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*Sen. Russell B. Long.

The Internal Revenue Service (IRS) audits a relatively small number of individual taxpayers each year. Overall, taxpayers who have been audited repetitively by the IRS were audited because their returns fit the usual selection criteria. However, IRS should reduce the number of repetitively audited taxpayers. Findings/Conclusions: All returns are selected for audit through the same system, and the system generally protects against selection abuse. Repetitive audits are like all audits in terms of recommended tax increases, indicating that taxpayers were not repeatedly selected, unless tax adjustments were probable. About 60% of repetitive audits resulted from: high scores under the computer-generated audit selection program, unallowable items on the return, or selection by an auditor as a result of auditing another year's return. Recommendations: The Commissioner of Internal Revenue should include repetitive audits in the planned study of factors contributing to voluntary taxpayer compliance with the tax laws. When classifying returns for audit potential, the Commissioner should discontinue the practice of not selecting returns because earlier audits did not change the tax amount, unless information about the previous issues is available to make a more informed audit/no-audit decision. He should make changes in the taxpayer contact procedure to prevent unnecessary, repetitive audits and require a written explanation and supervisory approval before auditing a return originally obtained for information or reference purposes. (Author/SC)

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*REPORT TO THE JOINT COMMITTEE
ON TAXATION
CONGRESS OF THE UNITED STATES*

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

Repetitive IRS Audits Of Taxpayers Are Justified

GAO is satisfied that, overall, taxpayers who were audited repetitively by the Internal Revenue Service were audited because their returns fit the usual selection criteria. All returns are selected for audit through the same system, and the system generally protects against selection abuse. Repetitive audits are like all audits in terms of recommended tax increases, indicating that taxpayers were not repeatedly selected unless tax adjustments were probable. Nevertheless, IRS can further reduce the number of repetitively audited taxpayers.



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762

To the Chairman and Vice Chairman
Joint Committee on Taxation
Congress of the United States

This report, one of a series in response to your Committee's request, addresses the reasons why the Internal Revenue Service audits some taxpayers repetitively and the dollar productivity of such audits. The report focuses on individual income tax payers. The Service agreed with our recommendations, and their implementation should further assure that only necessary repetitive audits are performed.

As arranged with your Committee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

A handwritten signature in black ink, reading "Luther B. Stacks".

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO
THE JOINT COMMITTEE ON TAXATION
CONGRESS OF THE UNITED STATES

REPETITIVE IRS AUDITS OF
TAXPAYERS ARE JUSTIFIED

D I G E S T

The Internal Revenue Service (IRS) audits a relatively small number of the individual tax returns filed each year. Even so, some taxpayers are repetitively audited; that is, IRS examines their returns for at least two out of three successive tax years. Does IRS have valid reasons for doing such audits?

Yes.

--IRS' system for selecting returns for audit generally protects taxpayers against abuse. All returns are selected through the same system, regardless of whether it is the taxpayer's first audit or the most recent of several. IRS has no special system that would result in a particular taxpayer's return being audited year after year.

--In terms of recommended tax increases, the results of repetitive audits have been very similar to the results of all audits. In other words, there is no indication that IRS repeatedly selected taxpayers for audit unless their returns indicated a probable tax change.

Obviously, no system is perfect and GAO recommends several ways to improve the selection process. But, overall, GAO is satisfied that taxpayers were audited repetitively because their returns fit the usual selection criteria.

FREQUENCY OF REPETITIVE AUDITS

GAO randomly sampled and analyzed over 2,800 audits of 1,201 taxpayers who had been repetitively audited. The taxpayers had filed their most recent returns in one of six IRS districts where GAO did its work. (See pp. 2 and 41.)

Although a return is filed within an IRS district, it can be audited by either an IRS service center or district office. Most audits, however, have been done by district offices. (See pp. 1 and 4.)

About 25 percent of the taxpayers in the six districts who had an audit closed by a district office during 1975 were repetitively audited. Including service center audits, about 16 percent of the taxpayers experienced repetitive audits. Neither GAO nor IRS can say for sure how many taxpayers have been audited repetitively, because IRS does not have this information. (See p. 3.)

For tax years 1966 through 1974, 57 percent of the sampled taxpayers had two of the returns they filed examined. Another 26 percent had their returns for three tax years examined. (See p. 5.) While all income groups have been subject to repetitive audits, business taxpayers overall were repetitively audited more often and nonbusiness taxpayers with incomes below \$10,000 less often than average. Business taxpayers were audited more frequently primarily because the IRS examiner, while auditing one year's return, believed returns from other years should be audited as well. (See p. 5.)

WHY REPETITIVE AUDITS OCCUR

According to IRS, a return can be selected for audit for 1 of more than 60 reasons. The reasons apply whether it is the first time or the latest of several years a particular taxpayer's return is selected. Overall, about 60 percent of the repetitive audits GAO reviewed resulted from one of three reasons:

- The return received a high score under IRS' computer generated audit selection program.
- The return apparently had an unallowable item(s) on it.

--It was selected by an examiner as a result of auditing another year's return--a multiyear audit. (See p. 8.)

About 68 percent of the sampled taxpayers who were repetitively audited by service centers fit into one of two selection patterns. They were successively audited for unallowable items or for questionable head of household filing status. Many of these taxpayers did not seem to understand why IRS said an item was unallowable.

For example, about 44 percent of the taxpayers audited because of unallowable items were questioned for the same item or items in later audits, even though generally the first audit was closed and the unallowable item explained before the later return was filed. IRS officials agreed to see if the explanations could be made clearer. (See pp. 9 and 10.)

A taxpayer may be audited repetitively for the same or different reasons. For GAO's sampled taxpayers, most first audits--about 60 percent--were generated by computer. For these taxpayers, the second audit most often resulted from computer identification (55 percent) or multiyear examination (20 percent). (See p. 12.)

IRS examiners can in some instances determine on their own that specific returns should be audited. GAO believes IRS should require audit personnel to provide more written justification when requesting a specific return. (See pp. 15 and 22.)

DOLLAR RESULTS

If taxpayers were generally being repetitively audited unnecessarily, the resulting tax increase for each audit and for each hour spent examining the returns would be less than that for all audits. No statistically significant difference of this kind was found, either by return selection category or in total. The mean tax increase

per return in GAO's repetitive audit sample was \$955, compared to \$770 for all audits; and the increase per examiner hour was \$178, compared to \$140 for all audits. (See p. 18.)

NO-CHANGE AUDITS: A PROBLEM
IRS IS WORKING ON

Repetitive audits more frequently resulted in tax changes than did audits generally. But, the amount of change per audit was about the same. Interestingly, the overall no-change rate for first, second, and third audits remained about the same. Moreover, 29 percent of the sampled taxpayers had at least one audit that did not change their tax. This included 8 percent whose tax did not change for each audit. (See pp. 18 and 20.)

Taxpayers who experience repetitive audits that result in no tax change may well find them a source of irritation. Some persons may consider the 8 percent figure too high. Whether it is or not, IRS can be reasonably expected to minimize the number of such audits. While only a perfect selection system would eliminate them all, IRS has begun two new procedures to reduce the number of audits resulting in no or small tax changes.

Taxpayers' assistance

In June 1976 IRS began asking taxpayers to tell it when a scheduled audit is going to review tax issues previously examined in a no-change audit. If the issues are the same, IRS will probably not continue the audit. The procedure is a welcome change. But one problem is that, to be effective, the taxpayer must provide IRS with information. IRS cannot quickly get this information from its records. It should be able to when its computer system is expanded. Until then, IRS will need the cooperation of taxpayers. (See pp. 23 and 26.)

Another problem is more immediately solvable: the procedure does not apply to certain audits done by revenue agents or to cases in which an earlier audit resulted in the taxpayer's receiving a small refund. Taxpayers in such cases should also be given the opportunity to avoid a later audit. (See pp. 29 and 30.)

Prior tax issues not considered

The other procedure IRS implemented also gives GAO concern. When classifying returns for audit potential, IRS will generally pass those of taxpayers whose tax did not change in previous audits, regardless of the issues examined. IRS does not have a system for knowing, at the time of selection, what tax issues were previously examined. Thus, current returns which could be audited for issues different from those previously examined can pass undetected. (See pp. 25 and 26.)

Statistics GAO developed show that the procedure may not be in the Government's and the taxpayers' best interests. About 55 percent of the sampled taxpayers who had a return audited without a tax change had a later return examined. Of that number, 48 percent had their tax changed. Changes that increased tax averaged about \$480 per taxpayer and those that decreased tax averaged about \$282 per taxpayer. Usually, the change audit included one or more issues different from those examined in the no-change audit. Unless IRS gets information on prior issues before it decides which returns to audit, its procedure will not be fully effective. (See p. 31.)

As GAO noted in a previous report, IRS does not know the extent to which audits affect taxpayer compliance. IRS plans to study this. As part of that study, IRS should assess the effect that repetitive audits have and, if warranted, reevaluate its procedures for such audits.

RECOMMENDATIONS

The Commissioner of Internal Revenue should:

- Include repetitive audits in the planned study of factors contributing to voluntary taxpayer compliance with the tax laws.
- When classifying returns for audit potential, discontinue the practice of not selecting returns because earlier audits did not change the tax amount, unless information about the previous issues is available to make a more informed audit/no-audit decision.
- Make the changes specified on page 32 to the taxpayer contact procedure, to prevent unnecessary repetitive audits.
- Require a written explanation and supervisory approval before auditing a return originally obtained for information or reference purposes.

INTERNAL REVENUE SERVICE COMMENTS

IRS agreed with all of GAO's recommendations. The Commissioner of Internal Revenue said the recommendations will provide taxpayers and IRS with further assurance that only necessary repetitive audits are performed. He also believes the report reflects favorably on existing IRS policies and procedures concerning repetitive audits. (See app. I.)

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ABBREVIATIONS

DIF	discriminate function
GAO	General Accounting Office
IRS	Internal Revenue Service

CHAPTER 1

INTRODUCTION

The Internal Revenue Service (IRS) audits a small fraction of the total tax returns filed annually. Even so, some taxpayers incur repetitive audits--IRS examination of two out of three successive tax years. Such examinations prompt many questions: How often are taxpayers repetitively audited? Why is a taxpayer repeatedly selected for audit? Is one group of taxpayers being singled out? Are such audits dollar productive? What is IRS doing to avoid unnecessary repetitive audits? Our review answered these questions.

IRS AUDITS

As part of its mission, IRS strives to encourage the highest possible degree of voluntary compliance with the tax laws--that is, the ability and willingness of taxpayers to accurately assess their taxes. To promote compliance, IRS communicates the requirements of the law to the public, determines the extent and causes of noncompliance, and does whatever necessary to enforce the law.

Of all its enforcement activities, IRS uses the audit of tax returns as the primary means to encourage voluntary compliance. According to IRS, about 36 percent (\$504 million) of its fiscal year 1976 appropriation related to audit activity. During fiscal year 1976, IRS audited about 4.2 million ¹/_{of the 113 million tax returns (all types of taxes) filed in calendar year 1975. About \$5.1 billion in recommended additional tax and penalties resulted from these examinations.}

IRS determines how many returns it will examine each year through an annual planning process. The audits are then done by 10 service centers and 58 district offices located across the country. A district covers part or all of one State while a service center covers a number of district offices.

At the district level, the audit of a return is accomplished through correspondence, or can take place in an IRS office, the taxpayer's home or place of business, or in the

¹/IRS does not consider all of these to be audits. See page 41 and our report "How The Internal Revenue Service Selects Individual Income Tax Returns For Audit," GGD-76-55, Nov. 5, 1976.

office of the taxpayer's accountant or attorney. Audit method and location are governed by such factors as return complexity and the best interest of the Government and the taxpayer. Service centers audit by correspondence, examining returns containing less complex issues.

SCOPE OF REVIEW

The Joint Committee on Taxation requested this study, which focused on filers of individual income tax returns (Form 1040 type returns). To do this study, we reviewed IRS policies, procedures, and records for selecting and auditing individual income tax returns; interviewed IRS examiners and other personnel responsible for the return selecting and auditing processes; and reviewed taxpayers' letters complaining about repetitive audits and IRS responses. We also reviewed the audit histories of 1,201 randomly selected taxpayers who had experienced repetitive audits, and analyzed 2,812 audits of their returns. The procedures followed in selecting and analyzing the sample are presented in appendix II.

We did our work primarily at the IRS national office in Washington, D.C., and at the Philadelphia, Reno, San Francisco, St. Louis, Wichita, and Wilmington district offices. The six district offices are responsible for the eastern half of Pennsylvania, Nevada, the northern half of California, Missouri, Kansas, and Delaware, respectively.

CHAPTER 2

THE EXTENT, BASIS, AND

PRODUCTIVITY OF REPETITIVE AUDITS

While the IRS develops an annual plan as to the number of returns it will examine, it does not plan the number of repetitive audits that will be performed. However, in accomplishing the annual plan, repetitive audits do occur.

Whether an audit is repetitive or not, IRS uses the same system to select the returns. The structure of this system generally protects against abuse in the selection process. However, IRS can take additional measures to make sure taxpayers are not unnecessarily inconvenienced.

The average dollar yields of repetitive audits are about the same as those of all audits. Repetitive audits, however, more often result in a tax change. On the other hand, some taxpayers have experienced repeat audits that have produced little or no tax change. IRS is trying to avoid such audits.

EXTENT OF REPETITIVE AUDITS

Because of data limitations, neither we nor IRS know precisely how many taxpayers have been repetitively examined. But it is clear from our sample data that repetitive audits are done more often by districts than service centers. About 16 percent of the taxpayers incurring either a district or service center audit during 1975 had experienced repetitive audits. For districts alone, the percentage of repetitively examined taxpayers was 25 percent.

Repetitive audit frequency can also be viewed in terms of the number of times taxpayers are audited. IRS records show that most of our sampled taxpayers had not more than three tax years examined over a 9-year period. Taxpayers, however, have complained of more audits than are shown by IRS records. This may be due to a difference between IRS' definition and taxpayer perception of what constitutes an audit.

Percentage of taxpayers audited during 1975 who had been repetitively examined

IRS records the audits of individual taxpayers on a computerized master file. According to master file information, about 16 percent of the 389,000 taxpayers in the six districts who had a service center or district audit closed during 1975 had incurred repetitive audits.

However, taxpayers audited by district offices are more likely to incur repetitive audits. To illustrate, district offices performed about 70 percent of all individual return audits during fiscal year 1974. In contrast, district offices performed about 83 percent of our sample audits done in fiscal year 1974. Based on certain assumptions ^{1/} applied to the master file data, we estimate that 25 percent of the taxpayers who incurred a district audit in 1975 had been repetitively examined.

The higher number of repetitive audits at the district level is probably related to the differences in content and timing between district and service center examination programs. Most service center examinations begin soon after IRS receives a return and, because they involve relatively uncomplicated issues, can usually be completed before the next return is filed. Districts, however, generally begin auditing returns later than service centers and take longer to complete them because of the issues involved. The district-audited taxpayer, therefore, usually has less opportunity than the service-center-examined taxpayer to avoid repeating any previous error when filing the next return.

Neither we nor IRS know the exact number of taxpayers who have been repetitively examined. IRS has maintained statistics on the number of returns examined but not the taxpayers. Further, the Individual Master File, the only practical source for identifying repetitively examined taxpayers and measuring repetitive frequency, does not include every taxpayer and tax year that has been audited. After varying periods of inactivity, taxpayer accounts and tax years are removed from the file. The percentages we computed, therefore, are conservative estimates based on the best available data.

^{1/}Two assumptions were used: (1) the service center to district audit ratio for the districts reviewed does not differ from the national ratio, and (2) the service center to district audit ratio for repetitively examined taxpayers audited in 1975 does not differ from the 1974 ratio in our sample. The use of a national ratio in the first assumption was necessary because IRS does not maintain statistics showing service center audits according to district.

Number of audits per sampled taxpayer

Repetitive frequency includes not only how many taxpayers are affected but how often each is examined. We therefore determined how many tax years our sampled taxpayers had been audited over a 9-year period--tax years 1966 through 1974. For the returns that had been filed, most taxpayers had two or three tax years examined as shown by the following table:

<u>Number of tax years examined</u>	<u>Percent of tax- payers in sample</u>
2	57
3	26
4	10
5 or more	7

Note: The greatest number of tax years examined for a given taxpayer was seven.

To cover the 9-year period for each sampled taxpayer, we supplemented the master file listings primarily with data from IRS microfilm records. However, our analyses of why repetitive audits occur, their dollar productivity, etc. were limited to those audits shown by the listings. The results of these analyses are presented in this chapter.

Repetitive audits by income group

IRS records the number of returns examined by taxpayers' adjusted gross incomes, or audit classes. At the time of our review, incomes were grouped into seven audit classes, three for business and four for nonbusiness taxpayers. The business classes are composed of those individuals who attach a Schedule C (Profit and Loss from Business or Profession) or Schedule F (Farm Income and Expenses) to their returns. The nonbusiness classes include all other individual taxpayers.

To determine if one income group was being repetitively audited more than another, we used the seven audit classes to compare the audit classes for the district audits in our sample to the total combined audit closings of the six districts reviewed. ^{1/} The comparison disclosed that while all income groups have been subjected to repetitive audits, business taxpayers, overall, were repetitively audited more often

^{1/}See app. II for the procedure we followed to make this and other comparisons presented in this chapter.

and nonbusiness taxpayers with incomes below \$10,000 less often than average. The major reason business taxpayers have been repetitively examined more often stems from the frequency with which they receive "multiyear" audits. Such audits occur when the examiner, while auditing one return, believes it necessary to audit the same type of return filed by that taxpayer for another year(s). In our sample, multiyear audits caused 25 percent of the business examinations but only 6 percent of the nonbusiness examinations.

The following table presents the comparison between the sample and the total district data.

<u>Audit class</u>	<u>Audit frequency</u>	
	<u>Repetitive audits (note a)</u>	<u>All audits</u>
	(percent)	
Nonbusiness:		
Less than \$10,000 (standard deduction)	9	11
Less than \$10,000 (itemized deductions)	26	34
\$10,000 to less than \$50,000	34	34
\$50,000 or more	3	3
Business:		
Less than \$10,000	10	8
\$10,000 to less than \$30,000	10	6
\$30,000 or more	<u>8</u>	<u>4</u>
	<u>100</u>	<u>100</u>

a/Based on our sample analysis.

Taxpayers have complained of more audits than IRS records show

Taxpayers have written IRS and/or their congressional representatives to complain about being audited repeatedly. The number of audits mentioned by the taxpayers is sometimes greater than shown by IRS records. Of 69 complaint letters received by the six districts that we reviewed, about 40 percent were in this category. IRS, in replying to these letters, usually indicated that its records showed fewer examined tax years but did not explain why there might be a difference.

One possible explanation for the difference concerns IRS' audit definition versus the taxpayer's perception of an audit. ^{1/} IRS says an audit occurs only when the taxpayer's books and records are examined--for example, when the taxpayer provides receipts and canceled checks to substantiate claimed deductions. Pragmatically, taxpayers may perceive that any IRS question about their return was generated by an audit. This could certainly be the case if the taxpayer provides an IRS examiner copies of prior or subsequent year returns. This situation is discussed below.

Inspection versus examination

During the course of auditing one year's return, the IRS examiner may ask to see or inspect the taxpayer's copy of another year's return. An inspection, according to the Internal Revenue Manual, is " * * * essentially equivalent to the classification of a return to determine if an examination is necessary. This means that no records should be examined and no questions asked the taxpayer concerning the copy inspected."

The number of inspected returns differs among districts. In one district reviewed, for example, the general policy is for revenue agents to inspect both the preceding and subsequent tax year returns, while in another district agents are required to inspect subsequent year returns only.

Taxpayers may be confused about inspections because IRS does not require that they be told that an inspection rather than an audit is occurring or, if told, may not understand or accept the difference. We spoke to 56 examiners about their practice of informing taxpayers of inspections. Eighty-four percent said they inform taxpayers, and 16 percent said they did not. Some of those who informed taxpayers believed that even when the difference between audit and inspection is explained, taxpayers can still be confused about the matter.

^{1/}IRS considers few taxpayer contacts made by its service center audit divisions to be audits but, because of the way they are recorded, such contacts would not cause the difference between the tax year numbers cited by taxpayers and IRS records.

Examiners are also confused about the difference. We asked the 56 examiners to describe what they do when inspecting returns. All but one said they would not ask to see the taxpayer's books and records. However, when it comes to asking taxpayers questions, about 36 percent said they would ask general or specific questions about the inspected return. The other 64 percent said they would not ask any questions. Therefore, what one examiner considers an inspection, another may consider an audit.

We discussed our observations with IRS officials. To reduce the confusion about the difference between an inspection versus an audit, they agreed to

--remind all examiners of the Internal Revenue Manual procedure concerning inspections, and

--amend the manual to require examiners to inform taxpayers about the purpose and results of inspections.

BASIS FOR REPETITIVE AUDITS

All returns, whether a taxpayer is examined repetitively or nonrepetitively, are selected through the same audit selection system. In a previous report we concluded that there generally is little chance for abuse in the selection process. 1/

IRS has identified more than 60 reasons for selecting returns for audit. 2/ Any one or a combination of these reasons may cause a taxpayer to be repetitively examined. Cumulatively, about 60 percent of the audits we reviewed resulted from three reasons--computer score, identification of unallowable items, and expanding an audit to cover a later return (multiyear audits).

Why service centers selected taxpayers for repetitive audits

In years past, IRS neglected from an audit standpoint millions of individual income tax returns containing small errors because correcting such errors through full-fledged

1/Report to the Joint Committee on Taxation, "How The Internal Revenue Service Selects Individual Income Tax Returns For Audit," GGD-76-55, Nov. 5, 1976.

2/IRS calls the reasons source codes.

district audits was considered too costly. In searching for ways to obtain additional audit impact, IRS turned to its service centers and focused on these returns beginning in 1972. Since then IRS has developed a number of service center examination programs, 12 of which were operational during our review. (See app. III.)

Our sample included 425 service center audits, broken down by program as follows:

	<u>Percent</u>
Unallowable items	58
Head of household filing status	22
Discriminate function (DIF) (note a)	11
Claims	5
All other	<u>4</u>
	<u>100</u>

a/See p. 49 for an explanation of the DIF system.

These 425 audits involved 286 taxpayers, about 24 percent of our taxpayer sample. Of the 286 taxpayers, 125, or about 44 percent, were audited more than once by a service center.

There were many combinations of reasons why the 125 taxpayers were audited more than once by service centers. But two combinations most commonly occurred--an unallowable items audit followed by another unallowable items audit, or a head of household audit followed by another head of household audit. About 68 percent of the 125 taxpayers received multiple unallowable item or head of household examinations.

Notwithstanding the relatively few service center audits, there are indications that taxpayers do not understand why IRS said an item was unallowable. Under the unallowable items program, IRS sends the taxpayer a letter which tells him (1) about the problem with his return, (2) how the problem affects his reported tax liability, and (3) what to do if he agrees or disagrees with IRS' finding.

When the taxpayer does not understand the problem or does not accept IRS' explanation, he probably will file his subsequent return as he did before. In our sample, about 44 percent of the taxpayers who experienced multiple unallowable item examinations had the same item(s) questioned in the later audit. This occurred even though the first audit was generally closed and the unallowable item explained before the subsequent return was filed. For example, IRS disallowed the automobile license fees

deducted by one taxpayer in successive returns and the amount of child care expenses claimed successively by another taxpayer.

IRS is trying several approaches to improve taxpayer performance in these areas. In reply to previous recommendations, ¹/ IRS said it would change its letters notifying taxpayers of an unallowable item by (1) revising the letters' format and (2) asking taxpayers to explain why they believe a questioned item is allowable.

We discussed with IRS officials the indication from our current analysis that taxpayers are having difficulty in understanding the unallowable explanations. The officials agreed to review the current explanations and change the language as necessary to make them more easily understood by taxpayers.

Why districts selected taxpayers for repetitive audits

Most returns selected for audit by district offices involve issues that are not as readily identifiable or as easily resolved as those examined by service centers. At the district level, the reasons for selecting and examining returns are usually grouped into six major categories. Each category is listed below with the percentage it represented of the district audits we reviewed.

<u>Return selection category (note a)</u>	<u>Percent of district audits in our repetitive sample</u>
Computer identified returns	53
Audits initiated by IRS and others	11
Claims and other refund requests	6
Related pickups	9
Multiyear audits	12
Miscellaneous	<u>9</u>
	<u>100</u>

^a/App. IV describes the selection categories, lists the reasons within each category, and provides the percentage of district audits we reviewed by selection reason.

¹/See pp. 12 and 13 of our report to the Joint Committee on Taxation, "Audit Of Individual Income Tax Returns By The Internal Revenue Service," GCD-76-54, Dec. 2, 1976.

In many instances, the reason recorded for selecting a return for audit is a judgmental decision on the part of audit personnel. They select the one reason which, in their judgment, best explains why the return is being selected. Because of the nature of service center audit programs, this judgmental decision comes into use more at districts than service centers. The selection reasons IRS had recorded for the returns in our sample were generally appropriate.

Selection pattern between repetitive and all audits

Repetitive audits done by districts were generated from the same selection categories as audits in general. However, as shown below, the proportion of repetitive audits generated from each selection category differs from that found in the total audit population.

<u>Reason category</u>	<u>District audits in sample closed after 9/72 (note a)</u>	<u>All audits closed by the six districts reviewed from 7/72 to 6/75 (note a)</u>
	(percent)	
Computer identified	54	68
Initiated by IRS and others	10	12
Claims	6	4
Related pickups	8	4
Multiyear audits	12	5
Miscellaneous	<u>10</u>	<u>7</u>
	<u>100</u>	<u>100</u>

a/The comparison covered approximately the same time frame. See pp. 43 and 44.

These differences result from a characteristic which is more common to repetitive audits than to the total audit population. Many of the sampled audits, while repetitive in number, were performed simultaneously--that is, two or more of the taxpayer's returns were audited at the same time. Excluding computer identified audits, the number of simultaneous audits in our sample ranged from 58 percent in the "initiated by IRS" category to 93 percent in the multiyear category.

Simultaneous audits are not as common in the total audit population. Rather, computer identification is the principal way IRS selects returns to audit and this process is independent from year to year. Thus, the computer identification category in a sample of repetitive audits would logically decline relative to other selection categories. Conversely, the other selection categories would logically increase relative to the computer identification category.

The differences discussed above indicate that many repetitive audits are based on audit personnel belief that the potential tax consequences are significant enough to warrant examination of more than one return filed by a given taxpayer. Therefore, from a practical standpoint, the reasonableness of auditing taxpayers repetitively can best be evaluated by analyzing dollar yields achieved. Our comparison of dollar yields between repetitive and all audits showed that they are about the same. (See pp. 18 through 19.)

Selection patterns among repetitively examined taxpayers

A taxpayer may be audited repetitively for the same or different reasons. To determine if a pattern of reasons existed among repetitively audited taxpayers, we identified the most frequent reason for first audits and then related it to the reasons for the second and third audits. The audits were those shown on the master file listings for our sampled taxpayers. While both service center and district audits were included, the patterns found generally represent district selection reasons.

Most first audits--about 60 percent--were computer identified. The next most frequent reason was the unallowable items program which caused 7 percent of the first audits.

The computer identified first audits were most frequently followed by computer identified second audits. Computer identified returns are generally examined independently of one another. The next most common reason for the second audits was multiyear pickups. Tax returns selected because of multiyear pickups would, by definition, be examined during the audit of the computer identified returns, and would not be considered repetitive by IRS. Computer identified and multiyear audits accounted for 55 and 20 percent, respectively, of the related second audits.

Only a small number--14 percent--of the sampled taxpayers who experienced a computer identified first audit also had a third audit within our sample. However, for those who did, it too was usually computer identified (47 percent) or caused by a multiyear audit (16 percent).

Because of the small number, we did not analyze reason relationships beyond the third audit. We did, however, ascertain the primary reason sampled taxpayers incurred more than 3 audits. We considered a reason as being "primary" if it accounted for half or more of the total audits the taxpayers had incurred as shown on the master file listings. Seventy-two of the 1,201 sampled taxpayers had more than 3 audits. The primary reasons for these audits were generally in the computer-identified, examiner-initiated, or taxpayer-caused areas. For about 24 percent of the 72 taxpayers, no single reason was frequent enough to qualify as primary. Following is a summary of the reasons why sampled taxpayers incurred more than three audits.

<u>Primary reason</u>	<u>Percent of taxpayers</u>
Computer-identified	25
Examiner-initiated:	22
Multiyear audits	13
Related pickup of partner, shareholder, or corporate officer	9
Taxpayer-caused:	20
Requests for refunds	11
Delinquent returns	5
Fraud	4
Intelligence division referrals	6
Other	3
No primary reason	<u>24</u>
	<u>100</u>

Examiner initiated repetitive audits

In most instances, the person who examines the return does not initiate the selection process. But examiners can and do select specific returns to audit. For example, an examiner, while auditing one year's return, can request and audit the taxpayer's return for another year. While no service center audits in our sample were examiner initiated, about 27 percent of the district audits were.

Audits initiated from information reports

After auditing a taxpayer, the examiner may write an information report which can lead to a future audit of the taxpayer. Because of its particular nature, we reviewed the "information" selection reason in more detail.

Under the information report procedure, the examiner completes a form providing the reasons, and their source, for another possible audit. The form or report can apply to either a filed return or the next return that should be filed. The examiner submits the completed form to his immediate supervisor for approval. The supervisor should approve it only if the audit effort required would generate a material amount of additional or delinquent tax. An approved report is next screened for potential by district classification personnel. A report may be rejected if the classifier believes, for example, that it contains insufficient information to permit an efficient followthrough or cites a tax issue not worthy of a followup audit.

A report accepted by a district classifier is sent to the appropriate service center where it is eventually associated with the affected return. The report and return then go to the service center audit division where a classifier decides whether the return should be examined. The classifier may select the return for audit because of issues other than those raised in the information report. A return selected for audit is sent to the district that generated the report, where it may again be classified in terms of need for audit.

The Internal Revenue Manual directs examiners to prepare information reports in specified instances. For example, the manual states that an information report will be completed when the examiner finds that the taxpayer has failed to keep adequate records to properly substantiate entertainment and other business expenses. When the information report is about inadequate business records, the manual instructs classifiers to select the associated returns for audit unless it appears that the taxpayer is no longer in business or is no longer claiming deductions for business expenses.

We reviewed 319 information reports provided by IRS and written by audit personnel from the six districts studied. The reasons cited in the reports generally appeared to justify classification of the subject returns. For example:

- 96 reports (30 percent) concerned an adjustment made to income or income that should be reported.
- 46 reports (14 percent) noted that the taxpayer had no support for questioned items, maintained inadequate records, or apparently did not file a return.
- 42 reports (13 percent) involved items that would be carried forward to future returns or items involving capital gains and losses.
- 18 reports (6 percent) discussed the current disallowance of claimed exemptions.
- 17 reports (5 percent) dealt with depreciation items.

Although an examiner initiates the information report process, a return is selected for audit only after numerous IRS personnel separate from the examiner evaluate the need for an audit. We believe the procedures for using the information report process are generally adequate to protect against abuse in selecting taxpayers for audit.

Other examiner initiated audits

The examiner can obtain a given return through his own initiative by preparing a requisition which must be approved by his immediate supervisor. On the requisition the examiner indicates, by a code number, the reason he is requesting the return. For example, one code indicates that the return is being requested because it was filed by the taxpayer's partner. The examiner is not required to provide any more information to justify the request. If the requisition is approved, the return is forwarded from storage directly to the examiner. This requisition procedure is generally followed under all the examiner initiated selection reasons.

In our report "How The Internal Revenue Service Selects Individual Income Tax Returns For Audit" (GGD-76-55, Nov. 5, 1976), we recommended that IRS, to further protect against abuse during the audit selection process, require its examiners to explain on the requisition why they need the return. IRS did not agree with that recommendation and said the codes are sufficiently comprehensive in most instances to determine why the return was requested. IRS added that it was reviewing the selection codes to insure their proper definition. Since then, IRS has revised certain code definitions but has not required examiners to provide written explanations for returns they select to audit. Because of

the many examiner initiated audits (about 27 percent) in our sample and the reasons given in our previous report, we continue to believe the examiner should explain in the requisition why the return is requested.

In addition to requisitioning returns directly for audit, examiners obtain returns for information purposes. These returns may later be examined. Although the examiner indicates on the requisition why the return was requested for information purposes, he is not required to either document why the audit was necessary or seek the written approval of his supervisor to audit the return. Both of these steps should be taken to provide greater taxpayer protection against unwarranted audits.

IRS POLICY ON CONSECUTIVE AUDITS BY THE SAME EXAMINER

When the same examiner repetitively audits a taxpayer, audit objectivity may suffer and the taxpayer may feel harassed. To avoid this situation, IRS has a policy generally restricting an examiner from auditing--except simultaneously--a taxpayer's return for consecutive years. There is, however, no implementing system. Rather, IRS generally relies on the memory of its personnel to prevent violations.

About 32 percent of the IRS examiners and supervisors we interviewed were unaware of the policy. Nevertheless, we found only 15 violations among our sampled taxpayer cases. In those cases where the policy was violated, the examiner usually did not identify the taxpayer's returns for audit, and when the examiner did, it appeared to be a reasonable extension of the closed initial audit.

That there were not more violations can be attributed more realistically to the return selection and assignment system than to the policy's existence, especially since the policy has not been formally implemented. Repetitive audits by the same examiner are more of a problem in some offices because of staffing numbers. However, the number and nature of the policy violations do not indicate the need for a formal and probably costly procedure to implement the policy.

PRODUCTIVITY OF REPETITIVE AUDITS

IRS' audit selection methods are designed to identify returns with potential for tax change. Therefore, if

taxpayers were generally being repetitively audited unnecessarily, the average amount of tax change from repetitive audits would be less than the average from all audits. This was not the case in our sample. While some sampled taxpayers incurred audits resulting in little or no tax change, the average dollar productivity of the repetitive audits was similar to that for all audits.

Productivity of service center audits

While each service center serves more than one IRS district, IRS does not accumulate service center statistics by the districts served. In the absence of such statistics for the six districts in our review, we compared the service center audits in our sample that were closed after September 1972 to the combined national service center averages for fiscal years 1973, 1974, and 1975.

With the exception of head of household audits, there was no statistically significant difference between the dollar yield of repetitive audits and all audits for each service center program. For the head of household program, the no-change rate $\frac{1}{2}$ of repetitive audits was significantly higher than that for all head of household audits.

Qualified taxpayers can use the head of household tax rate to compute their tax liability. To generally qualify for this lower rate, taxpayers must be single or legally separated on December 31 and have paid more than half the cost of maintaining the principal home of a relative or foster child. The relative must be the taxpayer's dependent for tax purposes unless he or she is the taxpayer's unmarried child, grandchild, stepchild, or foster child. IRS' current return preparation instructions specify that when claiming the head of household rate, names of nondependent relatives must be written in the space provided on the return. However, prior to tax year 1974, the return did not include this space and taxpayers were not instructed to list the nondependent relative.

To be filed correctly, the head of household return should include at least two exemptions--one for the taxpayer and one for the dependent relative--unless the relative is a nondependent. Under IRS' head of household program,

$\frac{1}{2}$ /The rate of audits resulting in no change to the tax liability reported by the taxpayer.

returns are identified by computer when the head of household rate is used but only one exemption has been claimed. These returns are then manually screened to determine if a non-dependent relative is listed. If not, the taxpayer's use of the rate is questioned. Prior to 1974 returns, the taxpayer's use of the rate was questioned once the return was computer identified because manual screening for nondependent relatives was not possible.

All of the audits for 29 of the 33 sampled taxpayers who incurred multiple head of household audits ended without change to the reported tax liability. These audits generally involved 1972 and 1973 returns which did not require that nondependents be listed. Whether the no-change rate for repetitive audits lessened when taxpayers were instructed to list nondependents is unknown.

Productivity of district audits

If taxpayers are generally incurring unnecessary repetitive audits, the resulting dollar yield per audit and per examiner hour would be less than that for all audits. Moreover, repetitive audits would more frequently result in no tax change than would all audits.

Our comparisons showed that, on the average, repetitive audit productivity per audit and per examiner hour was about the same as the productivity of audits in general. There was no statistically significant difference between repetitive audit dollar yield--either by selection category or in total--and the dollar yield for all audits. The mean tax increase per return in our repetitive audit sample was \$955 compared to \$770 for all audits, and yield per examiner hour was \$178 compared to \$140 for all audits.

Our comparisons also showed that repetitive audits more frequently resulted in tax change than did audits in general. As shown below, the no-change rate differences between repetitive and all audits were statistically significant for four of the six selection categories and for all categories combined.

<u>Selection category</u>	<u>Percent no-change returns</u>		<u>Statistically significant difference</u>
	<u>Repetitive</u>	<u>All audits</u>	
Computer identified	22	33	Yes
Initiated by IRS and others	18	24	Yes
Claims (note a)	12	3	Yes
Related pickup	4	10	Yes
Multiyear audits	7	9	No
Miscellaneous	24	27	No
All categories combined	18	28	Yes

a/For claims a no change represents nonacceptance of the claim.

In summary, our comparisons show that repetitive audits are more likely to result in a tax change than are audits in general, but the amount of tax change per audit is about the same. Consequently, we believe there is no reason, from the standpoint of overall productivity, why repetitive audits should not be performed.

Audit productivity on a taxpayer basis

The preceding analysis indicates that the productivity of repetitive audits on the average compares favorably with that of all audits. It does not, however, address the extent to which individual taxpayers are subjected to repetitive audits that consistently result in low yields or no changes. In terms of yield, such an analysis is complicated by two major factors. First, IRS does not maintain statistics on a per-taxpayer basis, thus there is no general benchmark against which to compare the yield per audit for individual taxpayers. Second, the results of service center and district audits must be combined since taxpayers may experience both types over any given period of time. Because service center and district audits have different average yields and no-change rates, combining them could result in distortion leaving the question of relative productivity unanswered. Recognizing these factors, we analyzed the productivity of repetitive audits on an individual taxpayer basis.

Dollar yield of frequent audits

We selected those taxpayers in our sample who had been audited three or more times to assess the productivity of repeatedly auditing the same taxpayer. We excluded audits

of taxpayers' claims and IRS employees from our analysis and, as in our other productivity computations, audits completed prior to October 1972.

Of our sampled taxpayers, 145 (12 percent) had been audited three or more times. These taxpayers incurred an average of \$2,000 per audit in recommended additional taxes and penalties. This amount exceeds the \$144 average for all service center repetitive audits and the \$955 average for all district repetitive audits in our sample. However, the additional taxes plus penalties per taxpayer varied considerably. Of the 145 taxpayers, 20 (14 percent) had an average increase of \$50 or less per audit. Conversely, the average increase for 26 other taxpayers (18 percent) ranged from about \$2,000 to \$69,000.

Because of the small number of sampled taxpayers who were audited three or more times, the variation in tax changes experienced by them, and the absence of a benchmark for identifying a productive audit, it is impossible to determine the relative productivity of repeatedly auditing the same taxpayer. However, we believe that these taxpayers, on the whole, were not audited unnecessarily since 86 percent of them incurred an average increase of more than \$50 per audit.

Number of taxpayers experiencing no-change audits

The repetitive audits in our sample, when considered overall, have statistically significant lower no-change rates than those for audits in general. However, contrary to expectation, the overall no-change rate for first, second, and third audits remain about the same. Although factors such as simultaneous audits help explain why the rate does not change as audits increase in number, we believe another reason is the limited use made of information obtained from prior audits. Chapter 3 discusses the procedure IRS is presently implementing to make better use of this information.

We also analyzed 1/ our taxpayer sample to determine the extent to which individual taxpayers were experiencing repetitive no-change audits. The analysis showed that 29 percent of the sampled taxpayers had experienced at least one no-change audit. This total was composed of

1/All audits listed by the master file for each sampled taxpayer were used in this analysis, excluding audits of taxpayers' claims and of IRS employees.

--20 percent who had one no-changes and one or more change audits,

--1 percent who had two or more no-change audits plus one or more change audits, and

--8 percent who had all no-change audits.

Taxpayers who experience repetitive no-change audits may well find them a source of irritation and some may view the 8-percent figure as being too large. As discussed in chapter 3, IRS has taken recent actions which should reduce the number of repetitive no-change audits, but some will continue to occur. Only a perfect selection system would eliminate all such audits.

Number of taxpayers experiencing small-change audits

We also analyzed 1/ the extent to which taxpayers were being repetitively audited but experiencing only small tax changes. We defined "small" as being tax increases of less than \$50 or refunds of less than \$10. Only 12 percent (150) of the sampled taxpayers were in this category, about two-thirds of whom were the taxpayers discussed above who experienced all no-change audits.

Service center audit programs were developed to correct small tax errors and, as might be expected, many of the 150 taxpayers had two or more service center audits. For example, 9 percent had two or more tax returns examined under the unallowable items program, and 19 percent had two or more audits under the head of household program. IRS does not consider actions under those programs to be audits.

Although our analysis shows that small change audits occur, many are probably unavoidable given existing service center selection criteria. We did not attempt to determine whether this criteria should be changed.

CONCLUSIONS

Among the important elements of a repetitive audit situation is why a taxpayer was selected for audit and the dollar results of those audits. Taxpayers' returns are selected by IRS for repetitive audit for any number of

1/All audits listed by the master file for each sampled taxpayer were used in this analysis, excluding audits of taxpayers' claims and of IRS employees.

reasons. However, these reasons are the same reasons all audits are generated.

Our previous review of IRS' return selection process found that taxpayers are generally protected against selection abuse but that IRS should require examiners to explain on the requisition form why they need a return. IRS has taken steps to help insure that audit personnel are obtaining returns for valid reasons. For example, the computer will not accept return requisitions prepared by audit personnel when the reason provided is DIF or unallowable items. However, while we found no evidence to indicate that examiners were initiating audits for the purpose of intentionally harassing taxpayers, we continue to believe that IRS can further strengthen the return selection process by requiring more written justification for obtaining and auditing a return.

Repetitive audits, overall, are as productive as audits in general. Therefore, considering that average repetitive audit productivity is equal to that for audits in general, that the related dollar amounts are significant, and that there is no legal reason for forgiving a taxpayer a significant amount of tax owed, we believe repetitive audits should be performed.

On the average, repetitive audits have a lower no-change rate than do audits in general. Even so, some taxpayers experience repetitive audits resulting in little or no tax change. Reducing the number of such audits would increase average productivity and enhance IRS' public image. IRS actions to reduce the number of repetitive no-change audits are discussed in the following chapter.

RECOMMENDATION TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that the Commissioner require a written explanation and supervisory approval before auditing a return originally obtained for information and reference purposes.

INTERNAL REVENUE SERVICE COMMENTS

The Commissioner of Internal Revenue agreed with our recommendation and will require supervisory approval before an examiner begins an audit of a return initially obtained for information and reference purposes. (See app. I.)

CHAPTER 3

WHAT IRS IS DOING TO AVOID

UNNECESSARY REPETITIVE AUDITS

When deciding whether to select a return for audit, IRS personnel generally know if the taxpayer was audited previously and the dollar results of the audit. However, they generally do not know what tax issues were previously examined because such information is not readily available.

To avoid unnecessary repetitive audits, however, IRS amplified its classification procedures in 1975, and later began asking taxpayers to identify, in certain cases, a pending repetitive audit dealing with issues examined previously. After being notified by the taxpayer, IRS may terminate the audit. We believe the classification procedure in its present form should be discontinued and the types of cases covered by the taxpayer notification measure broadened.

AVAILABILITY OF PAST AUDIT INFORMATION

After an audit is closed, districts send the return and the examination workpapers--the audit file--to the appropriate service center. There, the audit results (dollar increase, decrease, or no-change) are recorded in computer form but the tax issues (for example, medical expenses, cost of goods sold) that were examined are not. Then the audit files are shipped to Federal records centers located in various sections of the country. ^{1/} Returns examined by service center audit divisions are processed in the same manner as district-examined returns.

The dollar results of an audit are ultimately posted to the taxpayer's Individual Master File account. The account is also posted to show instances where the audit division reviews a return for audit potential and decides to accept the return as filed.

Audit division knows past audit results but not issues examined

Returns requested by the audit division are accompanied by a control record showing the most current tax year audit

^{1/}Nonexamined returns are also stored in the records centers.

information in the taxpayer's master file account. Before October 1976, this information was provided only for computer identified returns; since then it has been provided for all returns. This data helps audit division personnel know whether the taxpayer has been previously audited and, if so, the latest tax year examined and the dollar results of that examination.

The control record, however, does not tell what tax issues were previously examined. To obtain this information, the past audit file must be requested from the Federal records center or a document listing the issues must be kept locally for reference. Neither is generally done because, according to IRS, the time and costs involved would be significant.

IRS is developing a computerized system to replace the one currently used for tax administration. IRS is considering, as part of this system, the computerization of issue data for reference if a taxpayer's subsequent return enters the audit selection process. While a fully operational system is some time away, an interim measure, scheduled to begin in calendar year 1978, has been approved for use when an audit results in no tax change. In such cases, up to five examined issues will be computerized.

To date, IRS has taken three distinct approaches to try to prevent unnecessary repetitive audits. Two of these did not require that specific information about previously examined tax issues be obtained. The third and most recent approach relies on taxpayers to pinpoint cases where issue information should be obtained.

COMPUTERIZED APPROACH TO CURTAIL DIF SELECTED REPETITIVE AUDITS

In January 1972, IRS initiated a computerized procedure to exclude from the DIF inventory those returns where the last audit resulted in no change. Under the DIF system (see p. 49), high scored returns are listed on the DIF inventory file. When a district or service center audit division orders DIF scored returns to classify and audit, those in the inventory are sent.

Under the computerized procedure, IRS went back two tax years from the one being filed to see if an audit had occurred. The most recent year audited and the results of that audit determined whether the current return would be excluded from the DIF inventory. The procedure, in effect, permitted two tax years to pass after a no-change audit

before the taxpayer would again be selected for audit through DIF. ^{1/} However, the taxpayer's current return could be selected for audit under another selection method. For example, the return would be examined if it was "picked up" because of a partnership audit.

The computer procedure was terminated in March 1975, essentially because:

- The public became aware of the procedure causing IRS to be concerned about future compliance problems. IRS feared some taxpayers might take advantage of the possibility that their subsequent returns would be free from audit.
- IRS was not completely satisfied with the procedure because it excluded certain returns from DIF inventory that should have been examined. These returns contained issues such as a capital gain or casualty loss which are inherently different each year and, therefore, susceptible to annual audit.

The procedure was replaced with a manual screening process.

CLASSIFICATION APPROACH TO PREVENT REPETITIVE AUDITS

The classification approach involves a visual screening of the return by audit personnel and applies basically to the DIF selection method (see p. 49). Like its computerized predecessor, it requires that the taxpayer's previous no-change audit be considered when evaluating the need for another audit. Returns, however, are not automatically excluded from audit solely due to the no-change examination because audit personnel must consider also the tax issues present in the current return.

^{1/}IRS used two years to avoid auditing the taxpayer indefinitely. Also, if the taxpayer's return was selected for audit in the third year and found to have an issue that would be present in earlier years, IRS could still audit the two prior returns. By law, IRS generally has 3 years in which to audit a return.

Audit personnel are not to select certain returns for examination

The Internal Revenue Manual instructs audit personnel to review the return control record to see if an audit for one of the two immediately preceding tax years ended without adjustment. If it did, the return being considered for audit is not to be examined unless the questionable issue (or issues)

- was not considered during the no-change audit (for example, capital gains, casualty losses, and other nonrecurring items);
- was erroneously considered during the no-change audit; and/or
- was considered, but should be reconsidered because the facts and circumstances are subject to change and there is a high probability of change.

To determine whether the questionable issues meet the criteria, audit personnel are instructed to use their best judgment when the audit file is not at hand. The manual does not require that the file be obtained. If there is some question whether to select the return, the manual stipulates that it not be selected.

IRS is saying, in effect, that taxpayers generally will not be audited if they experienced a recent no-change examination. Without the audit file, which is generally not obtained, the classifier or examiner cannot be sure what issues were previously examined. Because the past issues and circumstances are not known, the current return, according to the manual, will not be examined. Taxpayers whose current returns contain issues different from those previously examined without change may benefit from this procedure.

TAXPAYER NOTIFICATION APPROACH TO REDUCE REPETITIVE AUDITS

IRS has taken another measure to further reduce unnecessary repetitive audits. It is asking taxpayers to bring to its attention scheduled audits which will cover the same tax issues previously examined without adjustment. IRS will then decide whether to continue the audit. This procedure, which became effective in June 1976, does not apply to certain examinations conducted by revenue agents or to cases where the prior audit resulted in the taxpayer's receiving a small refund.

How taxpayers are informed of the procedure

IRS notifies most individual taxpayers by letter that their return is under examination. The letter tells the taxpayer what issues will be examined, what supporting documents are needed, and whether to mail IRS the documents or bring them to an IRS office. IRS is using the letter to inform the taxpayer of the notification procedure, and has revised it to say:

"* * * if your tax return was examined in either of the two previous years for the same items checked on this letter and the examination resulted in no change to your tax liability, please notify [IRS] as soon as possible. The examination of your return will then be suspended pending a review of our files to determine whether it should proceed."

Although the procedure became effective in June 1976, the letters (IRS uses more than one form) were not available for district use until early 1977.

While the letter doesn't mention it, the procedure also applies to cases where the prior audit resulted only in a small tax increase. This is not mentioned because IRS intends to treat future examinations ending in small tax increases as regular no-change audits. The taxpayer will not have to pay the increase and IRS will record it as a no-change audit. This change became effective in December 1976.

Ending the examination

When a taxpayer responds that a past audit ended without adjustment, examiners are instructed to take the following actions:

- If the taxpayer responds before a scheduled interview that his return for either of the two preceding years has been audited for the same issues and the audit resulted in no change or a small tax change, the examiner should advise the taxpayer that his appointment is postponed pending a review of his files and should obtain a transcript of the taxpayer's master file account for the two preceding tax years.

- If the taxpayer alleges such prior audit activity during an interview and is reluctant to substantiate the deduction for the current year, the interview should be concluded and the examiner should obtain a transcript of the taxpayer's account for the two preceding years.
- If the taxpayer volunteers prior year records showing that the issues in the prior audit are the same as in the current year, the examiner will obtain a transcript of the two tax years preceding the one under audit. The examiner may conclude the current examination when the transcript shows no change or a small tax change for the corresponding audit and no substantive change for the remaining year. In cases where a substantive change occurred, the audit files will be obtained and reviewed as though the taxpayer did not furnish records.
- If the taxpayer does not furnish prior year records, the examiner will requisition the return(s) and the related case files for the year(s) showing audit activity on the taxpayer's transcript of accounts. The examiner will determine from the case files whether the issues currently under examination relate clearly enough to a prior year no-change or small tax change to warrant a similar determination.
- Whenever the examiner decides to conclude the examination based on a prior year no-change or small-change audit, he should obtain his supervisor's approval and properly document the workpapers.
- If both prior years were examined for the issues in question and one year resulted in no change or a small tax change and the other year resulted in a substantive adjustment, the current year examination should be continued as a regular examination. The supervisor will indicate his approval in the workpapers.

The procedure does not define a "substantive adjustment" but does indicate that all issues in the two returns must be alike before the examination can be terminated. If the return being considered contains one or more issues that differ from those in the previous return, the examiner and supervisor must decide whether the expected tax outcome from those issues is worth the audit effort. This decision is not unlike any other when selecting returns for examination.

The notification procedure as initially implemented did not include returns examined through the service center audit programs. We asked IRS officials why these programs were excluded, especially those like DIF correspondence which IRS considers as return audits. We were told that the programs were not intentionally excluded and IRS has since taken steps to expand the procedure to its service center DIF and claims programs.

According to IRS officials, revenue agents are not precluded from using the new procedure but, because of their responsibilities, are not required to inform taxpayers of it. Revenue agents usually examine more complex returns than do tax auditors and are not limited to specific, predetermined issues. Rather, they are responsible for examining all issues that come to light as the audit progresses. Because of this, there is less assurance that the audit will not lead to additional tax issues.

Revenue agents generally notify taxpayers of a scheduled audit by telephone rather than by letter. Even so, IRS provides revenue agents a form letter for use in contacting those taxpayers that cannot be reached by telephone. This letter explains that the audit will be suspended if the issues being examined have been previously examined without change. We believe all individual taxpayers should be told of the procedure, however contacted.

The audit division has requested IRS' internal audit division to review the notification procedure's effectiveness, and internal audit will do so as part of its regularly scheduled reviews.

Small refund cases not covered

Although it addresses small tax increases, the procedure does not apply to cases where the prior audit resulted in a small refund. IRS believes that taxpayers are entitled to receive all refunds due them regardless of the amount involved. And, that if a prior audit resulted in the taxpayer receiving a refund, the present return may also contain errors which will result in a refund. Therefore, taxpayers who have received refunds from previous audits are excluded from the notification procedure--that is, they are again subject to audit.

We agree that taxpayers who may receive refunds should be examined. But, from the taxpayer's point of view, the inconvenience and expense of an audit may outweigh the receipt

of a small refund. We believe that taxpayers who received small refunds from prior audits should have the opportunity to forego a repetitive examination if the other requirements of the procedure are met.

Current procedures can
reduce the number of
repetitive audits

We reviewed complaint letters received by the six districts about repetitive audits and estimated the number of these taxpayers who might have received relief had IRS' current procedures been in effect at the time. The six districts provided 69 such letters which had been received over a period of at least a year--the period varied by district but ended during 1975 or 1976.

The complaint letters were generally prompted by another IRS audit. In addition to the number of audits they had already experienced, the taxpayers frequently complained about the resulting personal time and expense (loss of work, accountant fees, etc.) incurred and/or expressed a feeling of being harassed or singled out. Fifteen specifically mentioned their limited incomes.

IRS had responded to each of the letters. While occasionally telling the taxpayer to attach a statement to the next year's return explaining any large or unusual deductions or explaining the previous no-change audit, our testing indicated that the districts took no apparent measures to preclude the specific taxpayer, regardless of audit history, from further audit. Neither were any apparent measures taken to earmark the taxpayer for future audit.

The current procedures--classification approach and taxpayer contact letters--for preventing certain repetitive audits could have affected the audit history of 32 (46 percent) of the 69 taxpayers. Nineteen of these taxpayers could have incurred fewer audits because an examination(s) followed one that resulted in little or no tax change. The last recorded audit for another 13 taxpayers ended in no change.

The remaining 37 taxpayers (54 percent) would probably not have been affected by the current procedures generally because of the time lapse between past audits or the prior audit results. For example, one of these taxpayers, according to IRS records, had four of six consecutive tax years audited and all resulted in tax increases from about \$200

to \$1,000. Another had five consecutive years examined with resulting tax increases ranging from \$150 to almost \$400. Others, however, had smaller tax changes. Five of the 37 taxpayers had experienced tax changes averaging less than \$100.

IRS is relying on the new procedures to reduce complaints concerning repetitive audits. Our evaluation of how the current procedures could have affected the 69 taxpayers is not a statistical measure of the reduction that can be expected. It does, however, indicate that a reduction is probable, that some taxpayers do not necessarily view repetitive audits in terms of tax results, and that some taxpayers affected by the procedures will still incur examinations resulting in small or no tax change.

CONCLUSIONS

IRS is concerned about repetitive audits and has implemented procedures to reduce the number of unnecessary ones performed. These procedures include the acceptance of a return based on past audit results generally without regard to the issues previously examined--the classification approach. Under this approach, taxpayers whose current returns contain issues different from those previously examined without change can pass undetected.

In our sample, 199 (55 percent) of the taxpayers who incurred a no-change audit had a later return examined. Of that number, 48 percent incurred a tax change. Changes that increased tax averaged about \$480 per taxpayer and those that decreased tax averaged about \$282 per taxpayer. Usually, the change audit included one or more tax issues that were different from the prior no-change audit. For those audits that ended without change, the tax issues were usually the same as in the previous no-change audit. Thus, the classification procedure is not fully effective without prior issue information.

Additionally, taxpayers who previously received small refunds should also be given the opportunity to possibly eliminate a subsequent audit, and revenue agents should use the notification procedure consistently. This will help insure that all taxpayers are treated equally and should further reduce the number of no- and small-change repetitive audits.

As administrator of the tax law, IRS' primary concern is to encourage the highest possible voluntary compliance by taxpayers. Audit activity is IRS' primary method for accomplishing this objective. Therefore, whether IRS should expand its current procedures to prevent even more repetitive audits depends on the effect audits have on compliance.

But IRS does not know exactly how audit coverage and other factors affect compliance. It plans, however, to study compliance and hopes to identify those factors that produce the greatest stimulus. The study should include repetitive audits, especially their effect in terms of increasing voluntary compliance. Based on the study results, IRS should re-evaluate its current posture and procedures concerning repeated audits of the same taxpayer.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that the Commissioner:

- Discontinue the classification approach to reducing repetitive audits unless information about the no-changed issues is available to make a more informed audit/no-audit decision.
- Inform all individual taxpayers scheduled for audit about the process for suspending certain repetitive audits.
- Amend the procedures for preventing repetitive audits to permit audit personnel to terminate--under certain conditions--scheduled audits of taxpayers whose prior audits for the issues currently questioned resulted in refunds. The taxpayer, as a condition to the procedure, must initiate the action to terminate the audit.
- Include repetitive audits in IRS' compliance study.

INTERNAL REVENUE SERVICE COMMENTS

IRS agreed to implement all of our recommendations. In commenting on the recommendations, the Commissioner of Internal Revenue pointed out that:

- IRS recognized that the classification procedure was not foolproof but implemented it because of concern about unnecessary repetitive audits.

- Taxpayers who receive small refunds as the result of audits were inadvertently excluded from the taxpayer notification procedure.
- IRS anticipates some difficulty in including repetitive audits in its study of factors that affect voluntary compliance.

Department of the Treasury / Internal Revenue Service / Washington, D.C. 20224

Commissioner

SEP 23 1977

Mr. Victor Lowe
Director
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Lowe:

Thank you for the opportunity to review your draft report to the Joint Committee on Taxation entitled, "Repetitive Audits of Taxpayers are Justified." Representatives of your office and our Audit Division met on September 2, 1977 to discuss and resolve technical problems in the draft report.

Readers of your report will learn that the Service has strived to protect taxpayers from unnecessary repetitive audits. We define unnecessary repetitive audits as multiple examinations of taxpayers that result in little or no tax change.

On the other hand, as your report states, some repetitive audits are necessary, because of some taxpayers' continued low compliance. As your report notes, successive audits performed on these taxpayers have been shown to be productive.

We define repetitive audits to be those successive audits of other tax years of the same taxpayer that are not done simultaneously with other years. Also the audit of other taxpayers even though connected in some way with the taxpayer is not a repetitive audit of that taxpayer.

Our emphasis on the definition of repetitive audit and the distinction between necessary and unnecessary repetitive audits is important because different conclusions regarding repetitive audits can be reached depending on how these audits are defined.

We do appreciate your report citation of our definition as to what constitutes an audit of a tax return. We continue in our view that an audit is when an examination is made of all or part of a taxpayer's books and records that a taxpayer produces to support the income, deductions, and credits claimed on his/her return. We believe that limited contacts, such as our Unallowable Items Program, should not be considered audits because they do not require the examination of books and records.

Mr. Victor Lowe

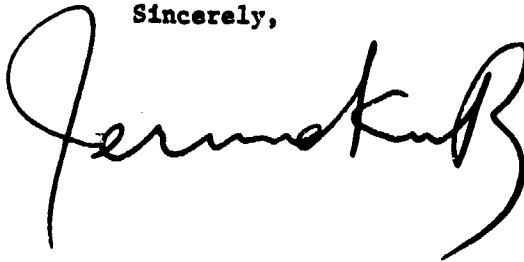
The difference is important since it is possible for a taxpayer to be included in our Unallowable Items Program for one year and later audited by an examiner for the same or a subsequent year. In our opinion this taxpayer has not experienced a repetitive audit.

We believe the recommendations in the report will further provide us with procedures whereby taxpayers and the Service can be assured that only necessary repetitive audits are performed. We also believe the report reflects favorably on existing Service policies and procedures on repetitive audits.

In general, we agree with the recommendations. Attached are our comments regarding specific recommendations and other statements in the draft report. The comments are referred to the applicable page number in the report.

With kind regards,

Sincerely,



Attachment

- GAO notes:
1. IRS' definition of repetitive audit differs from that used by GAO. See p. 41.
 2. Page number references in IRS' comments may not correspond to pages in this report.

GAO Report Title:

Repetitive Audits of Taxpayers are Justified

Recommendation, Page 29

Require written explanation and supervisory approval before auditing a return originally obtained for information and reference purposes.

Comments:

We agree with this recommendation. To ensure review of an examiner's determination to audit a return requisitioned for information or reference purposes, we will require group manager approval before an examiner begins the audit of such a return.

GAO Report Title:

Repetitive Audits of Taxpayers are Justified

Recommendation, Page 42

Discontinue the classification approach to reducing repetitive audits, unless information about the no-changed issues is available to make a more informed audit/no-audit decision.

Comments:

We agree with this recommendation. When we instituted the classification procedure to reduce unnecessary repetitive audits, we were not using the so-called notification procedure. In implementing the classification procedure, we recognized that it was not foolproof and, because of our concern about unnecessary repetitive audits, we instructed our classifiers to resolve questions of doubt in favor of taxpayer. In June 1976, we implemented the notification procedure. It is more effective in preventing unnecessary repetitive audits and has the added advantage of more fully protecting the interests of the Government. Accordingly, we will discontinue the existing classification procedure.

On January 1, 1978, we plan to implement a procedure for recording issue codes on no-change cases using the computer. Thus, information on a no-change issue in a prior year will be available for consideration by classifiers. This should enable us to reduce unnecessary taxpayer contact and further prevent repetitive audits of the same issue.

GAO Report Title:

Repetitive Audits of Taxpayers are Justified

Recommendation, Page 42

Inform all individual taxpayers scheduled for audit about the process for suspending certain repetitive audits.

Comments:

We agree with this recommendation. When we implemented the new repetitive audit procedures in June 1976, we did not include audits conducted by Revenue Agents because of extremely limited application as explained in your report. Notwithstanding our original intention, we subsequently revised all audit contact letters, including those used by Revenue Agents, to incorporate the repetitive audit procedures. This created the possibility of treating similarly situated individual taxpayers differently when a Revenue Agent did not use a letter to arrange an appointment. To eliminate this possibility and consistent with our objective of preventing all unnecessary repetitive audits, we will require Revenue Agents when not using letters to arrange appointments to advise individual taxpayers of our repetitive audit procedures.

GAO Report Title:

Repetitive Audits of Taxpayers are Justified

Recommendation, Page 42

Amend the procedures for preventing repetitive audits to permit audit personnel to terminate--under certain conditions--scheduled audits of taxpayers whose prior audits for the issues currently questioned resulted in refunds. The taxpayer, as a condition to the procedure, must initiate the action to terminate the audit.

Comments:

We agree with this recommendation. Taxpayers who received small refunds as the result of an audit were inadvertently excluded from the June 1976 repetitive audit procedures. We will correct this situation.

GAO Report Title:

Repetitive Audits of Taxpayers are Justified

Recommendation, Page 42

Include repetitive audits in IRS' compliance study.

Comments:

We agree with this recommendation. We will attempt to include as part of our study on factors that affect compliance an analysis of repetitive audits and the affect they have on voluntary compliance. We anticipate, however, some difficulty in designing this aspect of the study and determining how best to use the data.

We have data from a TCMP Panel Study which involved the repeat audit of the same taxpayer in subsequent TCMP cycles to determine if the taxpayer was more compliant than other control group taxpayers. The overall results showed, in general, that the group of taxpayers that had been examined in the past were more compliant than the control group. However, we do not feel that this type of aggregated data should be used to eliminate simultaneous audits or repetitive audits that result in substantial tax changes. Instead, we should determine why a taxpayer continues to be noncompliant and take appropriate corrective actions.

HOW THE REPETITIVE AUDIT SAMPLE
WAS SELECTED AND ANALYZED

To answer many of the questions about repetitive audits, we took a sample of taxpayer accounts from IRS' Individual Master File. While the file lacks a complete tax history of every taxpayer, it is the only practical source for identifying repetitive audit cases in any number. We used statistical techniques to select and analyze the sample.

SELECTING THE SAMPLE

The Individual Master File, a part of IRS' computerized recordkeeping system, contains an account for each person filing an income tax return. The account is maintained by tax year, and each account is assigned to an IRS district. Transactions affecting the account are posted to the appropriate tax year and coded to explain what occurred--a payment on taxes owed, an audit division adjustment, etc. While either an IRS service center or district office can audit a return, the transaction codes do not distinguish between the two.

At our request, for the six districts reviewed, IRS provided a listing of master file accounts with more than one audit. ^{1/} Listed were all tax years shown by the master file that IRS' audit division had examined or was reviewing at the time. From the listing, we randomly selected 1,201 accounts having closed audits for at least two out of three successive tax years. We then reviewed all closed examinations for each account. We are 95 percent confident, with a possible sampling error of plus or minus 5 percent, that our sample results are valid estimates of the total accounts in the six districts having repetitive audits per the master file when the listing was produced.

Definition differs from IRS'

We selected our sample using a broader definition of "audit" and "repetitive" than does IRS. An audit, according to IRS, is made only when a taxpayer is required to produce

^{1/}The listing was extracted from the master file during May 1975 (San Francisco and St. Louis districts) and July 1975 (Philadelphia, Reno, Wichita, and Wilmington districts) and was of taxpayers whose most current return was filed in one of the six districts.

records to substantiate return items. When service center audit personnel contact taxpayers about return deductions and other items, they, unlike district personnel, do not usually request the taxpayer's records. IRS, therefore, does not consider such contacts to be audits. ^{1/} Neither does IRS consider the simultaneous audit of two or more returns for a given taxpayer to be repetitive. Except as noted, IRS does consider the examination of two out of three successive tax years to be repetitive.

We did not make the distinctions IRS does for a number of reasons. For example:

- While service center audits may not have the same effect on taxpayer compliance as regular audits, we believe there is ample reason to consider their effect as substantial.
- From a practical standpoint, the average taxpayer would, in our opinion, consider himself audited if he were to receive a letter from IRS saying that a review of his return indicates a question and that he can justify what he did or pay the additional tax.
- A taxpayer involved in a simultaneous audit may be contacted as often as if separate audits occurred. And IRS counts, for statistical and master file recording purposes, each return examined simultaneously as a separate audit.
- Taxpayers who have complained about being repetitively examined have not made the distinctions regarding service center and simultaneous audits, and a comprehensive review of repetitive audits would therefore include them.
- It would have been impractical and virtually impossible to accurately make those distinctions through analysis of the master file data.

^{1/}Our differing positions regarding service center audits are presented on pp. 56 through 58 in our report to the Joint Committee on Taxation, "How The Internal Revenue Service Selects Individual Income Tax Returns For Audit," GCD-76-55, Nov. 5, 1976.

ANALYZING THE SAMPLE DATA

Our sample included 2,812 audits incurred by the 1,201 sampled taxpayers. About 4 percent of the district audits we reviewed were not done by the districts studied. That is, the returns were filed in and examined by other districts. Because such "out-of-district" audits were few and resembled the other sample data, we did not exclude them from the sample.

Correcting for sample size

We selected a sample of taxpayers in each district included in our review that provided reliable results while minimizing the number of taxpayers sampled. This resulted in a larger proportional sample in the less populated districts. We corrected for this nonproportional sampling whenever we estimated characteristics of the sampled population. The correction was made by multiplying our data by weighting factors. The weighting factor for each district was computed by dividing the ratio of the population of each district to the combined six-district population by the ratio of the sample number in each district to the total sample.

Correcting for master file retention cycle

After varying periods of inactivity, accounts and tax year sections are removed from the Individual Master File. For example, a tax year section is removed when it has a zero balance for longer than 27 months, the earliest of the removal dates. Inactive accounts and tax years are removed each January from the file. When our taxpayer listings were extracted from the master file, the latest cutoff date for tax year removal was October 1972.

The tax year removal cycle caused some distortion in our sample data. For example, district audits in our sample closed before October 1972 had larger amounts of tax change and fewer instances of no change than audits closed beginning in October 1972. To overcome the sample distortion, we generally limited our analysis to audits closed during October 1972 and after. Whenever it was not possible to limit the sample data, it is so noted in the report.

Comparing repetitive to all audits

To determine the relative productivity, basis, etc. of repetitive audits, we used as a point of comparison IRS

statistical information on the number of all returns examined--IRS does not keep audit statistics on a taxpayer basis. The statistics were of the total audits closed by the six districts reviewed and all service centers for the period July 1, 1972, through June 30, 1975--the same approximate time frame as our sample data when limited. We used national service center data because statistics on service center audits are not available on a district basis.

The differences between our sample of repetitive audits and total audits for the six districts and all service centers were evaluated using the Chi square test of statistical independence and the confidence intervals for a normal distribution at the 95-percent confidence level.

Source of dollars analyzed

The report, in part, discusses the productivity of repetitive audits--the dollar amount of tax change, if any, that resulted from the audits. IRS' statistics on the number and results of audits are reported on an audit division basis. The results that we used were those determined by IRS' audit division, including the division's district conference function. Taxpayers who do not agree with the examiner's tax findings may appeal the findings within IRS and/or the courts. The first level of appeal within IRS is the district conference activity. We did not go beyond the audit division to analyze "results" because 96 percent of the sampled taxpayers did not appeal further according to available records.

SERVICE CENTER AUDIT PROGRAMS OPERATIONAL
DURING THE PERIOD COVERED BY THE
REPETITIVE AUDIT SAMPLE

Most of the returns and related audit issues for the service center audit programs are identified by the computer or by persons other than those who perform the audits. For example, personnel from outside the audit division identify returns with possible unallowable items. Other returns and issues, such as those in the social security referral program, are actually identified by agencies outside IRS.

With two exceptions, the criteria for selecting returns under the service center programs are so specific that judgment plays only a minor role in the process. The two exceptions are the DIF correspondence and the claims programs under which classifiers must decide which returns and issues therein should be audited. Even here, however, the decision is being made by someone other than the person who will be responsible for auditing the return.

DESCRIPTION OF THE SERVICE CENTER PROGRAMS

Unallowable items

Items on individual tax returns which appear to be obviously unallowable by law are identified and corrected during initial processing. Some unallowable items are manually identified while others are computer identified. For those returns identified as containing unallowable items, service center audit division personnel, through correspondence with taxpayers, make necessary corrections.

Head of household

A high volume, low-cost program that corrects tax returns erroneously filed by taxpayers as unmarried head of household. The program includes returns in which the taxpayer claimed the head of household tax rate but only claimed one exemption. Tax returns meeting this condition are computer identified. IRS determines if the taxpayers are entitled to the unmarried head of household tax rate by sending them a short questionnaire requiring yes or no answers. This service center program became part of the unallowable items program in January 1977.

DIF correspondence

Audit division classifiers request the highest DIF-scored low- and medium-income nonbusiness returns, review them, select those to be audited either by the service center or by the district offices, and accept the remaining returns as filed. Returns are selected for audit by the service center if they involve issues that can be resolved easily by mail (such as interest and contributions) and if information on the return indicates that the taxpayer can communicate effectively in writing.

Information returns

Information on certain types of income, such as wages, dividends, and interest, is transcribed from the taxpayer's return onto computer tape. These tapes are compared with informational tapes and samples of paper documents filed by employers, banks, dividend-paying establishments, and certain payers of income. From the comparison, an inventory of potential underreporters is generated. A computer-printed transcript is prepared for each of the cases. These transcripts compare the amount and type of income reported on information documents with the amount and type of income reported on the taxpayer's return. In addition, Social Security Administration wage information is also printed on the transcripts. The transcripts are then screened to evaluate tax potential, and the returns of apparent underreporters are then secured. Next, the tax returns are compared with the transcripts to further evaluate tax potential. If a determination can be made that the taxpayer reported all income, but in the wrong place on the return, or that the amount of the cumulative discrepancies is minimal, the return is accepted as filed. If the cumulative discrepancies are significant, however, the general procedure is to send a computer generated notice to the taxpayer, explaining the discrepancies and recomputing the tax. The taxpayer may agree to the increase in tax or explain his/her reason for not agreeing. Those cases in which the taxpayer has not satisfactorily explained the discrepancies, or has not responded at all, are referred to the service center audit division for followup action. The screening of transcripts, the comparing of tax returns to transcripts, and initial taxpayer contacts were done by audit personnel before the middle of 1976; since then, other service center personnel perform these activities.

Multiple filers

The National Computer Center checks returns to see if more than one return has been filed for the same year under

the same social security number. If more than one return has been filed and the names on the returns have certain similarities, the returns are extracted as audit cases. Classifiers select returns for examination by the service center and for examination by the district offices. For example, two joint returns filed by the same taxpayers will be selected for examination by the service center. However, two nonjoint returns involving duplicated dependency exemptions or deductions will be forwarded to district offices.

Federal-State cooperative audit

Copies of examination reports from State tax agencies are referred to the service centers for association with the Federal income tax returns. These State examination reports and the associated Federal returns are reviewed by classifiers to identify the Federal returns to be examined under this program.

Claims

Involves the verification of refund claims filed by taxpayers with issues that can be effectively handled by correspondence. The guidelines followed by, for example, the Kansas City service center for this program provide, in part, that an evaluation is to be made of all documents in the file, and if enough information is available to reasonably accept the claim or if the claim is not worthy of examination, it is to be accepted. Also, if the item on the claim would not have been questioned on the original return, it is not to be considered questionable on the claim.

Social security referral

Social security forms OAR-7000 (Notice of Determination of Self-Employment Income) are referred to service centers when the Social Security Administration has made a determination of self-employment income. The referrals involve adjustments to tax returns for self-employment and possibly income tax. IRS procedures require these referrals to be classified.

Interest paid on redemption of H bonds

The Federal Reserve Banks prepare information reports on series H bond payees and send copies to the service center for the district in which the bank is located. IRS procedures provide for the taxpayer service division at the service center to assemble these reports with the payees' tax returns and refer them for classification by audit personnel.

Highway use tax

The service centers received, through a private organization, information on State motor vehicle registrations, useful in determining the proper reporting of highway use tax. In selecting returns for examination under this program, IRS instructions provided that service center personnel match this information with the highway use tax return to determine deficiencies. Those returns with apparent deficiencies were sent to service center classifiers who screened out those cases involving a large number of vehicles. Those cases were forwarded to the appropriate district office; cases involving a small number of vehicles were retained for service center examination. This service center program was discontinued in November 1975.

Runaway parents

State welfare agencies periodically requested the last known address of a parent who had deserted and no longer supported his or her family. In addition to supplying the requested addresses, IRS used the names and social security numbers provided by the welfare agencies to identify returns for audit. Under this program, IRS checked whether the runaway parent had claimed a spouse and/or children as exemptions. Instructions for this program provided that only non-joint returns would be selected for examination by the service centers and that joint returns would be sent to the appropriate district office. In selecting nonjoint returns for examination, the instructions provided that classifiers would screen the returns to insure that the taxpayer had claimed exemptions for children. Also, the complete return would be screened and other significant questionable items would be identified for audit. If the other identified issues required an interview audit, the return would be sent to the appropriate district office. This service center program was discontinued in November 1975.

Self-employment tax program

This program encompasses returns showing income which may be subject to self-employment tax. The returns once identified are given to service center audit personnel for classification. For returns selected, taxpayers are sent an examination report or asked to provide further information about the source of the income. Once the additional information is received, an examination report is mailed to the taxpayer if the income is subject to self-employment tax.

AUDIT SELECTION CATEGORIES AND
REASONS USED BY IRS DISTRICT OFFICES

At the district level, the reasons why IRS selects returns for audit are grouped into six major categories: computer identification, initiated by IRS and others, claims and other refund requests, related pickups, multiyear audits, and miscellaneous. These categories are described below. Table I on page 52 shows the selection reasons within each category and the percentage of sampled district audits by reason.

AUDIT SELECTION CATEGORIES

Computer identification

Most individual returns are selected for audit under the computer selected category, principally through the Discriminate Function (DIF) system. In our sample, about 49 percent of the district audits were DIF selected. ^{1/}

The DIF system is composed of two stages. All individual returns are first computer "scored" through sophisticated mathematical formulas as to their audit potential. The higher the score, the greater the apparent audit potential. The highest scored returns are then manually screened to exclude those not warranting an audit.

The manual screening process is done by classifiers who are examiners that have been assigned the screening task. Classifiers are unaware of what caused the return to receive a high score but use their judgment and auditing experience to determine which returns do and do not warrant examination. In making their decision, they consider return attachments and other explanatory data not considered by the computer.

In our November 1976 report on how IRS selects returns for audit, we concluded that DIF is an effective return selection system, but that its effectiveness could be improved

^{1/}The remaining district audits we reviewed in the computer category came from returns identified through the pre-DIF computer selection system (3.0 percent) and DIF specials (1.5 percent). The latter refers to returns manually screened for audit potential because of special return conditions identified by computer.

if IRS measured the effect classifiers have on it. As a result of our recommendation, IRS has taken steps to measure this effect. Any subsequent change in the DIF system will affect how returns are selected for audit, including those which happen to be repetitively examined.

Audits initiated by IRS and others

Audits in this category are generally (1) initiated because of information provided the district audit division by another IRS organization or a non-IRS party, (2) generated because of a particular compliance project, or (3) initiated by an IRS examiner.

The district audits we reviewed resulted most often from the return preparers program, IRS intelligence division referrals or requests, and independent pickups by examiners. Through the return preparers program, a national compliance project, IRS audits returns that it has reason to believe have been prepared by unscrupulous preparers. Independent pickups in our sample frequently involved income issues and included, for example, the situation where an examiner questioned a taxpayer's reported income after the examiner audited a business to which the taxpayer sold merchandise. Audit personnel usually screen returns identified through the preparers program or by the intelligence division to evaluate the audit potential. Independent pickups do not go through such a screening process but the need for an audit is evaluated by the examiner's supervisor.

Claims and other requests for refunds

When IRS receives a claim or other request for an adjustment in taxes, the original return may be manually screened to determine if audit effort is warranted to substantiate the claim. In many cases, the audit results in disallowance of the claim or in assessment of additional taxes or penalties.

Related pickups

During an audit, the examiner may find it necessary to audit related returns affecting the income and deductions of a taxpayer to determine whether the taxpayer correctly determined his tax liability. Included in this category are returns filed by partners, family members, and corporate officers and shareholders.

Multiyear audits

During an audit, the examiner may find it necessary to audit returns filed by the same taxpayer in prior or subsequent years to determine, for example, whether loss carrybacks or carryforwards are proper and whether adjustments made to the return being audited might apply to the other years' returns.

Miscellaneous

This category is a catch-all for examined returns not specifically falling into the other categories. The most frequent reasons for district sampled audits in the miscellaneous category were "reference and information returns" and "other." These two reasons accounted for about 4.8 percent of the district audits we reviewed and about 53 percent of those in the miscellaneous category.

Audit personnel initiate the action to obtain returns for information and reference purposes; for example, an examiner may request, when auditing the return of one spouse, the other spouse's return to see if both claimed the same exemptions. After reviewing the return, the examiner may decide to examine it. Most of the "other" audits we reviewed were of IRS employees or involved investment credit carryback cases. IRS employees with less than 1 year of continuous service are required to have any two open tax years examined.

TABLE I
WHY RETURNS OF SAMPLED TAXPAYERS
WERE SELECTED FOR DISTRICT AUDIT

<u>COMPUTER IDENTIFIED RETURNS</u>	<u>Percent of district audits</u>
DIF selected returns	49.0
Other computer identified returns	4.5
 <u>AUDITS INITIATED BY IRS AND OTHERS</u>	
Self-employment tax program	0
Married taxpayers filing separately	0
Political campaign contribution compliance	0
Form 1120S loss	0
ITT (shareholders)	0
Tax shelter	0
Employee returns	0.7
Contributions to retirement and disability funds	0
Runaway parents	0
Return preparers program	3.6
Form 4298 (information report)	0.3
Collateral examination request	0.5
National office requests and projects	0
Appellate referral or request	0
Collection referral or request	0.5
Intelligence referral or request	2.3
Regional or district office projects	.9
Independent pickup by examiner	1.1
Joint compliance program	0.1
Narcotics	0
Social security referral or request	0.3
Taxpayer request	0
Excessive exemptions	0.2
Justice Department referral or request	0
Other U.S. agency referral or request	0
State information (including State abstracts)	0.3
 <u>CLAIMS AND OTHER REQUESTS FOR REFUNDS</u>	
Form 843 (claim)	1.8
Form 1040X (amended U.S. individual income tax return)	2.7
Informal claim	1.0
Form 1045	0.3

<u>RELATED PICKUPS</u>	<u>Percent of district audits</u>
Delinquent return--different taxpayer.	0.1
Delinquent return--same taxpayer	1.3
Partner	2.8
Corporate shareholder	1.7
Corporate officer	1.8
Family member	1.1
Employee or employer of taxpayer	0.3
 <u>MULTIYEAR AUDITS</u>	
Prior year audit--other than net operating loss or investment credit	1.5
Subsequent year audit--other than net operating loss or investment credit	9.0
Net operating loss	0.3
Carryback or carryforward	0.8
 <u>MISCELLANEOUS</u>	
Unallowable items	0.8
Multiple filers	0.2
DIF medical	0.2
Form 1099--medical (Statement for Recipients of Medical and Health Care Payments)	0
Returns identified for GS-9 auditors	0
Redetermined dividends	0
Securities and Exchange Commission information	0
Head of household	0.2
Form 3921--stock option tax	0
Regular classification	0.7
Taxable form 1040X	0
Bankruptcy, receivership	0
Previously allowed refund	0.2
Pre-refund	0
Taxpayer compliance measurement program	0.8
Interest paid on redemption of H bonds	0
Information document match	0
Reno casino	0
Lottery	0
Fraud regular	0.8
IRS racketeer	0

APPENDIX IV

APPENDIX IV

	<u>Percent of district audits</u>
Strike force	0.3
Wagering tax stamps and coin-operated gaming device stamps	0
Other cases in which Justice Depart- ment has an interest	0
Reference and information returns	3.1
Other	<u>1.7</u>
	<u>a/99.8</u>

a/Does not equal 100 percent because of rounding.

PRINCIPAL OFFICIALS
RESPONSIBLE FOR ADMINISTERING
ACTIVITIES DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF THE TREASURY:		
W. Michael Blumenthal	Jan. 1977	Present
William E. Simon	Apr. 1974	Jan. 1977
George P. Shultz	June 1972	Apr. 1974
COMMISSIONER OF INTERNAL REVENUE:		
Jerome Kurtz	May 1977	Present
William E. Williams (acting)	Feb. 1977	May 1977
Donald C. Alexander	May 1973	Feb. 1977
Raymond F. Harless (acting)	May 1973	May 1973
Johnnie M. Walters	Aug. 1971	Apr. 1973
ASSISTANT COMMISSIONER (COMPLIANCE):		
Singleton B. Wolfe	Mar. 1975	Present
Harold A. McGuffin (acting)	Feb. 1975	Mar. 1975
John F. Hanlon	Jan. 1972	Jan. 1975
DIRECTOR, AUDIT DIVISION:		
John L. Wedick, Jr.	June 1975	Present
Peter J. Medina (acting)	Mar. 1975	June 1975
Singleton B. Wolfe	July 1965	Mar. 1975

(268011)