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NEW APPROACHES IN TAX ADMINISTRATION FOR THE 1970'S

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Commissioner of Internal Revenue

I am privileged to have this opportunity to participate in the Sixteenth Annual Tax Conference under the direction of the Marshall-Wythe School of Law of the College of William and Mary.

This is a welcome opportunity for me, not only for the stimulating and productive exchange of ideas I foresee coming from today's program, but also for the chance it affords to further cement the cordial relationship that exists between ourselves and our good tax practitioner neighbors in Virginia.

As you know, the IRS never has considered itself to be the source and the fount of all wisdom in the complex field of taxation. In fact, just the opposite might be closer to the truth, which is why we do not attempt to go-it-alone in our efforts at administration.

At the outset of my remarks, I would like to emphasize the dependence of the Service on the constructive participation of tax professionals individually and through their Associations and Societies, in our efforts to improve tax administration. We appreciate the very close and friendly relations existing throughout the country, between members of the Bar, Certified and Public Accountants, faculty and students of law schools, state and local tax officials, business groups, and the Internal Revenue Service. We appreciate this fine spirit of cooperation, and we rely heavily upon the values resulting from it.

As the program indicates, I have selected "New Approaches in Tax Administration" for my topic today. As you also know, the subject of taxes is anything but new.

Here in Williamsburg, the Governor, his counsellors, and the citizens were debating and worrying about taxes 200 years ago. Taxes were, in fact, fighting words. Some might say, "They still are."

Looking back, we who must live with today's Internal Revenue Code and all of its amendments, including the new features of the Tax Reform Act of 1969, can envy the colonists for the relative simplicity of their tax problems. For that matter, we don't have to go back 200 years for comparison. The 1913 Act was also brief. Even the 1939 Code was simpler. The 1954 Code rearranged matters but did not simplify. The subsequent Acts have not lessened our problems.

This is not, of course, the work of a mischievous spirit. This represents the constant adaptation of tax administration—one of the world's most ancient arts—to the realities of a changing world. This is a struggle that is conducted on two levels.

First, there is the legislative level. The seeming simplicity of the

1913 law was soon found to be illusory. There were hundreds and thousands of questions which the simple law could not answer. Every year we find it necessary to answer more questions and to face new situations. Unfortunately, this requires longer and more complex statutes.

Second, there is the administrative level. That is the level where I live, and that is what I would like to talk about.

America's Changing Life Style

Today, tax administration must adjust to the dramatic changes in America's life style. It must recognize how that life is affected by changes in the sources and values of money, by revolutionary progress in the technology of computers and other administrative tools, by the bewildering alterations in business organization and methods.

Ours is, of course, a money business. I suppose I ought to be thankful that the modern tax collector does not have to cope with taxes paid in pigs, or corn, or calico. But the value of money keeps changing, and this has a daily impact on tax administration. A simple example occurred to us last fall when we asked that the obsolete \$600 filing requirement for individual income tax returns be raised. The \$600 figure was enacted at a time when GNP was about 200 billion dollars. Now it is on the doorstep of a trillion dollars.

I am also thankful that the old "hand methods" of the traditional tax collector have been replaced by computers and other mechanical and electronic marvels. Truthfully, today's volume of tax business could not be handled by the old methods. Before World War I, the Internal Revenue Service processed a few million returns. Now it must cope with more than 100 million tax returns, plus nearly 300 million information returns.

Another part of this changing world is concerned with the organization and methodology of business.

In the past two or three decades, many corporate structures have experienced dramatic changes resulting from growth and from mergers. Many have become highly diversified, and most have acquired or located plants, divisions and subdivisions across the nation, and in many foreign countries.

This growth and change, together with increasingly intricate business practices and business transactions, produced organizations so enormous in size and so complicated in operations that, for these giants, the Service's traditional examination procedures became outmoded and unsatisfactory.

Once upon a time, a single revenue agent could examine any return. A few years back, the Service had to abandon this procedure for large corporations. Instead, it developed a team audit approach now known

as our "large case program." This brought together in a single coordinated examination such specialists as engineer agents, attorneys and specialists in international finance, in addition to accountants. Through the team audit approach, we have made encouraging progress in coping with the increasing complexity of corporate activities and in curtailing the time it takes to make a final determination of tax liability.

It seems clear to us, however, that this progress has been insufficient, particularly where giant conglomerates are concerned. To the list of specialists just enumerated, we may need to add economists, computer specialists, financial or security specialists and statisticians.

More than new skills and knowledges will be required. The entire approach to tax examination must change. Even now the Service is testing and applying procedures whereby computers are screening and analyzing transaction records stored on the taxpayer's own tape files. In time, most of our large case audits will be accomplished through computerized methods. But even with the help of computers, Revenue Agents must still examine many documents in the same laborious fashion as did their predecessors of thirty years ago. To reduce the volume of this tedious work, we are now exploring the possibilities offered by scientific sampling methods.

From these trends you can readily perceive that auditing is becoming an interdisciplinary science. Who knows, maybe we will even find a role for psychiatrists in the tax audit of the future? We may well find them helpful today—for example, where the mental defense is urged in a criminal investigation of tax fraud.

Progress in Tax Administration Means Breaking With Tradition

Obviously, the traditional requirements of accounting for Revenue Agents will have to be supplemented by other kinds of training. A whole new breed of revenue agents will be needed to meet these challenges.

We are already teaching selected agents how to audit computer systems, how to ferret out hidden Swiss and other bank accounts, and how to find their way through the maze of conglomerate finances.

We have to make changes in our internal methods too. Returns have always meant paper documents. Most of them still are. However, every quarter we now get approximately 10 million quarterly wage reports in connection with social security taxes, and we get roughly 50 million annual reports on dividends and interest payments on magnetic tape instead of on paper returns. Will all returns convert to tape some day? I doubt it, but we cannot foreclose the idea.

It seems difficult to remember that computers have been with us for a whole decade. When the Service first plunged into automatic data

processing, it must have seemed like the millennium to the old timers. Now we are getting a bit blasé about computers. In fact, we are beginning to rethink our computer needs and to determine what kind of new system we ought to have by the end of this decade.

This is not only a question of improved equipment—although that is an important aspect. Primarily, it is a quest for the means to serve more effectively, and more rapidly, the data needs of both the taxpayers and the component branches of the Service.

*Speedy Retrieval of Information—Greatly Improved Service
to Taxpayers*

The latest development in our continuous program to use machines effectively in serving taxpayers is known by the initials IDRS, which means Integrated Data Retrieval System. A pilot operation has already proved itself in our Southwest Region, and an improved system will be gradually installed in each of the regions. When the present ADP system was designed it was not feasible to provide instantaneous selection and printout of individual accounts, except in the order in which they were listed serially on the Master File. In other words, the only way of obtaining information on a specific account was to run miles and miles of the tapes. This created a considerable time lag in responding to questions.

Now we have supplemented the Master File with IDRS. This is a special file of information on a taxpayer's current transactions which is piped into all district offices and major local offices. This file is updated weekly and provides local offices with updated information for answering queries about the status of accounts. It is so fast that frequently a taxpayer's telephone inquiries can be answered in a few seconds, because the local office can press a few keys and get back a reading on a TV-type screen while the taxpayer holds the telephone. Needless to say, this kind of service pleases many taxpayers and makes life somewhat easier for our revenue agents and revenue officers who must deal directly with the public perhaps hundreds of miles away from the computers. Because of this fast service, many thousands of unnecessary letters and memoranda are also eliminated.

Taxpayers are not the only ones who need information. Each of the operating branches of the Service—especially Data Processing, Audit, Collection, and Intelligence—has important requirements for controls and statistics as well as case information. Their needs and the needs of taxpayers will be blended with the advanced technology of the computer industry in producing what we call the "System of the 70's."

Machines alone do not account for our new approaches. People design systems under which other people use machines to accomplish

defined objectives. Moreover, we are having to rethink our broad usage of human resources. Nowhere is this illustrated so forcefully as in the audit of returns. As you know, audit has frequently been considered one of the most tradition-bound activities of the Service.

One of our tenets for audit was the belief that only a fully trained revenue agent could adequately audit the return of a business taxpayer. Ideally, every employee should have enough training to cope with any problem which may come before him. However, there just are not enough graduates with accounting majors to enable us to recruit enough agents of this background in competition with the demands of private practice and industry.

This has required us to face up to the necessity of using auditors with somewhat less professional training than agents to audit certain classes of returns, including small business. These auditors can be drawn from the vast pool of college graduates with more general courses of education. With appropriate on-the-job training and careful selection of issues that can be resolved without professional accounting judgments, these people can and are doing a fine job. Further, with continuing education, they can become revenue agents.

Selection of Returns for Audit—By Computer

Of course, this means new methods of assigning returns to employees with the necessary qualifications. Fortunately, we have developed a discriminant function system—DIF, for short—which enables us to select returns for audit on the most scientific basis yet used by the Service. In the old days, selection was largely by the sense of smell of experienced agents. Now, the first screening is by computers using highly sophisticated mathematical formulae to measure the potential error in different types of returns. Only after the returns having the highest error-potential are selected, do the seasoned agents come in to conduct the final weeding-out.

The DIF formulae are changed every year to take advantage of the latest information and experience. This is really the essence of the DIF system. It substitutes facts for intuition as much as possible. In doing so, it serves a number of purposes.

In the first place, to the extent that DIF avoids audit of returns that need no change, it saves taxpayers the nuisance—some taxpayers call it other things—of being called on to explain item by item the details of their returns. Second, it saves the Government the cost of making such unneeded audits. Third, it reenforces the self-assessment system by assuring honest taxpayers that our enforcement efforts are being directed, as far as possible, at the taxpayers most likely to need some attention. Of course, the DIF system does not find error—but rather returns having the greatest probability of error—any selected

return may be found accurate in every respect—but a group of such returns, on audit, will show a high rate of change.

The DIF system is the outgrowth of another set of initials, TCMP. This stands for the Taxpayer Compliance Measurement Program. It is a system for periodic testing to determine the nature, frequency, and significance of taxpayer performance, especially in the audit, delinquent account, and delinquent return fields.

For example, in selected years, a scientific sample of all individual income tax returns is drawn and subjected to special, intensive examination which involves direct contact with the taxpayers. From these examinations, we compile data on the kinds of errors different classes of taxpayers are making, the size of the errors, the frequency of the errors, and other data which give us a thermometer-reading of taxpayer compliance.

This provides the raw material that the mathematicians use in building the DIF formulae, in combination with data derived from the regular examination program.

Of course, not all taxpayer errors are willful. One of the pluses of the TCMP program is that it identifies common taxpayer problems that can be dealt with through education and publicity, rather than more expensive enforcement methods. For example, notable successes have been made in recent years in getting better reporting of interest and dividends income through public information programs.

TCMP is only one of a number of research programs which clue us in to the needs of the times. These programs are aimed at better administration and better service to taxpayers.

Assistance for Taxpayers by Legal Provision and Administrative Decision

The past year will be long remembered for some of its efforts to help taxpayers. A special opportunity arose last fall during the consideration of the Tax Reform Act of 1969. As practitioners, you probably think of the 1969 Act primarily for its technical aspects, such as the minimum tax on preference items and the tighter provisions for exempt organizations.

But, most small taxpayers, instead, will think of the Act for its changes in filing requirements and withholding provisions.

As I mentioned earlier, the \$600 filing requirement for individual returns had become more than obsolete since its adoption in 1944. When the Treasury Department and the Congressional Committees agreed on a low income allowance to lift the tax load from people virtually in a poverty status, the Internal Revenue Service came up with the new filing requirement formula, which was enacted. Now, a single individual does not need to file until his income reaches \$1,700,

and a married couple does not need to file unless its combined income is at least \$2,300. For the aged, the filing requirement is increased \$600 if either the taxpayer or his spouse is 65 or over, or by \$1,200 if both husband and wife are 65 or over. We estimate that this will save taxpayers the trouble of preparing over 5,000,000 returns. It will, by the same token, save the Government the cost of processing these returns.

Under prior laws, it was difficult to eliminate many low income returns because the individuals usually had worked for wages during part of the year and had had tax withheld. Since the excessive withholding tax could not be refunded without the filing of a return, there was little incentive for changing filing requirements.

This created a particular imposition on young people, who typically work during school vacations, and also on elderly people, who are more or less retired and work only occasionally. In both of these and certain other situations, there is usually no tax due at the end of the year even though there may have been tax withheld from their wages.

A second important feature of the 1969 Act was the enactment of a Service proposal to eliminate withholding from individuals who could certify that they owed no tax the preceding year and expected to owe no tax during the current year. This is accomplished simply by filling out a brief form (Form W-4E) and handing it to the employer. We estimate more than 6,000,000 individuals will be exempted from withholding under this provision.

To make the withholding system more flexible and adaptable to the realistic needs of employees and employers, other changes were developed by the Service and enacted in the 1969 law. These provided more generous withholding allowances for persons having large itemized deductions, optional withholding on annuities, and a certain amount of flexibility in employer withholding computations.

Our latest effort to ease the chores of taxpayers coming about through administrative decision, was the recent announcement that we are making a dramatic increase in the scope of returns on which the taxpayer can choose to have the Service compute his tax and send him a bill or refund, as the case may be.

Formerly, this option was limited to returns with less than \$5,000 income consisting almost entirely of wages subject to withholding. The new rule is that we will compute the tax—if the taxpayer wants us to—on incomes up to \$20,000 consisting of any combination of wages, dividends, interest, pensions and annuities. Note that this is the first time that pensions and annuities are included.

The old rule was so restrictive that last year it was used on only a little more than 800,000 returns. Under the new rule, over 30,000,000 will be eligible to take advantage of our service. We know that many

will not elect the option, but this is certainly a major effort to provide improved service for taxpayers.

In designing the new rule, we were thinking especially of the aged taxpayers. That is why we gave the privilege to the recipients of dividends, interest, pensions and annuities, as we did to wages. Then we went a step further. We said that if an elderly taxpayer qualified to have us compute his tax, we would also compute his retirement income credit for him—provided he supplied a couple of lines of basic information. I don't need to remind you that this credit computation under the law is not easy, and this feature should be of real benefit to a great many senior citizens.

Ideas of taxpayer service change with the times, just like everything else. Once it was considered enough just to send out the forms. Now, we are steadily building taxpayer service and assistance programs in each of our districts. One of the newer aspects of these programs is called Centiphone. In certain pilot districts, we already have made arrangements with the telephone company so that taxpayers in any part of the district—usually a whole state—can make toll-free calls to the district office to ask questions and get information. Sometimes it is a relatively unsophisticated question about a bill. Sometimes it is a technical question. These calls come into an office staffed to answer the bulk of questions. Other questions are referred to experts.

When this system is backed up by IDRS, as mentioned before, we have the means for providing quick, reliable assistance to taxpayers.

What will tomorrow bring?

I don't know. I do know, however, that your tax collectors are preparing for it. And there will be new approaches in tune with the times.