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Report to the Commissioner of Internal Revenue

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TAX ADMINISTRATION

FedState Efforts Offer Opportunities but Program Needs Improvement

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GAO

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General Accounting Office
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General Government Division

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October 31, 1996

The Honorable Margaret Milner Richardson
Commissioner of Internal Revenue

Dear Ms. Richardson:

The income tax laws of many states are built upon the federal tax code. Consequently, cooperation between the Internal Revenue Service (IRS) and state tax agencies offers opportunities for helping to achieve IRS' strategic goals of increasing taxpayers' compliance with tax laws, improving taxpayer service, reducing burden on taxpayers, and increasing the efficiency of tax administration. IRS and the states are aware of the advantages of working together and have been involved in a federal/state (FedState) cooperative program for years. This report discusses the potential benefits of the FedState program, conditions that may impede the success of the program, and concerns raised by state officials regarding the potential impact of IRS' latest reorganization of the FedState program.

Background

IRS and state revenue offices are both charged with responsibility for collecting taxes. More than half of the states have based their income tax systems on the federal tax system, with an overlap of many taxpayers.[1] For the most part, this common customer base is dealt with separately by IRS and the state agencies. Given their common roles and customer bases, opportunities for collaboration among IRS and states' revenue offices exist. IRS is facing budget reductions and downsizing. Because of decreasing resources, it becomes even more important to identify ways that IRS and the states can cooperate to improve efficiencies and maximize their return on investment.

IRS and the states have been involved in cooperative tax administration efforts since the 1920s. By engaging in cooperative efforts, state agencies and the federal government have attempted to achieve greater compliance and efficiency than they could by working separately. Early cooperative efforts involved the sharing of taxpayer income and tax liability information. In 1957, these activities became governed by formal agreements between IRS and the states to specify the types of tax information to be shared. In 1978, IRS fixed responsibility for the exchange of federal and state tax information with the disclosure officers in its

[1]See app. I for a listing of states with income taxes and their conformity with federal income tax system requirements.

regional and district offices.[2] IRS also charged its district directors with responsibility for working personally with state tax agencies to establish and conduct FedState cooperative projects. In 1991, the Office of FedState Relations was established in the National Office to facilitate cooperative tax administration and foster joint projects. IRS originally assigned a senior executive and five staff to this office. IRS chose to not provide full-time field staff to facilitate and foster projects. District directors continued to be responsible for liaison and personal involvement. Most disclosure officers were assigned responsibility for coordinator and facilitator duties on a part-time basis. As of November 1995, 49 states were participating in the FedState program, and, according to IRS officials, approximately 600 to 700 projects were ongoing or proposed.

In recent years, IRS and the Department of the Treasury have drafted and proposed legislation to further the FedState program. In June 1995, the President announced that he would submit to Congress proposed legislation to facilitate additional FedState cooperative efforts to streamline tax administration, such as joint filing and processing of return information. The proposed legislation would allow IRS and state taxing agencies to delegate tax administration powers and compensate one another pursuant to agreements. The most recent version of the legislation was submitted to Congress in March 1996. No action has been taken yet.

In 1978 and 1985, we issued reports on the FedState program.[3] The 1978 report to the Joint Committee on Taxation concluded that the program had a low priority within IRS and had no unified direction because responsibility for the program was not fixed. In response, IRS assigned program responsibility to the Office of Disclosure Operations. Both the 1978 and 1985 reports concluded that IRS and the states were not using much of their exchanged data and were not sharing other potentially useful information. In response, IRS established reviews to determine if states needed and used the confidential return information provided by IRS.

Results in Brief

Potential benefits of the FedState program include increasing taxpayers' compliance with tax laws, improving taxpayer service, reducing burden, and improving the efficiency of tax administration functions. For example,

[2]Disclosure officers are responsible for overseeing the access to taxpayer data, which is protected under Section 6103 of the Internal Revenue Code.

[3]See Better Management Needed in Exchanging Federal and State Tax Information (GAO/GGD-78-23, May 22, 1978); and TAX ADMINISTRATION: The Federal/State Tax Information Exchange Program (GAO/GGD-86-8, Dec. 13, 1985).

joint federal and state taxpayer education efforts can reduce taxpayer burden by making it easier for taxpayers to get information about tax requirements.

To ensure optimal use of the FedState program by local IRS and state offices, IRS' Office of FedState Relations is responsible for providing guidance and monitoring program accomplishments. A primary responsibility of the director of the office is to plan and direct a program involving the integration and coordination of IRS resources devoted to FedState activities, and evaluating these overall activities to ensure optimum results. Although IRS has undertaken many different types of FedState projects, IRS' FedState office has made little effort to ensure that the current project mix constitutes the optimal use of FedState program resources. FedState projects were generally initiated at the local IRS district office or state level without the benefit of an overarching strategic planning function to help identify areas where the greatest potential contributions could be made. Similarly, the Office of FedState Relations provided little guidance to the local units. Changes in the organizational location, turnover of staff, and fluctuating staffing levels for the Office of FedState Relations may have affected the consistency of the FedState efforts. Also, the FedState program lacks the performance-based data needed to monitor project accomplishments.

According to the state officials we spoke with, the success of FedState cooperative efforts has hinged on the good working relationships established over time by IRS officials and their counterparts in state agencies. Some state officials have raised concerns about how the latest IRS reorganization—which reduces the number of IRS district offices and shifts IRS senior managers out of many states—could affect FedState arrangements and the future success of the program. Some state and IRS officials we spoke with said that personal commitment to the program is important for developing a productive FedState program. In this regard, IRS has developed a transition plan to respond to states' concerns about the reorganization. Because of the recency of the reorganization, it is too early to determine whether the plan will adequately address the states' concerns.

Objectives, Scope, and Methodology

Our review of the FedState program arose from a December 9, 1994, hearing on compliance costs and taxpayer burden held by the Subcommittee on Oversight of the House Committee on Ways and Means. At that hearing, the Subcommittee expressed interest in how the states and the federal government could work together to reduce taxpayer burden. Our objectives for this report were to (1) identify the potential benefits of FedState cooperative efforts; (2) determine what, if any, conditions may impede the success of the program; and (3) determine what, if any, FedState program concerns the states have with IRS' planned reorganization.

To achieve our interrelated objectives, we interviewed IRS officials responsible for the FedState program in IRS' national and southeast regional offices, as well as its Albany, NY; Atlanta, GA; Baltimore, MD; Columbia, SC; Phoenix, AZ; and St. Paul, MN, district offices. We interviewed state revenue department officials knowledgeable of FedState activities in Arizona, Georgia, Maryland, Minnesota, New York, and South Carolina. These locations were selected on the basis of their proximity to our offices or because IRS officials said they were characterized by a high level of FedState activity.

We also (1) reviewed FedState documents, such as the 1994 FedState Cooperative Ventures Catalog and the FedState Concept of Operations Report from IRS, and program reports from state department of revenue offices we visited; (2) collected detailed information, such as project descriptions and any data on costs and benefits, on FedState projects in the states we visited; and (3) reviewed various legislative proposals related to FedState activities.

We interviewed Federation of Tax Administrators (FTA) officials knowledgeable of the FedState program. FTA represents state tax administrators and is actively involved in promoting effective working relationships among IRS and state tax agencies. We held a group discussion with and surveyed state tax administrators on their views regarding cooperative FedState efforts at the June 1995 FTA conference in Cleveland, OH. Participation in the discussion and survey was voluntary.

Our work was done between January 1995 and April 1996 in accordance with generally accepted government auditing standards. We provided a draft of this report to the Commissioner of Internal Revenue and the Executive Director, FTA, for their comments. We met with FTA on August 15, 1996, and with IRS officials on September 4, 1996, to discuss this report. Their comments are summarized and evaluated beginning on page 13 and incorporated into this report where appropriate.

Fedstate Cooperative Efforts Offer Opportunities to Improve Compliance, Improve Taxpayer Services, Reduce Burden, and Improve Tax Administration

Due to the similarities in the functions of IRS and state revenue departments, numerous opportunities exist to improve tax administration efficiencies through FedState cooperative efforts. For example, taxpayer data tape exchanges can improve compliance and enforcement by enabling IRS and the states to identify noncompliant taxpayers and take appropriate action. Similarly, joint federal and state taxpayer education and assistance efforts can reduce taxpayer burden by making it easier for taxpayers to obtain information about tax requirements. More sophisticated technology provides additional ways for IRS and the states to reduce taxpayer burden. For example, in one district the state and IRS can automatically transfer telephone taxpayer assistance calls to each other to respond to taxpayers more quickly and efficiently.

Data limitations prevented us from ascertaining whether the existing mix of FedState projects has helped IRS toward meeting its goals of improving compliance, increasing efficiency, and reducing taxpayer burden. A project designed to increase compliance may also have the positive effect of reducing burden or increasing efficiency. An official in IRS' Office of FedState Relations told us that four of the most common efforts have been taxpayer data tape exchanges, federal/state joint electronic filing programs, state refund offset programs, and the joint dyed diesel fuel program.

Taxpayer Data Tape Exchanges

Taxpayer data tape exchanges, which began in the 1960s, constitute one of the oldest FedState cooperative efforts. According to IRS, currently almost all states participate in tape and information exchanges. By exchanging tapes that include taxpayer return data, IRS and the states have been able to identify taxpayers who failed to file returns or who filed returns but owed more taxes. Although comprehensive data on the revenues collected through this effort have not been systematically tracked, the data collected by some states and IRS districts demonstrate that computer tape exchanges have increased revenues. For example, one state billed taxpayers for $37.5 million in 1990 state income taxes on the basis of data in IRS tapes that showed IRS adjustments to taxpayers' federal taxes. The state billed those taxpayers who had failed to report and pay additional state income tax due as a result of the federal adjustments.

Federal/State Joint Electronic Filing

The joint electronic filing effort—which was initiated in 1991 as a limited research test with the South Carolina Tax Commission—is an initiative among IRS and the states to allow taxpayers to simultaneously file state and federal returns electronically. According to IRS, 31 states will participate in the 1996 FedState Electronic Filing program. Electronic returns go to IRS, which then is to send the states their portions of the filing. While no systematic effort has been made to assess the benefits of joint electronic filing, IRS believes that joint filing increases efficiency because it encourages electronic filing and thus eliminates the costs of processing and storing paper returns. Also, according to IRS, electronic filing reduces administrative costs to both IRS and the states because mathematical errors are detected electronically and transcription errors are eliminated. Finally, IRS said that joint electronic filing reduces taxpayer burden by enabling taxpayers to submit their state and federal returns in a single electronic transmission, thus avoiding corresponding mathematical errors.

State Refund Offset Program

The state refund offset program, also referred to as the State Income Tax Levy Program (SITLP), allows IRS to levy state tax refunds to fulfill federal tax debts. According to IRS, a levy is more efficient than other collection enforcement actions. The program has been in operation since 1985. According to an IRS official, 31 states participated in SITLP, which in 1995 netted IRS $81.7 million in due taxes.

Joint Dyed Diesel Fuel Program

To increase the efficiency of its motor fuels compliance efforts, IRS is part of the dyed diesel fuel program, which was established in 1994 and involves sampling fuel in storage and vehicles to ensure that red-dyed fuel, which is tax free, is not used as taxable fuel on highways. According to IRS, 15 states have contracted with IRS to sample and test diesel fuel in vehicles used on highways. IRS believes the program has increased compliance. IRS' preliminary data indicate that diesel fuel excise tax collections increased by about $1.2 billion, or 22.5 percent, from calendar year 1993 to 1994.

Other FedState Efforts

In addition to these four common efforts, numerous efforts have been initiated at the IRS district and state levels. For example, IRS and 1 state revenue department conducted a joint video conference seminar linked to 19 locations statewide to inform tax practitioners of changes in the tax laws. IRS and the state hoped this combined video conference would (1) improve taxpayer service by informing a greater number of practitioners in more remote locations and (2) increase efficiency by reducing the amount of time and money IRS and state employees spent traveling to such seminars. Another IRS district and state tax agency targeted a localized group of nonfiling and underreporting self-employed taxpayers. To increase efficiency, IRS and the state tax agency each audited a segment of such taxpayers' returns and assessed taxes, shared audit results, and based assessments on each other's audits. According to an IRS official, this effort yielded approximately $5 million in state and federal taxes and added 400 filing taxpayers. Other examples of joint efforts are included in appendix II.

Additional FedState Program Actions Could Increase Potential Benefits

While the FedState program offers opportunities for increasing taxpayer compliance, improving taxpayer service, reducing the burden on the taxpayer, and increasing the efficiency of tax administration, IRS has not developed an overall strategy to guide FedState projects to better assure the most efficient use of IRS resources. The Office of FedState Relations was established to foster and facilitate FedState cooperative efforts. The Director of the Office of FedState Relations has been responsible for planning and directing FedState efforts that involve the integration and coordination of IRS resources, and reviewing and evaluating FedState activities to ensure optimum results. However, IRS has not developed an overall strategy for the Office of FedState Relations to fulfill its purpose, to link FedState efforts with IRS' overall agency goals and objectives, or to establish an evaluation mechanism for the program.

Strategic planning at the program level offers a framework for tying agency goals and objectives with program-level actions. This helps to ensure that budget trade-offs at the program level are directly tied to the agency's overall strategy. In the absence of such planning efforts, the agency will lack assurance that the individual programs in which it participates represent the best choices for achieving its overall goals and objectives.

Weaknesses in the FedState National Office

Currently, FedState efforts vary from state to state. While these variances generally reflect differences in state and regional operating agendas, they also underscore a weakness in IRS' FedState efforts—namely, the lack of a centralized strategic planning function. Currently, no unit within IRS is responsible for providing a strategic framework for the projects. While IRS' Office of FedState Relations is responsible for facilitating cooperative projects between IRS and the states, the office offers little guidance to help local units choose the most productive projects, nor does it help local units to determine whether their project efforts are helping IRS to achieve its strategic goals. For example, such guidance to local units might identify

FedState efforts that are most beneficial to both IRS and state offices, efforts that link strategically to IRS' main goals, and efforts that help ensure that IRS resources are most efficiently used. Absent such guidance, local units may be missing out on projects that offer greater benefits or operating projects that are not worthwhile.

We found that most decisionmaking about FedState programs occurred at the district level, where IRS district and state officials worked together to identify and initiate projects. The local level was a natural decisionmaking location since participation by the district or state was voluntary and depended on the project. State and IRS officials told us that it is important to maintain the local focus of the efforts because of the variation in needs, resources, and taxpayer issues. According to the IRS district and state officials we interviewed, the level of FedState activity that existed between district IRS offices and state tax agencies was highly dependent on the working relationship between their respective managers and the top managers' commitment to the FedState program. To assist in developing this working relationship, it seems to us that local districts and state agencies could benefit from guidance to help ensure that they are pursuing the FedState efforts that would benefit them the most.

The Office of FedState Relations views its role as an advocate for the program and as a clearinghouse for project ideas. In addition, IRS officials said the Office of FedState Relations worked to develop legislation designed to make it easier for state revenue offices and IRS to engage in joint or reciprocal tax administration functions such as filing of returns and processing of returns and return information. The most recent version of the legislation was submitted to Congress in March 1996, and no subsequent action has been taken yet. The proposed legislation would authorize IRS to enter into tax agreements with the states and to delegate tax administration responsibilities and compensate each other for activities. As a clearinghouse, the Office of FedState Relations provided information to districts on existing and proposed projects, primarily through a catalog that included descriptions of FedState projects provided by the IRS districts themselves. According to IRS, the catalog was not intended to be comprehensive and did not include information on such things as status, costs, and results.

IRS has not developed a strategic framework for achieving FedState's purpose of facilitating and fostering cooperative efforts between IRS and the states. Without a strategic plan, IRS cannot be assured that FedState resources are being focused on those projects that will contribute most to

IRS' mission. Nor has the office set performance goals to guide cooperative efforts or determine how well its programs are doing. Setting performance goals is an integral part of managing for results and is a current organizational emphasis in IRS. IRS also has not provided guidance as to what types of FedState efforts have the greatest potential to further IRS' mission.

Organizational and Staffing Changes May Affect the Consistency of FedState Efforts

The Office of FedState Relations has undergone several organizational and staff changes. As a result, the office has not had the benefit of stable and continuous support and direction in terms of resources and staffing. In the past 2 years, at least six different individuals have held the position of FedState director or acting director and the organizational location of the office has changed twice. According to IRS officials, the size of the staff has fluctuated between 5 and 21 people. Further, the director position has been downgraded from a senior executive position to a GS-15 position. According to an official in the Office of FedState Relations, the current staff comprises 19 individuals, most at the GS-12 level or higher. Four of these staff persons were transferred to the Office of FedState Relations because their former offices were reorganized or their positions were abolished. IRS officials said that further staffing changes may take place.

FedState Program Does Not Monitor or Assess Cooperative Efforts

Neither IRS nor the states have systematically monitored or assessed the results of individual FedState projects. With performance-based data, IRS national and district offices could make more informed decisions on resource allocations and program priorities. Such data might also provide support for IRS' national office to encourage broader participation by IRS district and state revenue offices. Currently, IRS does not have the project information needed to ensure that the FedState program is managed in a way that maximizes resource investments. In 1994, IRS compiled a FedState catalog of projects that listed more than 280 proposed or actual FedState efforts. FedState officials told us that this listing was not comprehensive. Further, the FedState office generally does not have information on the status of these projects, such as project implementation dates, the resources required to operate the projects, or project benefits.

Quantitative, results-focused data have been collected for some FedState projects. Of the 126 projects we reviewed in 6 districts, data to monitor or assess the projects were collected on 31, or 25 percent. Further, none of the 126 projects we reviewed was evaluated in terms of total project costs.

Of the 31 measured projects, few provided measures that linked project outcomes to IRS' main goals of increasing compliance, reducing burden, and improving tax administration efficiency. The most common measure was the amount of additional revenue generated by the projects. For the remaining 95 projects, success was measured intuitively or projects were just assumed to provide benefits.

IRS has recognized the need to evaluate the results of FedState projects. However, the results of these efforts have been limited. For example, in 1994, a former Director of the Office of FedState Relations said the office planned to create an information-sharing cost model to show the benefits of the FedState program and generate greater interest in FedState projects among the states. However, this model has not been created. According to the current Director of the Office of FedState Relations, the project was terminated due to a lack of resources.

In another effort to evaluate FedState projects, in 1994 the Office of FedState Relations instituted a best-practices approach that encouraged local offices to submit information on their most successful FedState projects. The office developed guidance for local offices to use in describing projects, resources required, and results achieved. Thus far, only two projects have been selected as best practices, according to IRS officials. IRS has sent descriptions of the projects, along with implementation guidelines, to its local offices nationwide in the hope that they will be widely adopted.

According to IRS officials, the Office of FedState Relations also planned to work with field FedState staff to complete plans by November 1995 to measure the benefits of selected FedState projects. According to an IRS official, few measurement plans have been submitted because FedState field staff were overwhelmed by the demands of measuring projects, coordinating ongoing FedState projects, and handling staffing changes and duties related to IRS' reorganization. IRS did not provide more specific details on the nature of the issues and the impact of staffing and organizational changes on IRS' ability to measure program results.

In addition, IRS' Western Region Internal Audit group reviewed federal and state information sharing in the Western Region. In May 1994, it reported that district management could not accurately identify and track the costs or accomplishments of FedState activities and that current systems did not capture this type of data. The review also found that without accurate tracking techniques, the districts could not address the effectiveness of

FedState projects in reducing taxpayer burden, increasing compliance, and improving quality. In response, the Western Region's Chief Compliance Officer created a working group to develop a cost/benefit model to measure the success of FedState projects. They later rolled this project into a National Office Research and Analysis plan.

IRS' Reorganization Has Caused Concern Among Some States About the Future of FedState Operations

The FedState program's ability to contribute significantly to IRS' strategic objectives relies considerably on the participation of IRS districts and states. Due to the voluntary nature of the program, the quality of the relationships among the states and IRS district offices is a critical component of the decision to initiate projects. However, because of IRS' latest reorganization, some states have voiced concerns about the possible deterioration of FedState relationships that have developed over the years.

In May 1995, IRS announced a planned reorganization of its field office structure to reduce the number of IRS district offices from 63 to 33 and the number of regions from 7 to 4 by the end of fiscal year 1996. Before the reorganization, each state had at least one district office. Along with a district director, most district offices had part-time FedState coordinators who acted as liaisons to the states. With the reduction in the number of districts, IRS plans to put the area covered by the districts to be eliminated under consolidated management of another district. IRS staff is to remain in locations that were formerly district offices; however, the district director and other management positions are to be eliminated.

Concerns About IRS' Reorganization on FedState Relationships

In our discussions with state officials, many expressed concern about the effect that reorganization would have on their relationships with IRS. To help better understand these concerns, we held a joint meeting with representatives from nine state tax agencies. Many participants told us that they placed a high premium on the personal commitment of top managers at IRS district offices. They also said that they viewed the good lines of communications that they had developed through ongoing personal contacts and close working relationships with their district IRS counterparts as being important to the success of FedState activities. The participants said that the elimination of district offices in some states may impede FedState cooperation because (1) there may be no IRS counterparts for state officials in those states that have lost IRS district offices and (2) the geographical distance between state offices and some district directors may tend to discourage the development of a close working relationship. In essence, these participants were concerned about the continuation of ongoing FedState projects and the prospect of future projects.

IRS' Response to the States' Concerns

In 1995, the IRS Transition Executive, responsible for overseeing IRS' reorganization, produced a transition plan that, according to officials from the Office of FedState Relations, will be implemented. The plan addresses the states' concerns by recommending to regional IRS commissioners that a full-time FedState coordinator and a full-time disclosure officer be established in each of the continuing district and regional offices. In the past, district FedState coordinators were not full-time positions; rather, FedState activities were typically considered a collateral duty of the district disclosure officer. Some IRS officials had expressed concern about disclosure officers being given the role of coordinator, since their primary responsibility is to safeguard data, not to look for ways to share it. According to IRS officials, the highest-level official remaining in each district office scheduled to be closed will be designated FedState liaison as a collateral duty. It is too early to assess whether the plan will address the states' concerns because of the recency of the reorganization.

Conclusions

FedState cooperative efforts provide IRS and the states with opportunities to increase taxpayer compliance, improve taxpayer service, reduce taxpayer burden, and improve the efficiency of tax administration activities. However, IRS has not provided the strategic framework, guidance, and performance goals for the FedState program that would enable it to take fuller advantage of these opportunities. Specifically, IRS' Office of FedState Relations has not provided guidance to local IRS districts and states, and the level and types of efforts undertaken appear to rely primarily on the commitment of IRS district management and the state. It is important to maintain the local focus of the efforts because of the variation in needs, resources, and taxpayer issues. At the same time, data that identify best practices would better enable IRS to promote the practices' adoption on a wider scale.

Further, IRS has not developed performance goals for the FedState program and has not collected data on most programs to monitor or assess program progress and results. Consequently, IRS national and district offices do not have the information needed to manage and assess the FedState program as a whole and make informed decisions about individual FedState projects. As a result, IRS may be missing opportunities to target program efforts and maximize potential program benefits.

Finally, some state tax officials are concerned that IRS' reorganization of its district offices may impede or even end the long-standing relationships with IRS district officials that have made cooperative FedState projects possible. It is too early to determine what impact the reorganization will have on the program.

Recommendations to the Commissioner of Internal Revenue

To enhance opportunities for increased benefits from the FedState program we recommend that you

- develop and monitor, in conjunction with the states, implementation of a strategic framework that links FedState project objectives to IRS and state mission objectives; and
- establish performance goals and ways to monitor and assess program results.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from you or your designated representatives. Responsible IRS officials, including the Director, Governmental Liaison and Disclosure, and the Director, Office of FedState Relations, provided comments and supplementary documents in a September 4, 1996, meeting and additional comments dated September 27, 1996. We have incorporated modifications in response to their comments in this report where appropriate. FedState officials emphasized that the conditions identified in our report related to the way the program operated before they took charge. They are in the process of making changes they think will improve the program and they said our concerns would be addressed in that process.

In response to our recommendation to develop a strategic framework, Office of FedState Relations officials said they believed they had already undertaken important steps toward a strategic plan, in particular by establishing FedState plans and procedures in Spring 1996. By definition, they said, the program focuses on the identification, exploration, and implementation of innovative solutions to mutual challenges at the local level. Further, they commented that while they recognized the importance of strategic planning at the national level, IRS will continue to look to IRS executives to leverage these opportunities with their state counterparts at the local level.

IRS officials said they have established plans and procedures that will link FedState project objectives to IRS and state mission objectives. For example, they told us they established the National FedState Steering Committee. Among other responsibilities, the Committee has been developing FedState policies and procedures to ensure that specific FedState goals are consistent with IRS goals. The Committee developed FedState project guidelines which were forwarded to IRS regional offices in August 1996. This guidance is responsive to our recommendation and should help IRS improve its program.

The Office of FedState Relations also has been developing a "FedState Program Letter" for fiscal year 1997. According to IRS officials, the Program Letter will provide general guidance about the FedState program, its objectives, current priorities, and other information. FedState officials said the Program Letter will outline long-range objectives as well as set priorities for fiscal year 1997. Further, they commented that they have stabilized the management team and have filled director positions with permanent, top-level managers which should help to overcome concerns about the instability of the Office. We believe that IRS has taken important steps toward a strategic framework, but it is too early to assess the effectiveness of these steps because they were recently implemented or have not been finalized.

IRS officials also agreed with our recommendation to establish performance goals and ways to monitor and assess program results. They said steps to improve in these areas have already been taken. For example, the Office of FedState Relations distributed guidance to district and service center FedState coordinators on how to report the results of individual FedState projects. The guidance requests that coordinators quarterly report information on their FedState projects, including baseline measures for new initiatives and specific results for ongoing projects. Also, in August 1996, the Office of FedState Relations provided FedState coordinators guidelines on how to develop projects and propose projects that might be replicated nationwide. Among other things, these guidelines request that coordinators specify how projects results are to be measured and how the measurements relate to the goals of the project. We believe that, when fully implemented, these steps may provide more of the information IRS needs to manage and assess the program.

We are encouraged by the enthusiasm and commitment current IRS officials show for the FedState program. However, during our review various FedState officials have told us about plans or procedures to develop FedState program and project measures. Many of these were abandoned or were never fully realized. To be successful, IRS' current plans to develop a strategic framework and measures must be fully implemented and supported by the appropriate IRS officials at the national and local levels.

In a meeting on August 15, 1996, we obtained comments on a draft of this report from Federation of Tax Administrators (FTA) officials responsible for FedState-related issues, including the Executive Director and Government Affairs Associate. The officials generally agreed with our recommendations. However, the officials said that the strategic framework must allow enough flexibility for state taxing agencies and local IRS officials to decide which FedState projects they will pursue. Also, the officials said FTA conducted a study that showed the revenue benefits to the states from IRS' taxpayer data tape exchange program. FTA issued its report on September 25, 1996.

The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight not later than 60 days after the date of this report. A written statement must also be sent to the House and Senate Committee on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

We are sending copies of this report to interested congressional committees, including the Chairman and Ranking Minority Member of the House Committee on Ways and Means and its Subcommittee on Oversight, the Chairman and Ranking Minority Member of the Senate Finance Committee, the Secretary of the Treasury, and other interested parties. Copies will also be made available to others upon request. Major contributors to this report are listed in appendix III. Please contact me on (202) 512-9110 if you have any questions concerning the report.

Sincerely yours,

Lynda D. Willis
Director, Tax Policy and
Administration Issues

Contents

Abbreviations

AGI	adjusted gross income
EP/EO	employee plans/exempt organizations
FTA	Federation of Tax Administrators
FTI	federal taxable income
IRS	Internal Revenue Service
SITLP	State Income Tax Levy Program

States With an Income Tax and the Degree of Conformity to Federal Income Tax

State	State income tax?	Degree of conformity to federal income tax
Alabama	Yes	None
Alaska	No	Not applicable
Arizona	Yes	Adjusted gross income (AGI)
Arkansas	Yes	None
California	Yes	AGI
Colorado	Yes	Federal taxable income (FTI)
Connecticut	Yes	AGI
Delaware	Yes	AGI
District of Columbia	Yes	AGI
Florida	No	Not applicable
Georgia	Yes	AGI
Hawaii	Yes	FTI
Idaho	Yes	FTI
Illinois	Yes	AGI
Indiana	Yes	AGI
Iowa	Yes	AGI
Kansas	Yes	AGI
Kentucky	Yes	AGI
Louisiana	Yes	AGI
Maine	Yes	AGI
Maryland	Yes	AGI
Massachusetts	Yes	AGI
Michigan	Yes	AGI
Minnesota	Yes	FTI
Mississippi	No	None
Missouri	Yes	AGI
Montana	Yes	AGI
Nebraska	Yes	AGI
Nevada	No	Not applicable
New Hampshire	Yes	Only interest and dividends are taxed
New Jersey	Yes	None
New Mexico	Yes	AGI
New York	Yes	AGI
North Carolina	Yes	FTI

(continued)

State	State income tax?	Degree of conformity to federal income tax
North Dakota	Yes	State tax calculated as a percentage of federal liability
Ohio	Yes	AGI
Oklahoma	Yes	AGI
Oregon	Yes	FTI
Pennsylvania	Yes	None
Rhode Island	Yes	State tax calculated as a percentage of federal liability
South Carolina	Yes	Based on FTI
South Dakota	No	Not applicable
Tennessee	Yes	Only certain interest and dividends are taxed
Texas	No	Not applicable
Utah	Yes	FTI
Vermont	Yes	State tax calculated as a percentage of federal liability
Virginia	Yes	AGI
Washington	No	Not applicable
West Virginia	Yes	AGI
Wisconsin	Yes	AGI
Wyoming	No	Not applicable

Note: If a state's income tax conforms to the federal income tax, its "starting point" will be (1) federal adjusted gross income (AGI); (2) federal taxable income (FTI); or (3) federal tax liability, with certain modifications to deal with areas where the state may wish to differ from federal rules.

Source: Significant Features of Fiscal Federalism, Volume I - Budget Processes and Tax Systems (1994), Advisory Commission on Intergovernmental Relations, June 1994, pages 58-60.

Type, Description, and Illustrative Examples of FedState Projects

Type	Description	Example
Assistance to taxpayers	The development of materials and the provision of customer service by all functions.	IRS and a state revenue agency opened a “New Business Assistance Center” to inform new business owners of their federal and state tax responsibilities and how to comply.
Initial processing of returns	The receipt and processing of tax returns, payments, and information documents, both paper and electronic.	To prevent erroneous Earned Income Credit refunds, a state obtained a list from IRS of taxpayers with freezes on their accounts that they used to determine whether to also freeze a taxpayer’s account.
Adjustments to accounts	Account adjustments to tax, penalties, and interest, including amended returns, taxpayer requests, claims, and service-initiated changes.	In one state, after IRS audits a taxpayer’s return, it informs the taxpayer that any changes to federal tax liability may affect state tax liability and the taxpayer may be required to file an amended state tax return.
Document matching and nonfiler programs	The matching of information documents against tax returns and accounts to identify nonfilers.	IRS obtained state tax filing records to identify taxpayers filing a state income tax return but not a federal income tax return.
Examinations and determinations	The selection and examination of income, excise, employment, employee plans/exempt organizations (EP/EO), and estate and gift returns to determine tax liability (including appellate review). Also includes EP/EO determinations.	IRS and a state conducted a joint sweep of auto dealerships to determine whether they were filing IRS Form 8300s and reporting state sales tax for cash sales over $10,000.
Collections	Includes all efforts to secure payment of tax liabilities.	In some states, if a taxpayer owes both the IRS and state revenue agency, the taxpayer can go to either IRS or the state revenue agency and set up an installment agreement to resolve both accounts.
Investigations	Encompasses all civil and criminal investigative activities.	Two IRS districts and a state department of revenue have a project to identify and conduct joint investigations of individuals who are filing fraudulent tax returns electronically.
Information systems	The development and maintenance of information systems, including telecommunications, systems security and privacy, and systems standards.	A state department of revenue provides one IRS district with all information the state receives on fuel sales, purchases, licenses, and distributors’ reports. Using this information, the district created an automated database to promote and monitor compliance in the motor fuel industry.
Resources	Financial, human resource, and asset management.	In several states, IRS and the state revenue office share training resources. For example, an IRS district trained state revenue employees on federal corporate tax laws.

(Table notes on next page)

Source: IRS FedState Cooperative Ventures Catalog, 1994; and information gathered in GAO visits to IRS offices between January 1995 and April 1996.

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