

GAO

Report to the Honorable
Joseph K. Knollenberg, House of
Representatives

October 1995

TAX ADMINISTRATION

Information on IRS' Taxpayer Compliance Measurement Program



General Government Division

B-266278

October 6, 1995

The Honorable Joseph K. Knollenberg
House of Representatives

Dear Mr. Knollenberg:

This report responds to your September 12, 1995, request to provide information on the Internal Revenue Service's (IRS) Taxpayer Compliance Measurement Program (TCMP) for tax year 1994.¹ You specifically asked us for information on (1) how IRS addressed the problems discussed in our December 1994 report on the status of the program and, if the problems persist, how they would affect final TCMP results;² (2) informational sources other than TCMP that IRS could use to target its audits more effectively; and (3) the relevancy of TCMP data for alternative tax system proposals.

Results in Brief

IRS has generally taken appropriate action on the concerns we raised in our 1994 report that dealt with meeting milestones for starting TCMP audits, testing TCMP database components, developing data collection systems, and collecting and analyzing data. However, due to uncertainties about its fiscal year 1996 budget, IRS has delayed the start of its TCMP audits from October 1 to December 1, 1995. The delay is fortuitous because it could allow IRS to finish testing TCMP database components and data collection systems before audits begin. The date to start the audits could be further delayed if test results show that major modifications need to be made to the database or data collection systems.

IRS plans to collect the data on partners, shareholders, and misclassified workers as we suggested in our 1994 report. These additional data should allow IRS to better measure compliance levels, which could increase the value of TCMP audit results. Also, IRS plans to have auditors computerize some of their comments on audit findings, which should make it easier for researchers to analyze TCMP results. The automated comment feature could also provide IRS an opportunity to collect data on taxpayer burden and other issues that are not part of the TCMP database. We still are concerned that IRS has not developed a research plan that could be used to analyze final TCMP results. IRS could use preliminary TCMP data to help it formulate research questions.

¹IRS collects TCMP data by auditing every line on tax returns for a random sample of taxpayers.

²Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

We are not aware of any other available IRS or third-party data that could be used to develop return selection formulas that would allow IRS to target its audits as effectively as TCMP data. IRS is attempting to develop an Automated Issue Identification System that has the potential of selecting returns that should be audited. However, IRS does not expect to have the technological capabilities to fully develop and implement the system until after the turn of the century.

TCMP could be very useful not only for improving compliance in the existing tax system, but also as a tool for designing and administering a new system. While types of income and deductions included in each new proposed tax system vary, TCMP could still provide data on compliance issues that would have to be addressed in any of the new system proposals that we reviewed. To the extent that elements of the existing tax system are retained, TCMP could continue to fulfill its traditional role of providing data needed for selecting returns for audit, identifying sources of noncompliance, and identifying potential tax law changes. To the extent that new tax systems are proposed and adopted, TCMP data could alert tax system designers and administrators to potential areas of noncompliance and provide data on which to base rules and regulations. The longer it takes to implement a new tax system, the more useful TCMP data could be for helping design and administer the new system.

Background

For about 30 years, TCMP has been IRS' primary program for gathering comprehensive and reliable taxpayer compliance data. It is IRS' only program to measure noncompliance on a random basis, allowing IRS to make statistically reliable estimates of compliance nationwide.

IRS uses the data for measuring compliance levels, estimating the tax gap, identifying compliance issues, developing formulas for objectively selecting returns for audit, and allocating audit resources. Congress and federal and state agencies have used TCMP data for policy analysis, revenue estimating, and research.

The 1994 TCMP survey is planned to be the most comprehensive TCMP effort ever undertaken. That is because IRS is undertaking four surveys at once to collect comparable information on businesses organized in different ways. Currently planned to include about 153,000 tax returns, this TCMP was designed to obtain compliance information for individuals (including sole proprietors); small corporations (i.e., those with assets of \$10 million or

less); S corporations; and partnerships.³ This TCMP was also designed to obtain information at the national level as well as for smaller geographical areas across the country. About 120,000 of the sample returns are to cover businesses; about 33,000 are to cover individuals. This is to be the first time that IRS will conduct a TCMP audit for all four types of taxpayers at the same time.

The 1994 TCMP sample is stratified by market segments, as opposed to type of return, income amount, and asset size, which were the characteristics used to stratify samples in prior surveys. A market segment represents a group of taxpayers with similar characteristics, such as taxpayers engaged in manufacturing. IRS plans to stratify taxpayers into 23 business and 4 nonbusiness (individual) market segments. IRS will also have one market segment for foreign-controlled corporations. IRS believes that stratifying in this manner would allow it to more effectively use TCMP data for identifying noncompliance trends and selecting cases for audit. To assure comparability with previous TCMP surveys, the sample can also be stratified into the traditional groupings (i.e., type of return). As planned, in the 1994 TCMP, IRS would audit about 40,000 more returns than the aggregate for all entity types from the latest TCMP surveys conducted on these entities. IRS' primary reasons for this increase are the use of market segments and ensuring statistical validity for IRS' 31 District Office Research and Analysis sites, which are located throughout the country.

IRS considers the 1994 TCMP effort to be particularly important because it would be the first comprehensive effort to validate its current market segment compliance strategy for identifying and correcting noncompliance, and also because existing compliance data are getting old.⁴ IRS expects to have completed audits on about 30 percent of the sample returns by October 1996 and to have final TCMP data in late 1998. IRS plans to collect data on the reasons for noncompliance and the specific tax issues associated with the noncompliance. IRS also plans to place greater emphasis on quality audits to ensure that accurate data are collected. Finally, in its TCMP training for auditors, IRS plans to emphasize the need to make effective use of internal data to reduce the amount of information requested from taxpayers, thus reducing the burden imposed on those taxpayers.

³An 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.

⁴The latest TCMP surveys were made of 1988 individual returns, 1987 small corporation returns, 1984 S corporation returns, and 1981 partnership returns.

Objectives, Scope, and Methodology

Our objectives were to (1) determine how IRS addressed the problems discussed in our 1994 TCMP status report and, if the problems persist, how they will affect final TCMP results; (2) identify informational resources other than TCMP that IRS could use to target its audits more effectively; and (3) assess the value of TCMP data for alternative tax system proposals.

To determine the actions IRS took on the concerns we raised in our 1994 report, we reviewed TCMP documents and discussed the actions taken with IRS officials responsible for designing and implementing the program. To determine whether other information sources could be used to replace TCMP, we relied on work we had done on TCMP and we discussed with IRS officials how IRS could use other potential data sources, including state and nongovernment sources. To determine the relevancy of TCMP data for new tax system proposals, we reviewed various published documents on these systems and compared them to the current income tax system.⁵

Our observations in this report are based in large part on the work we have done over the years on IRS' compliance programs in general as well as specific work on TCMP. We issued a report in May 1994 on all such work.⁶

We did our work in September 1995 in accordance with generally accepted government auditing standards. On September 29, 1995, we obtained oral comments on a draft of this report from officials responsible for planning and implementing TCMP in IRS' Compliance Research Division, including the National Director of Compliance Research. We have incorporated their comments where appropriate.

⁵The documents we reviewed include: Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCT-18-95), June 5, 1995; Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Second Edition, 1995); H.R. 2060, which deals with a flat tax and was introduced in July 1995 by Representative Dick Armey; S. 722, which deals with the Unlimited Savings Allowance and was introduced in April 1995 by Senators Pete Domenici and Sam Nunn; and documents on a simplified income tax, which we obtained from the office of Representative Richard Gephardt.

⁶Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994). This report has a bibliography of tax compliance-related reports that we have completed since 1982.

Our Concerns With IRS' Plans for the Upcoming TCMP

Our 1994 TCMP report discussed concerns dealing with various aspects of IRS' plans for the upcoming TCMP. Basically, these concerns centered on IRS being able to (1) meet major milestones for starting audits, (2) collect audit adjustment data on partners and S corporation shareholders, (3) collect data on potentially misclassified workers,⁷ (4) develop data collection systems, (5) make it easier for researchers to access TCMP audit workpapers, and (6) develop a TCMP research plan.

Meeting Milestones

In our 1994 report, we raised a concern about IRS' ability to meet its October 1, 1995, milestone for starting the TCMP audits. Our concern was based on the amount of work that had to be done to design and test the TCMP data collection system, develop training material, train auditors, and produce case file information.

In early September 1995, IRS postponed the start of its TCMP audits from October 1, 1995, to December 1, 1995. IRS attributed the delay to the uncertainties about its fiscal year 1996 budget. IRS does not expect the delay in starting the audits to affect the March 31, 1998, date for completing all 153,000 TCMP audits.

The delay in the start of the audits could allow IRS to complete various TCMP database testing, which has not been completed as originally scheduled. For example, IRS has not completed all its tests of the consistency of reported business return data, which were scheduled to be completed by August 31, 1995. The tests are designed to identify and eliminate inconsistencies in the data and need to be completed before audit cases can be sent to the field. According to IRS officials, the tests associated with reported return data on individual taxpayers (i.e., Form 1040 information) have been completed and returns are ready to be sent to field offices for audit. IRS expects to complete all tests of the business portion (i.e., corporations and partnerships) of the database by November 30, 1995. We are concerned that if major modifications have to be made to the data, the December 1, 1995, date to start audits of business taxpayers could be delayed.

⁷Workers can be classified as either "employees" or "independent contractors" (self-employed individuals who provide services). Under common law, the degree of control, or right to control, that a business has over a worker governs the classification. If a worker must follow instructions on when, where, and how to do the work, he or she is more likely to be an employee. It is important for IRS to know whether a worker is correctly classified because employees who have their taxes withheld are generally more compliant than independent contractors.

Data on Partners and Shareholders

In our 1994 report, we raised concern about whether the amount of information IRS would be collecting on partnerships and S corporations would be adequate to measure the compliance levels for these two entities.⁸ In response to the report, IRS officials said they would collect more data on partnerships and S corporations but would not collect data on partners and shareholders. IRS has since decided that it would capture data on partners and shareholders. This additional data could increase the value of TCMP data for determining tax impacts of partnership and S corporation audits and measuring the tax gap associated with these entities.

Data on Misclassified Workers

In our 1994 report, we were concerned that IRS would not be collecting sufficient information on businesses that misclassified their workers as independent contractors instead of as employees. We were also concerned that IRS would not be gathering data on taxpayers who file returns as sole proprietors, but who potentially may be employees and not independent contractors. According to IRS officials, IRS will be capturing tax data on referrals made to employment tax specialists on classification cases. Also, IRS has developed a detailed employment tax data collection instrument to gather in-depth data on the results of those employment tax issues that are identified in the TCMP audits.

Data Collection Systems

In our 1994 report, we commented on IRS' concurrent development of two data collection systems for use by auditors to directly enter their audit results onto computers. We were concerned that IRS had not made a decision on which of these two systems to use. Our concern related to the time IRS would need to test the selected system, develop training materials, and train auditors on how to use it. IRS stated that it needed a back-up system to the primary system, which is the Totally Integrated Examination System (TIES), as an insurance plan in case TIES proves less than satisfactory. TIES was being developed for use in IRS' regular audit program and is being modified to meet TCMP specifications.

According to IRS officials, complete system acceptability tests will be done on both data collection systems. IRS officials said that they expect the tests to be done by November 22, 1995, and that TIES will be available for use by the time audits are scheduled to start. If major modifications need to be

⁸These two entities each report income on two tax documents. Partnerships report on Form 1065, "U.S. Partnership Return of Income" and Schedule K, "Partners' Shares of Income, Credits, Deductions, etc.;" while S corporations use two similar forms, Form 1120S "U.S. Income Tax Return for an S Corporation" and Schedule K, "Shareholders' Shares of Income, Credits, Deductions, etc."

made to the systems as a result of the tests, we are concerned that IRS may not meet its December 1, 1995, revised milestone for starting audits.

TCMP Workpapers

In our 1994 report, we suggested that IRS find ways to make TCMP audit workpapers available through electronic media so that the workpapers would be readily available for compliance research. In commenting on our report, IRS agreed to explore the feasibility of retaining the computer disks for those cases where the workpapers are generated by computer. IRS officials subsequently informed us that it is not technically feasible to automate all audit workpapers. However, IRS has included a 100-line comment section in the TCMP data collection systems and in the TCMP database to capture clarifying information on complicated cases, which could provide researchers with some of the additional information found in the audit workpapers.

Adding the comment section to the TCMP database could enhance the overall value of the TCMP data and may be a good substitute, in some cases, for the audit workpapers. Therefore, it is important that auditors be instructed in the types of information to include in the comment section. The automated comment feature also provides IRS with an opportunity to collect information on issues that cannot be analyzed using the data elements currently planned to be on the TCMP database. For example, one criticism of TCMP audits has been that the audits are burdensome or overly intrusive for taxpayers.⁹ IRS could use the automated comment section to gather information on taxpayer burden, such as the time taxpayers estimate they spent preparing for the audit and the types of documents auditors had to get from taxpayers in order to verify tax return data.

TCMP Research Plan

In our 1994 report, we pointed out that IRS did not have a research plan that defines the research questions and the data to be collected that would answer the questions. IRS still does not have a research plan. In response to our 1994 report, IRS officials stated that from past TCMP surveys they know what elements are needed to do compliance estimation, measure the tax gap, and develop return selection formulas. They said that since virtually all the data from sampled returns are collected, IRS will have appropriate and comprehensive information to meet its research needs.

⁹See Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993). In this report we discussed the criticisms that had been directed to TCMP audits. These criticisms dealt with the audits being too costly and intrusive on taxpayers and the untimely production of data.

While the lack of a research plan may not directly lessen the value of final TCMP results, such a plan could put IRS in a better position to quickly analyze final TCMP data. One criticism of prior TCMP surveys has been that useable TCMP data were not produced in a timely fashion.

To help formulate research questions, IRS could analyze preliminary TCMP results. For example, IRS expects to complete about 46,000 TCMP audits by the end of fiscal year 1996, which could be enough cases to formulate research questions. IRS is reluctant to use preliminary unweighted or partially weighted TCMP data because the data are not statistically valid. Even though preliminary data may not be statistically valid, these data could provide early information on possible noncompliance trends and other problems, such as complexity issues, which could be useful to both IRS and Congress when they are examining potential modifications to the tax system.

Other Data Sources for Targeting Audits

IRS uses TCMP data to develop objective, mathematical formulas, which it uses to score returns for audit selection. As a result, IRS can make more efficient use of its audit resources and avoid unnecessarily burdening compliant taxpayers. For example, in 1969, the year before IRS started using this scoring system, about 46 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.

We are not aware of any other available data that can be used to develop return selection formulas that would allow IRS to target its audits as effectively as TCMP data. IRS is attempting to develop an Automated Issue Identification System that has the potential of selecting returns that should be audited. The system is being tested on individual tax returns in two IRS locations, and, according to IRS officials, the preliminary results are promising. However, this system would be dependent in part on the TCMP-developed return selection formula to identify the returns that should be audited. Also, this system would require that almost all tax return data be transcribed onto computers similar to the amount of data transcribed from returns that are selected for TCMP audits. IRS does not expect to have the technological capability to have all return information on computer until after the turn of the century.

There are third-party databases that potentially could be used to supplement the compliance data that IRS obtains from its TCMP surveys.

However, these databases cannot be used to develop return selection formulas because they either contain just aggregate data on businesses and individuals or have information just on specific tax issues. For example, Bureau of Labor Statistics and U.S. Census data can be used to make aggregate profiles of the population based on various income characteristics, such as average household earnings. Some states have databases that IRS could use to supplement its audit and other compliance activities, such as state sales tax data. Commercial sources for information on industry norms are also available to supplement IRS compliance activities. IRS currently uses these data sources in some of its compliance research projects.

TCMP and Alternative Tax System Proposals

There are a number of proposals to change the current tax system. The proposals are as follows:

- A Flat Tax would levy a single-rate wage tax on individuals and a single-rate cash-flow tax on businesses.
- An Unlimited Savings Allowance (USA) Tax would provide for a three-bracket individual income tax, with a full deduction for income saved rather than consumed. On the business side, a single rate would apply to income from both corporate and noncorporate businesses, with an immediate deduction for capital investment and purchases of inventory.
- A Simplified Income Tax would broaden the tax base, lower the tax rate, and eliminate most current deductions and credits.
- A Value Added Tax (VAT), a consumption tax, would be collected at each stage of the production process.
- A Retail Sales Tax, a consumption tax, would be collected at the retail level in the form of a sales tax.

To determine the relevancy of TCMP data to these alternative tax systems, we analyzed the tax return elements IRS plans to examine in its tax year 1994 TCMP and published documents on the systems. (See app. I for the results of this analysis.) In doing our analysis, we did not consider the TCMP costs and benefits or taxpayer burden for each of the proposals. Generally, we found that TCMP data could have some relevancy for each alternative tax system. The degree of relevancy depended on the number of current tax elements that would be retained under an alternative tax system—the more elements that are retained, the more relevant the TCMP data would be.

Relevancy of TCMP Results for Designing and Administering Alternative Tax System Proposals

Potentially, data obtained from TCMP audits could be used to guide both the final design and administration of a new tax system. While complete 1994 TCMP data would not be available until late in 1998, data on about 46,000 sample cases should be available by the end of fiscal year 1996. As questions arise during the process of drafting new tax laws, data from some of the 46,000 cases, while not statistically valid at the district level, may indicate obvious trends in nationwide data that could be used in making decisions on changes to tax law.

With respect to the administration of tax laws, each of the current proposals would require that tax administrators implement some form of compliance strategy. Any such strategy would likely be dependent on compliance data. The 1994 TCMP should be able to provide much of the information necessary for implementing such a compliance strategy. For example, any new tax system would likely continue to rely on audits to ensure compliance. Accordingly, auditors would continue to need compliance information on business income and expenses and, for some of the proposals, compliance information on individual income and deductions. For the most part, this data could be provided by the 1994 TCMP.

Some TCMP data would be useful in the design of all the proposed tax systems. For example, gross receipts, a key area of noncompliance in past TCMP audits, would be important in each of the new tax proposals. For this potential problem area, TCMP should show the compliance levels, provide specific tax issues associated with the identified noncompliance, and provide reasons for the noncompliance. The compliance data should help Congress to determine the potential extent of noncompliance that could be expected under the new tax system proposals. This would be important in setting tax rates. Similarly, data on the reasons why the noncompliance occurred and the specific tax issue involved could provide clues to legislative actions that may be needed to help prevent noncompliance under the new system or to help tax administrators identify noncompliant taxpayers more readily. Knowing these weak spots would be useful so that Congress could attempt to overcome these problems as it considers designs for new tax systems.

To the extent that the proposals for tax reform retain elements of the current system, such as properly determining business receipts and expenses, TCMP data could play a prominent role in helping to evaluate and design those parts of the proposed new tax system.

To the extent that a new tax system is adopted that differs radically from the existing system, TCMP data would still be useful. For example, TCMP information on gross receipts of retail businesses would be useful for designing and administering a retail sales tax system. Under this system, information on all business income and expenses could be relevant for profiling those retailers who would be more likely to underreport their gross receipts. Also, if a federal retail sales tax included consumer services not now covered by state sales taxes, TCMP could be the only source of information on underreporting of gross receipts by the sellers of these services.

It must be recognized that the results from TCMP would reflect noncompliance under the income tax law and the administrative practices in place today. Incentives or opportunities to evade tax on certain transactions may increase or decrease under a new system. For example, if a business taxpayer fails to report a sale of an asset under the current income tax, the business might avoid paying tax on a capital gain, a fraction of the selling price. Under many consumption tax proposals, all the proceeds of an asset sale are taxable, but at a lower rate. The incentive to not report the sale may increase or decrease relative to the current system, depending on the circumstances. In addition, opportunities to not comply in some areas may change significantly depending on whether administrative tools such as withholding and information reporting were included as part of the system.

In order to effectively select returns for audit under a new tax system, tax administrators may be able to use 1994 TCMP results in combination with information on the relative incentives and opportunities to avoid tax under that system, until direct measures of noncompliance under the new system became available.

The Use of TCMP Data in the Interim

The preceding discussion dealt only with the usefulness of TCMP results for administering each of the proposed tax systems once the new system had been fully implemented. The results of the planned TCMP would also be of use in administering the current income taxes in the interim period before a new system would be completely phased in and the old system completely phased out. The 1994 TCMP data would become increasingly important if it proves impossible to fully implement a new tax system until after the turn of the century. This is because IRS would need to continue to audit returns under the current tax law, and existing return selection

criteria are based on past TCMP survey data, which are growing older every year.

The usefulness of the forthcoming TCMP during the interim would depend on the effective date of the replacement system and on the extent to which the enacting legislation would include transition provisions. The 1994 TCMP data used to develop audit selection formulas for the current tax system are not scheduled to be developed before late 1998. However, if a new tax system became effective before that time and had few transition provisions, IRS could still use interim TCMP data on noncompliance issues to direct audits of tax returns filed under current rules.

If tax reform legislation were to take longer to pass, if the legislation provided for a significant period of time between the date of enactment and the effective date of the new system, or if the legislation contained numerous transition provisions, then the value of the planned TCMP would be greater. Items such as unused tax credits and deductions for depreciation, depletion, and net operating losses might be subject to transition rules. For example, it has been suggested that if a flat tax were enacted, businesses might be allowed to claim depreciation deductions during a transition period of several years for assets they purchased under the old system.¹⁰ Others have suggested that taxpayers could be subject to both the current income tax and a new consumption tax for a period of years, with the income tax rate declining as the consumption tax rate increases.¹¹

If the planned TCMP were cancelled and the current income taxes were not completely phased out before the next century, then IRS would be compelled to select income tax returns for audit on the basis of compliance information that was over 10 years old. Administrators of the new tax system also would have only this same dated compliance information to guide their enforcement efforts for several years before data from any future TCMP became available.

Conclusions

IRS has taken action on most of the concerns we raised in our December 1994 report. The delay in starting the TCMP audits because of budgetary concerns is fortuitous because IRS had not completed testing all the tax return database or data collection systems for the TCMP. These tests have to be completed before audits can start. If the tests show that major

¹⁰See Hall and Rabushka, *The Flat Tax*, second edition, 1995.

¹¹See Department of the Treasury, *Blueprints for Basic Tax Reform*, 1977.

modifications have to be made to the database or data collection systems, then IRS may not meet its December 1, 1995, revised date for starting audits.

There is still time for IRS to develop a research plan so that it could analyze final TCMP results more quickly. IRS could begin now to formulate research questions and could also use preliminary TCMP data as they become available to develop other questions.

It is important that there are no further delays because the existing TCMP data are old, and, to our knowledge, there are no other data sources that IRS could use to develop formulas for selecting returns for audit. IRS is attempting to develop a system that could be used for selecting returns, but this system would not be operational until after the turn of the century.

TCMP data could also be of value for helping with the design and administration of alternative tax systems. The value of the data would depend on how much of the current tax system would be retained under the new system.

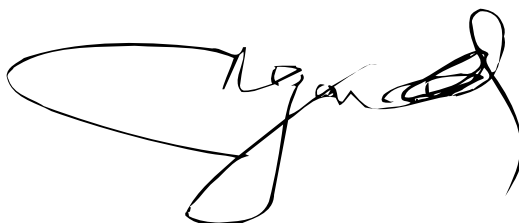
Agency Comments and Our Evaluation

On September 29, 1995, we discussed a draft of this report with IRS Compliance Research Division representatives, including the National Director of Compliance Research. They generally agreed with our assessment of the actions taken on the concerns we raised in our 1994 report, the availability of other information sources to replace TCMP, and the relevancy of TCMP data for new tax system proposals.

Copies of this report are being sent to various interested congressional committees, the Director of the Office of Management and Budget, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. It will also be made available to others upon request.

Major contributors to this report are listed in appendix II. Please contact me on (202) 512-9044 if you or your staff have any questions about the report.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Natwar Gandhi', with a large, stylized loop on the left side.

Natwar Gandhi
Associate Director, Tax Policy and
Administration Issues

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Abbreviations	
IRS	Internal Revenue Service
TCMP	Taxpayer Compliance Measurement Program
TIES	Totally Integrated Examination System

TCMP and Alternative Tax System Proposals

This appendix discusses some ways the individual and business segments of the 1994 TCMP could be used to evaluate the design and administration of the five alternative tax system proposals. The proposals are described below.

- A Flat Tax would levy a single-rate wage tax on individuals and a single-rate cash-flow tax on businesses.
- An Unlimited Savings Allowance (USA) Tax would provide for a three-bracket individual income tax, with a full deduction for income saved rather than consumed. On the business side, a single rate would apply to income from both corporate and non-corporate businesses, with an immediate deduction for capital investment and purchases of inventory.
- A Simplified Income Tax would broaden the tax base, lower the tax rate, and eliminate most current deductions and credits.
- A Value Added Tax (VAT), a consumption tax, would be collected at each stage of the production process.
- A Retail Sales Tax, a consumption tax, would be collected at the retail level in the form of a sales tax.

Individual Taxpayers

Under the VAT and Retail Sales Tax proposals, individuals would bear taxes as they consume goods and services, but, unless they were sole proprietors, they would not file tax returns. Therefore, the nonbusiness (e.g., individuals who are not sole proprietors) portion of the TCMP (about 18 percent of the sample) has no relevancy for these two types of taxes. The flat tax, the USA tax, and the simplified income tax would require returns for individual taxpayers who do not own businesses. Thus, TCMP data should have some relevancy in evaluating these alternative tax systems.

Table I.1 shows the TCMP data elements for individuals that could be relevant to policymakers and tax administrators in developing and administering the flat tax, USA tax, and simplified tax systems. The TCMP data elements are essentially the same as the line items found on the Form 1040, Individual Income Tax Return. The “yes” in the columns in table I.1 indicates that the TCMP element would be relevant for evaluating the proposals. Those columns in table I.1 that do not contain “yes” indicate that TCMP data collected for these elements would not be relevant for that particular tax system. The sample sizes shown in table I.1 are the number of individual returns IRS plans to audit in the TCMP.

Appendix I
TCMP and Alternative Tax System
Proposals

Table I.1: Relevant Individual TCMP Data Elements for Developing and Administering Alternative Tax Systems

TCMP data element	Relevant TCMP data by proposal		
	Flat tax	USA	Simplified income tax
TCMP sample size ^a	92,185	92,185	92,185
Filing status	Yes	Yes	Yes
Exemptions	Yes	Yes	Yes
Blind and/over 65 exemptions			Yes
Income types			
Wages, salaries, and tips	Yes	Yes	Yes
Taxable interest income		Yes	Yes
Nontaxable interest income		Yes	Yes
Dividend income		Yes	Yes
Taxable refunds or credits of state and local income taxes			
Nonfarm business income ^b	Yes	Yes	Yes
Alimony received		Yes	Yes
Capital gain or (loss) ^c		Yes	Yes
IRA distributions ^d	Yes	Yes	Yes
Pensions and annuities	Yes	Yes	Yes
Income from rental real estate, partnerships, S corporations ^e		Yes	Yes
Farm income ^f	Yes	Yes	Yes
Unemployment income	Yes	Yes	Yes
Social Security benefits		Yes	Yes
Other income		Yes	Yes
Adjustments to income			
IRA deductions for self and spouse		Yes	
Moving expenses		Yes	Yes
One-half of self employment tax ^g		Yes	Yes
Self-employed health insurance deduction			
Keogh retirement plan and SEP deduction ^g	Yes	Yes	
Penalty on early withdrawal of savings		Yes	Yes
Alimony		Yes	Yes
Schedule A deductions			
Medical and dental expenses			
State and local income taxes			
Mortgage interest ^h	Yes	Yes	Yes

(continued)

Appendix I
TCMP and Alternative Tax System
Proposals

TCMP data element	Relevant TCMP data by proposal		
	Flat tax	USA	Simplified income tax
Charitable contributions ^h	Yes	Yes	
Casualty and theft losses			
Other miscellaneous deductions ⁱ			Yes
Credits			
Child and dependent care expenses			
Credit for the elderly or disabled			
Foreign tax credit		Yes	Yes
Other credits ^j			
Other taxes			
Self-employment tax ^k	Yes	Yes	Yes
Alternative minimum tax			
Recapture taxes			
Social Security tax on tip income	Yes	Yes	Yes
Tax on qualified retirement plans			
Advanced earned income payments		Yes	Yes
Payments			
Tax withheld	Yes	Yes	Yes
Earned income credit		Yes	Yes
Excess Social Security Tax	Yes	Yes	Yes
Other payments	Yes	Yes	Yes

(Table notes on next page)

^a64,010 of these returns are sole proprietors and are also included in the analysis of businesses.

^bUnder flat tax and USA proposals, this income would be reported on a separate business income form. Distributed business income would be taxed under the individual tax in the USA system.

^cWhile gains and losses as such would not be computed under the flat tax and the USA tax, data from this line would provide information about the proceeds from capital transactions, which are part of the tax base.

^dInformation from this line would be useful for administration purposes because some of this income might still be taxable.

^eUnder the USA tax, income reported on this line from partnerships and S corporations would be part of the tax base. Rental income would be useful for business returns.

^fFarm income would be considered business income under flat tax and USA proposals. However, distributed income would be taxable to the individual in the USA proposal.

^gThese deductions would become part of business tax returns under a flat tax.

^hUnder Senator Spector's flat tax proposal, all mortgage interest and charitable contributions could be deducted. Hall and Rabushka have suggested that 90 percent of mortgage interest on existing loans might be deductible during the flat tax transition phase.

ⁱInvestment interest expense and job-related expenses shown on this line were moved to adjustments to income under the Simplified Income Tax proposal.

^jOther credits are (1) jobs credit, (2) credit for alcohol used as a fuel, (3) credit for increasing research activities, (4) low-income housing credit, (5) disabled access credit, (6) enhanced oil recovery credit, (7) renewable electricity production credit, (8) credit for employer Social Security and medicare taxes paid on certain employee tips, and (9) credit for contributions to selected community development corporations.

^kBecause employment taxes apparently would remain largely unchanged, this data element would be useful for all the alternative tax proposals. Additionally, it would be useful under the USA proposal for analysis of the employment tax credit being offered.

Source: Developed by GAO from summaries of the new tax proposals and analysis of TCMP coverage.

Flat Tax Proposal

As indicated in table I.1, some of the TCMP individual tax elements should be relevant for evaluating the flat tax proposal. However, there would be no need to evaluate the compliance associated with investment-type income or deductions, such as charitable contributions or state and local taxes, because these elements are not part of the proposal. The relevant individual tax elements are filing status, exemptions, wages and salaries, pension income, and unemployment compensation. TCMP data could be used to determine how accurately taxpayers have reported these elements and the reasons why taxpayers have failed to comply under the current tax system. For example, the TCMP data may indicate that even under a flat tax, current requirements are too complex for many taxpayers to determine

their proper filing status. The TCMP data could provide information on ways current law could be simplified to reduce complexity and improve compliance.

Usa Tax Proposal

As indicated in table I.1, almost all TCMP income elements for individuals would be included in the USA tax system and, thus, should be useful for evaluating this system. Under the USA system, taxpayers would be allowed unlimited deductions for net increases to savings; however, except for IRA deductions, taxpayers are not currently required to report these data. Therefore, TCMP data would not be useful for determining whether taxpayers would accurately report all investment deposits. On the other hand, TCMP data should be useful for determining the reporting accuracy of investment proceeds.

Under the USA system, all deductions under the current income tax, except for mortgage interest and charitable contributions, would be eliminated. TCMP data should be useful in developing compliance statistics and programs for these two items. However, TCMP could not be used to evaluate the postsecondary education deduction allowed under the USA proposal. Similarly, TCMP data could not be used to evaluate the fringe benefits that would be taxable under the USA proposal because these benefits, such as employer paid medical insurance, are currently not taxable and would not be studied in the TCMP survey of individuals. However, data on fringe benefits would be gathered on the business portion of the TCMP.

Simplified Income Tax System

As indicated in table I.1, almost all of the TCMP elements should be relevant for evaluating compliance with income reporting requirements. On the deduction side, only TCMP data on mortgage interest would be relevant for evaluating this system. Like the USA tax system, fringe benefits would be taxed; thus, the individual portion of the TCMP would not be useful for evaluating this type of income.

Business Taxpayers

All five alternative tax systems cover businesses, which include sole proprietorships, corporations, S corporations, and partnerships. About 82 percent of the TCMP sample covers businesses. Table I.2 indicates the TCMP data elements that should be useful for developing and administering the flat tax, USA, VAT, and retail sales tax systems. Table I.2 does not contain information on the simplified income tax system

because we were not able to obtain any information on the business portion of this tax system. However, on the basis of information available on the individual portion, it would appear that almost all business income and deduction items in the current system would be relevant under the simplified income tax system.

Table I.2: Relevant Business TCMP Data Elements for Developing and Administering Alternative Tax Systems^a

TCMP data element	Relevant TCMP data by proposal			
	Flat tax	USA	Value added tax	Sales tax
TCMP sample size	124,981	124,981	124,981	35,672
Income and cost of goods sold				
Gross receipts or sales	Yes	Yes	Yes	Yes
Cost of goods sold				
Inventory				
Purchases	Yes	Yes	Yes	
Cost of labor	Yes			
Other costs	Yes	Yes	Yes	
Gross profit				
Dividends				
Interest				
Gross rents ^b	Yes	Yes	Yes	
Gross royalties ^b	Yes	Yes	Yes	
Capital gain net income				
Net gain or (loss) from sale of business property ^c	Yes	Yes	Yes	
Other income ^d				
Business deductions				
Compensation of officers	Yes			
Salaries and wages	Yes			
Repairs and maintenance	Yes	Yes	Yes	
Bad debts		Yes		
Rents	Yes	Yes	Yes	
Taxes and licenses	Yes			
Interest				
Charitable contributions				
Depreciation ^e	Yes	Yes	Yes	
Depletion ^e	Yes	Yes	Yes	
Advertising	Yes	Yes	Yes	
Pension and profit-sharing plans	Yes			

(continued)

Appendix I
TCMP and Alternative Tax System
Proposals

TCMP data element	Relevant TCMP data by proposal		
	Flat tax	USA	Value added tax Sales tax
Employee benefit programs ^f		Yes	
Other deductions	Yes	Yes	Yes
Net operating loss deductions ^g	Yes	Yes	Yes
Tax credits ^h			

^aInformation gathered on businesses includes small corporations, S corporations, partnerships, and sole proprietorships.

^bTo the extent that tax law characterizes rents, royalties, and payments for the right to use property as income, as opposed to a return on investment, these amounts would be included in a VAT tax base.

^cWhile gains and losses as such would not be computed under these proposals, data from this line would provide information about the proceeds from sales of business property, which would be part of the tax base. Also, sales tax might be applicable if the sale were made to a final consumer.

^dSelected items of other income such as recovery of previously deducted bad debts may be included in the tax base for the flat tax, USA, and VAT proposals. However, most kinds of other income would probably not be included.

^eDepreciation and depletion information would be useful for obtaining data on the purchase price of assets that would be deductible under the proposed flat tax and USA tax systems.

^fWhile these benefits would not be deductible by businesses, the information should be useful under the USA tax proposal because the benefits would be taxable to individuals.

^gAlthough these deductions would not be carried over in the USA tax proposal, this data could be used in the design phase to correct problems that may arise as operating losses begin to occur under the new tax.

^hTax credits include (1) foreign tax credit, (2) possessions tax credit, (3) orphan drug tax credit, (4) nonconventional fuels tax credit, (5) general business tax credit, and (6) prior year alternative minimum tax credit.

Source: Developed by GAO from summaries of the new tax proposals and analysis of TCMP coverage.

Flat Tax

Under the flat tax proposal, businesses would be assessed a tax on gross receipts less the costs of providing the goods or services. Therefore, as indicated in table I.2, almost all of the TCMP tax elements dealing with business gross receipts and deductions should be relevant for administering a flat tax, such as designing compliance strategies, identifying returns for audit, and estimating the tax gap. If this proposal were implemented, TCMP data on business investment income and interest expenses would not be relevant.

USA Tax

As indicated in table I.2, many of the income and deduction items currently reported on business returns would still be reported on returns under the USA tax proposal. Thus, the TCMP data would be relevant for developing compliance programs, selecting returns for audit, and estimating the tax gap. Items that would not be relevant include investment type income (e.g., interest and dividends); and deductions for wages and salaries, interest payments, and contributions to employee pension programs.

VAT

As indicated in table I.2, if a VAT were adopted as a replacement for the existing income tax, TCMP data on business gross receipts and purchases would be relevant for looking at potential compliance problems with VAT reporting. Thus, TCMP information would continue to be useful in developing compliance programs, selecting returns for audit, and estimating the tax gap.

Retail Sales Tax

As indicated in table I.2, return information on gross receipts should be relevant for evaluating compliance problems under a retail sales tax system. A retail sales tax would generally apply only to businesses in the retail trade market segments. This group comprises about 24 percent of the planned 1994 TCMP sample.

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