part of IRS employees charged with the duties of keeping the agencies books and completing its financial reports. GAO/AIMD-93-2, June 30, 1993. See also GAO/T-AIMD-93-4, August 3, 1993 (testimony of Charles Bowsher, Comptroller General of the United States).

d. IRS was unable to correctly account for its receivables ledger. Serious problems were found in that IRS could not justify the entries claimed to be accounts receivable. Many were based upon erroneous assessments, uncredited payments, etc. GAO/AFMD-93-42, May 6, 1993.

e. Audit of IRS' 1993 financial statements revealed ongoing, systematic problems with the agency's accounting practices. Audit findings show the IRS is simply unable to keep accurate books and records of account. These findings are similar to those set forth in paragraph (c) above. GAO/AIMD-94-120, June 15, 1994.

But there is even more compelling evidence of IRS ineptitude, specifically in the area of its enforcement programs. This is directly relevant to the question of TCMP audits.

The GAO has specifically found that the IRS' estimates of revenue generated from its enforcement programs are simply unreliable. The agency does not support its estimates with any facts that allow GAO's auditors to verify them. In the words of the GAO, " * * * In fact, however, IRS does not know how much revenue its enforcement programs actually generate." Tax Policy and Administration, IRS Needs More Reliable Information on Enforcement Revenues, GAO/GGD-90-95, June, 1990 (emphasis added).

In sum, the IRS makes glowing statements concerning the value of its enforcement programs, including TCMP, but in reality, it has no clue whether the programs ever produce the intended results. When we couple the IRS' fundamental lack of recordkeeping with audits we know are incorrect, we must conclude that TCMP audits are simply

worthless in developing the data needed for effective tax law administration.

In recent testimony before a House Appropriations Subcommittee, Jennie S. Slathis of GAO described the problems found in verifying the accuracy of IRS' enforcement initiatives. She states as follows:

"* * *According to the IRS, the revenue data to be used in measuring the success of the compliance initiatives is to come from the Enforcement Revenue Information System (ERIS) -- a relatively new system designed to account for actual collections resulting from IRS' enforcement programs and to enable IRS to more accurately measure and predict enforcement costs and revenues. ERIS is not fully operational, but IRS believes it will be by the end of the year.

"We have some concerns about the reliability of IRS' ERIS data. Those concerns derive from an October 1993 IRS Internal Audit report which says, in part, 'information in ERIS reports is still not accurate, reliable, or consistent.' * * *" Tax Administration, Tax Compliance Initiatives and Delinquent Taxes, GAO/T-GGD-95-74, February 1, 1995.

The GAO reports cited above, taken as a whole, all point to one, inescapable conclusion: The IRS is itself unable to keep books and records or prepare financial statements. It is unable to do the very things it asks every taxpayer to do.

Since the IRS is incapable of tracking something so basic as its accounts receivable, how can it be expected to assimilate and use the complex TCMP data? Since the IRS cannot provide accurate information to Congress on the success of its various enforcement programs, what good are TCMP data, even if they are valid? Since the IRS cannot even keep track of its ADP equipment, how can it be expected to track and use TCMP data? Since IRS cannot account for 64 percent its Congressional appropriation, what right does the agency have to ask any citizen to justify the entries on every line of every tax form filed with his return?

In the concluding remarks to its report on the examination of the IRS' 1993 financial statements, the GAO makes this chilling, and very relevant statement:

"Further, IRS' lack of fundamental recordkeeping is inconsistent with recordkeeping requirements placed on taxpayers in support their returns and has far reaching implications, not only to IRS' credibility as the government's tax collector, but also on the federal government as a whole to responsibly use taxpayers funds. The IRS has more direct contact with the public than most government agencies and, as a result, the public's perception of the federal government as a whole is, in many cases, based on its interactions with the IRS. If IRS does not continue to improve accountability for its financial operations, its credibility could be diminished, reducing voluntary compliance by

taxpayers." GAO/AIMD-94-120, June 15, 1994,
page 38.

The question this Subcommittee should be asking is not whether the IRS should be allowed to conduct TCMP audits of honest citizens. This Subcommittee should be asking why it is the IRS, the government's tax collector, cannot comply with even the most basic recordkeeping and data reporting requirements it expects of every citizen.

All the data in the world is of absolutely no value to an agency which cannot record, assimilate or use it correctly.

3. TCMP Burden on Taxpayers.

The government bears a direct responsibility to administer the laws in a fashion which creates the least amount of burden for its citizens. Each year, it seems Congress heaps more information reporting requirements, new tax forms and more recordkeeping requirements on the average citizen in order to comply with tax laws. As the law becomes more cumbersome and complex the cost of compliance for all, including the IRS, goes up. TCMP unreasonably adds to the cost of compliance for many citizens.

TCMP selections are made on a completely random basis. Those selected are not chosen on the basis of any objective criteria. They are not suspected of making any errors. They are not suspected of cheating. Yet they are forced to undergo the most grueling kind of audit.

They must endure endless hours of preparation, copying records and reconstructing their financial activities. They must take time from work and family at their own expense to comply with an endless list of requests and questions served upon them by the examiner, only to face a new list when that one is satisfied. In many cases they must hire a tax professional to represent them. Fees for services run from \$100 to \$300 per hour. A professional's time in connection with a TCMP audit can run to 40 hours or more, depending upon the complexity of the case.

Many citizens have described the TCMP audit as a kind of rape. The agent makes repeated, sometimes unreasonable demands for information, rummages through every aspect of a person's life, drags the ordeal on month after month, and creates substantial expenses in the process. At the same time, the individual agent is not likely to understand the law he is enforcing. After all is said and done, his results are likely to be wrong.

We must ask the question, what is the point?

TCMP audits often delve into areas which are not necessarily shown on the tax return. For example, citizens are called upon to prove the income declared in the return is correct, but must do so with evidence which goes beyond bank statements and W-2 forms. To do this, the IRS often uses Form 4822, Statement of Annual Personal Estimated Living Expenses. Since one's personal living expenses are not an item in the tax return, most citizens keep no records of such expenses, including things like clothing, food, hair cuts, gifts, etc. Yet Form 4822 ask a citizen to reconstruct and report all such expenses.

If one is undergoing an audit of, say, tax year 1993, during the year 1996, he is asked to "remember" what he spent on hair cuts and the like in order to provide an "accurate" picture of his spending habits to the agent. From this "accurate" information, the agent then ascertains whether the citizen's claimed income was sufficient

to support those living expenses. This kind of "examination" is one reason the IRS' audit results are so often wrong.

TCMP audits are deeply invasive. They involve unearthing the most private aspects of a person's life. These are the kind of things the FBI or local police could never get access to without a search warrant. Yet the IRS merely demands the material and expects compliance under penalty of law. Citizens who have done nothing wrong are made to feel like criminals. Since the burden of proof in all matters is upon the citizen, not the IRS, they find themselves having to prove their innocence as to every line of the tax return.

I believe and assert there is much more to the TCMP audit than IRS is willing to tell. We know it cannot be simply a matter of data. The agency cannot correctly use the data it has. I believe the real issue is one of "presence."

For the years, the IRS has expressed the desire to "create and maintain a sense of presence" in the lives of all Americans. This idea was clearly expressed in a 1984 document entitled, Strategic Plan, IRS Document No. 6941. Creating "presence" means building the notion in the minds and hearts of all Americans, that the IRS is "watching you." The IRS insisted in its 1984 plan that creating presence was vital to "encouraging voluntary compliance."

More than anything else, TCMP is about creating presence. In this context, the results of TCMP audits are irrelevant. The data gathered is inconsequential compared to the enforcement gains achieved by persuading every American that the IRS is "watching you." This amounts to psychological warfare waged by the government of the United States, through the IRS, on its own citizens.

To the extent that TCMP is an integral part of the effort to "create and maintain presence," the undertaking is outrageous, especially in light of all the forgoing.

Given the IRS' lack of ability to do the same with regard to its own financial matters, it is unreasonable to lay those burdens at the feet of the American people.

4. Why Voluntary Compliance is Declining.

IRS maintains the reason TCMP is so necessary, is that voluntary compliance is in decline. IRS insists it needs TCMP data to understand the trends, to be able to deal with the enforcement problems of the day.

I can tell this Subcommittee in one sentence why voluntary compliance is in decline. I can explain very simply why the tax gap continues to grow, despite every enforcement program ever funded. I can explain why the number of tax return nonfilers is growing along with the underground economy. I know because I deal with these people every day. I listen to their stories. I help them through their problems.

The reason for the drop in voluntary compliance is very simple. More and more Americans are simply unable to pay the taxes they owe. Federal, state and local tax rates now consume more than 40 percent of a person's gross income. More citizens every day are forced to make a choice between paying their taxes and feeding their families. One in such a position will opt to feed the family every time -- without question and without hesitation.

To solve the problem of voluntary compliance, we must conquer the federal government's insatiable demand for more revenue. If revenue demands do not stabilize, then shrink in relationship to individual

expenses, no amount of enforcement programs or compliance initiatives will ever solve the problem. Congress must simply face the fact that it is spending too much of our money.

At the same time, we must pursue a course of radical tax reform. As evidenced by the GAO reports cited in this testimony, our system cannot possibly continue to operate under the status quo. The IRS, in its opinion, will never have enough information to enforce the law. It will never have enough money, manpower or equipment to administer the law. Yet we cannot, it seems clear, continue to allow the agency to grow in size, power and sweep, given its deplorable record of unaccountability on matters so basic as its own financial affairs.

Ultimately, to solve our nation's tax problems, we must abandon the IRS and the income tax system altogether. We must move to a system which is not dependent upon knowing the intimate details of every citizens' private life in order to collect the revenue needed to fund the government. We must move to a system which does not require 120,000 IRS employees and a budget of \$8.2 billion to administer. We must adopt a system which frees us of the requirements to file 210 million tax returns and 1.3 billion information returns annually. We must develop a system under which the American people will no longer have to chose between paying their taxes and feeding their families.

It is my considered opinion that only a national retail sales tax can accomplish all those things. I believe time has come for Congress to stop discussing bandaide treatments for a hemorrhaging patient.

Thank you.



