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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

GENERAL GOVERNMENT DIVISION

SEPTEMBER 5, 1980

B-199981

The Honorable Jerome Kurtz
Commissioner of Internal Revenue
Department of the Treasury

Dear Mr. Kurtz:

Subject: The Internal Revenue Service Needs to Reconsider Its Examination Strategy for Certain Partnership Returns (GGD-80-98)

By letters dated December 21, 1978, and December 21, 1979, the Joint Committee on Taxation asked us to study the Internal Revenue Service's administration of the partnership tax laws. This report, one in a series in response to those requests, deals with IRS' program for examining traditional partnerships as opposed to those partnerships established for tax shelter purposes. In particular, the report discusses IRS' processes for setting examination goals and developing Discriminant Function (DIF) System formulas for identifying those traditional partnership returns most in need of examination.

In two prior reports on the selection of individual returns for examination 1/ and the selection of corporate returns for examination 2/ we commented favorably on IRS' processes for developing examination goals and DIF formulas for such returns. This report, however, presents a critical view of IRS' handling of these processes for partnership returns.

About one of every two examinations of traditional partnerships during the 2-1/2-year period beginning October 1977 and ending March 1980 resulted in no change to the return as filed. Thus, there is a need for IRS to improve its procedures for rating the audit potential of partnership returns.

In addition, because IRS has developed new information indicating that the number of tax shelter partnerships may be much larger than previously suspected, there is a need

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1/ "How The Internal Revenue Service Selects Individual Income Tax Returns For Audit," (GGD-76-55, Nov. 5, 1976).
2/ "IRS Can Improve Its Process For Deciding Which Corporate Returns To Audit," (GGD-79-43, Aug. 3, 1979).

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for the agency to reassess its overall partnership audit plans. In essence, IRS has to come to grips with the question of whether resources previously planned for the audit of traditional partnerships should be diverted to the now larger universe of suspected tax shelter partnerships.

Our review was performed at the national office in Washington, D.C.; district offices in Chicago, Dallas, Los Angeles, and San Francisco; and service centers in Andover, Austin, Cincinnati, and Fresno. We reviewed and evaluated policies and procedures plus statistical data relative to partnership returns. At each location visited, we held discussions with appropriate personnel at various levels within the organization.

BACKGROUND

Until fiscal year 1978, IRS put little emphasis on examining partnership returns. While the usual annual goal was to examine about 1.5 percent of all partnership returns filed, partnership returns were generally treated as related documents and were selected for examination through a "back door" approach, that is, they were scrutinized only when some item on a partner's return (usually an individual or corporate return) needed verifying.

Since fiscal year 1978, IRS has given greater emphasis to examining partnership returns. This resulted primarily from increased use of partnerships for tax sheltering purposes and IRS' desire to have an aggressive program for identifying those shelters that violate the law. The program developed by IRS included a doubling of its examination goal to 3.0 percent of all partnership returns filed and an increased use of a "front door" approach in which the partnership return is the starting point for many examinations. To better focus its efforts, IRS also separated partnership returns into four audit classes. The four audit classes along with IRS' estimates of the number of returns in each for fiscal year 1980 follow.

Audit class	Estimated number of returns for FY 1980
Net loss of $25,000 or more	79,000
Net loss of $1 to $25,000	380,000
Net profit of $0 to $25,000	596,000
Net profit of $25,000 or more	189,000

IRS has generally equated the partnership class with losses of $25,000 or more with tax shelters, while generally equating the remaining three classes with traditional partnerships. IRS' reasoning is that traditional partnerships are usually formed to generate a profit while shelter partnerships are usually formed to generate losses.

In fiscal years 1978 and 1979, about 4.0 percent of IRS' total revenue agent examination time was spent on partnership returns--1.6 percent on the tax shelter and 2.4 percent on the traditional partnership audit classes.

IRS HAS PERFORMED TOO MANY UNPRODUCTIVE PARTNERSHIP AUDITS

An important measure of examination productivity is the percentage of all returns examined that result in a change to the return as filed. The higher the change percentage, the greater the productivity and, conversely, the higher the no-change percentage, the greater the unproductivity.

Two significant adverse effects of a no-change examination are (1) the unproductive use of IRS resources and (2) the needless subjection of a taxpayer to an examination. It is reasonable to expect that some percent of examinations will result in a no-change. However, it is to IRS' benefit to have the lowest no-change percentage possible. In our opinion, this is not being achieved for partnership returns.

In the 2-1/2-year period from October 1977 through March 1980, about 48 percent of IRS' examinations in the three traditional partnership classes resulted in no change. The following table shows results by fiscal year:

Traditional Partnerships

Fiscal year	Number of examinations	Number of no-change examinations	No-change percent	Cumulative no-change percent
1978	19,558	10,654	54	54
1979	19,230	8,322	43	49
1980(note a)	6,411	2,670	42	48

a/ Figures are for the 6-month period ending March 31, 1980.

The figures shown in the table indicate that the no-change percent is decreasing as the partnership program matures. Even so, the rate is high enough to cause concern. Concern about a similarly high no-change rate of 43 percent on individual returns in fiscal year 1968 led IRS to develop and implement the DIF system--a system that ranks returns in terms of potential for change.

Another reason for concern is that the no-change rate for traditional partnership examinations exceeded the no-change rate experienced for each of the other types of returns examined during fiscal years 1978 and 1979. The following table shows, by type of return, a comparison of average no-change rates for fiscal years 1978 and 1979 resulting from revenue agent examinations.

Type of return	No-change rate (percent)
Partnership (Traditional)	49
Individual	13
Corporate	24
Subchapter S	41
Fiduciary	34
Estate	12
Gift	22
Employment	22
Excise	23

As can be seen from the table above, the 49 percent no-change rate on traditional partnership returns was from 1.2 to 4.1 times greater than that experienced on other types of returns. Interestingly, the no-change rate for partnership returns was about double that experienced in the seven corporate audit classes from which examination resources were diverted to accommodate the increased emphasis on partnerships.

IRS officials at various levels expressed concern to us about the high no-change rate being experienced on partnership returns. These officials usually cited a lack of returns with high potential for change entering the audit stream as the cause. We concur and believe that two underlying factors have contributed significantly to that cause--(1) the lack of data needed to determine a proper level of examination effort and (2) the lack of data needed to develop effective DIF formulas for identifying returns with the highest potential for change among all those filed.

IRS LACKS DATA FOR DETERMINING PROPER LEVELS OF EXAMINATION EFFORT FOR PARTNERSHIPS

IRS' process for planning its level of examination coverage for partnership tax returns is not as sound as that for individual and corporate returns. In developing annual examination goals for individual and corporate returns, IRS uses data on the voluntary compliance of individual and corporate taxpayers plus data on the cost of, and yield from, examining such returns. IRS does not, however, have comparable data with which to plan an appropriate level of audit effort for partnerships. While IRS has attempted to improve this situation, the attempts have not produced the sound and reliable data needed.

IRS develops an annual examination workplan for each fiscal year. In developing a workplan, IRS establishes levels of effort by setting goals for the number of returns to be examined by type (partnership, individual, corporate, etc.). The volume goal for each type return is further subdivided into audit classes, which are delineated by amount of net income or loss, amount of adjusted gross income, amount of assets, or magnitude of some other item common to that type of return. To complete the plan, volume goals are matched with staff time available, and national volume goals and staff resources are translated into district office goals and resource commitments.

In setting the levels of effort for individual and corporate returns, IRS tries to strike a balance between two somewhat competing objectives. It tries to (1) achieve a favorable dollar yield from examinations by allocating resources to types and classes of returns where it is most likely that examinations will yield additional taxes and penalties in excess of the cost of performing such examinations and (2) establish or maintain a desired level of voluntary compliance by examining a sufficient number of each type and class of return. In trying to balance these objectives, IRS management relies to a great extent on information derived from two sources--the Taxpayer Compliance Measurement Program (TCMP) and the regular examination program.

The TCMP has encompassed all classes of individual returns and those classes of corporate returns consisting of corporations having assets of less than $1 million. Under TCMP, a random sample of returns is taken from each audit class. These returns are given specialized "TCMP audits" which, unlike regular audits, involve a thorough review of the entire return. Examiners are instructed to review every item, regardless of dollar amount, and to be especially alert for any unreported income, deductions, or credits. By subjecting a random sample of returns from a particular individual or corporate audit class to such intense scrutiny, IRS is able to accumulate data which can be used to estimate for that class the level of voluntary compliance, as well as the relationship that exists between audit coverage and yield.

An adequate TCMP data base, however, does not exist for partnership returns. IRS has not performed a TCMP exclusively for partnership returns and does not have one scheduled for the immediate future. In lieu of a special TCMP, IRS has attempted to accumulate partnership data through the last three TCMPs that have been performed for individual returns. However, due to deficiencies in the sampling methodology and scope of the partnership audits, the data produced has not been sufficient to permit reliable estimates of voluntary compliance levels or of relationships between levels of audit effort and yield.

IRS' sampling methodology did not produce a random sample from the universe of partnership returns. If an individual return selected for TCMP reflected income or loss from a partnership, that partnership return was also selected for a TCMP audit. This approach did not permit random selection from the partnership universe because those partnerships

having many partners had a greater chance to be selected than those having fewer partners.

A second deficiency in IRS' sampling methodology was that those partnership returns selected through the approach described above were not all audited. Rather, IRS established further screening criteria to arrive at those returns that were ultimately examined. For example, if the selected partner had minimal ownership interest and little influence in managing the partnership, the partnership return could be excluded. Each of several such additional criteria established by IRS made the sample less representative of the partnership universe.

The usefulness of the partnership data developed by IRS was further limited by differences in the scope of the audits performed by participating IRS offices. While the national office intended for all the partnership returns to be examined under TCMP standards, this intent was not clearly conveyed in the written instructions or the orientation sessions provided to the districts. As a result, the Chicago, Dallas, Los Angeles, and San Francisco district offices employed regular audit standards on the partnership returns examined while the Seattle and St. Louis district offices employed TCMP audit standards in the most recently completed TCMP for individual returns.

Not only does IRS lack a reliable TCMP data base for partnerships; IRS also lacks certain historical data on the results of partnerships examined under its regular examination program. Results from the regular examination program play an important role in the planning process for individual and corporate returns. Because TCMP returns are selected randomly and because TCMP audits are so thorough, IRS officials do not consider the TCMP yield data to be truly representative of actual operating experience. Therefore, IRS adjusts the TCMP yield data, using the results of regular audits, so that its estimates of yield will more accurately reflect actual experience.

Historical data for individual and corporate returns also provide the cost figures necessary for making cost/yield computations. IRS does not want to operate at a level of effort where cost exceeds yield. Accordingly, historical cost and yield data are critical for establishing levels of effort that will not produce such an undesirable situation.

Unlike the situation for individual and corporate tax returns, however, IRS has not developed data necessary for making cost/yield computations for partnership returns. Before fiscal year 1978, IRS did not keep any data on the dollar adjustments made to partnership returns and kept cost-related data for only those partnership examinations which resulted in no-change. Since fiscal year 1978, IRS has accumulated data on the cost of examining partnership returns and on dollar adjustments made to the income or loss reported on those partnership returns examined. IRS has not, however, accumulated data on the tax impact of these adjustments. Without information on tax impact, IRS cannot adequately consider cost/yield ratios in planning the proper level of examination coverage for partnership returns.

The Director of the National Office Examination Division told us that due to a lack of data on voluntary compliance, cost, and yield, the planning of levels of audit effort for partnerships has been less scientific than that for individual and corporate returns. According to the Director, the starting point for determining the composite level of effort for all four classes of partnership returns for fiscal year 1978 was the level of coverage IRS was then giving individual business returns (Schedules C and F of the 1040)--3.0 percent. Thus, the starting point for determining the coverage levels for partnership returns was unrelated to characteristics like compliance levels and like the cost of, and yield from, examining such returns.

Once IRS decided on 3.0 percent as the coverage level for the universe of partnership returns, IRS developed a level of effort for each of the four audit classes. In keeping with IRS' thrust toward tax shelters, the first audit class considered was the one composed of returns reporting a loss of $25,000 or more. The first coverage figure tried was 30 percent, but after going through mathematical computations it was realized that this figure was too high in view of existing resources. A final coverage figure of 24 percent was established for this class of returns.

After the 24 percent figure was established for the tax shelter class, IRS considered various level-of-effort ratios for the three traditional partnership classes. In establishing the ratios, IRS looked at the estimated number of return filings in each class in order to achieve its desired overall partnership goal of examining 3.0 percent of all partnership returns filed. In essence, IRS first established a figure for the tax shelter class and then backed into the figures

for the three traditional partnership classes. The fiscal year 1978 partnership examination plan developed through this process was as follows.

Audit class	Planned number of examinations	Planned percent coverage
Net loss of $25,000 or more	17,649	24.0
Net loss of $1 to $25,000	6,066	1.6
Net profit of $0 to $25,000	4,532	0.8
Net profit of $25,000 or more	7,282	4.1
Overall coverage	35,529	3.0

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The Assistant Commissioner for Planning and Research, in an April 8, 1977, report, noted that little statistical data had been developed from which to quantify the extent of noncompliance in the area of tax shelters. The Assistant Commissioner recommended that an effort be made to quantify the nature and extent of noncompliance in that area because the appropriate extent of IRS efforts could only be determined in light of such data.

The Assistant Commissioner's comments that an appropriate level of effort for tax shelters can only be determined in light of information on the nature and extent of noncompliance apply equally well to traditional partnerships. Establishing levels of audit effort without such information and/or cost/yield data can result in a high no-change rate because the level of effort may be greater than the noncompliance problem. Another factor, however, which could contribute to a high no-change rate is the lack of an effective system for identifying those partnership returns with high potential for change.

IRS LACKS DATA TO DEVELOP AN EFFECTIVE PARTNERSHIP DIF SYSTEM

An effective examination program requires both an effective planning process for establishing proper levels of effort and reliable criteria for directing that effort at those returns having the greatest potential for change. IRS has had considerable success in selecting corporate and

individual returns having potential for change by using a Discriminant Function (DIF) System based primarily on TCMP data. The DIF system for traditional partnerships, however, has not produced similarly favorable results because the data upon which it is based is not of similar quality.

A DIF formula is a mathematical formula containing variables which represent return characteristics. Each variable is weighted according to the degree of correlation between the characteristic represented and the probability that a return containing such a characteristic would be changed as the result of an examination. The formula is used to compute scores for returns--the higher the score, the greater the audit potential.

The characteristics and weights that make up the DIF formulas for individual and corporate returns are based on TCMP results. As we noted earlier, however, IRS has not made a TCMP survey exclusively for partnership returns. Rather, IRS has produced TCMP-type partnership data only in conjunction with its TCMP for individual returns. IRS first used such data in 1974 for developing a partnership DIF formula which was used on a limited basis for selecting partnership returns in 1975. IRS implemented a revised formula in January 1978. This formula, in turn, was replaced in January 1980 by three separate formulas--one for each of the three traditional partnership audit classes. Since 1975, IRS has limited the application of each of the DIF formulas to those partnerships having ten or fewer partners.

The DIF formulas have not been effective in identifying partnership returns with high potential for change. To illustrate, examination of partnership returns identified by DIF resulted in a no-change rate of 63 percent for fiscal year 1978. For the same period, the no-change rate on partnership returns examined through the TCMP was 60 percent. Thus, DIF was less effective in identifying returns with potential for change than was the partnership TCMP process through which partnership returns were selected solely on the basis of being related to randomly selected returns of individuals. The DIF and TCMP no-change rates combined with the no-change rates for partnership returns identified through other means produced the overall no-change rate of 54 percent for fiscal year 1978.

Given the high no-change rates resulting from DIF identified returns, we assessed IRS' methodology for developing

the partnership DIF formulas. That methodology did not reflect the scientific approach that we saw in IRS' development of DIF formulas for individual and corporate returns.

To develop effective DIF formulas, it is essential that data be gathered through uniformly scoped audits and also that there be consistency and precision in data accumulation. For individual and corporate returns, IRS achieves this through its TCMP examinations. Uniformity in TCMP audit scope is achieved in that examiners are required to audit all items rather than just those items they believe to be significant or to have high potential for change. Consistency in accumulation of data is achieved through the use of special checksheets on which examiners record for each line item both the amount as reported by the taxpayer and the amount as determined through audit. Precision in the data collected is achieved by having examiners record any difference of $1 or more between the two amounts on the checksheet even if there is no subsequent change in the tax liability amount reported by the taxpayer.

These standards, however, were not met in gathering the data used to develop the partnership DIF formulas. As was discussed earlier, not all IRS districts employed TCMP standards in auditing the partnership returns used to develop the data base for partnership DIF formulas. Without uniformity of audit scope, the standards of consistency and precision in data accumulation become academic. National Office officials expressed the opinion that reliable and effective DIF formulas can be developed only from audits performed under TCMP standards.

The Director of the National Office Examination Division told us that he believes DIF is not functioning effectively and that this is a main cause for the high no-change rate on partnership examinations. He also expressed the belief that there are more partnership returns not in compliance with the law than the number planned for audit, but that the DIF system is not effectively identifying these returns.

CURRENT INFORMATION INDICATES THAT PRESENT AUDIT CLASSES ARE NOT A PROPER PLANNING BASIS

IRS' partnership examination program was set up to address both tax shelter and traditional partnerships. For setting goals and measuring accomplishments, IRS has generally distinguished between the two types of partnerships on the

basis of audit classes. Recent data in IRS' information system, however, indicate that tax shelter partnerships may also be found in considerable numbers in those audit classes that have generally been equated with traditional partnerships. Thus, IRS has to come to grips with the question of whether resources previously planned for the audit of traditional partnerships should be diverted to the now larger universe of suspected tax shelter partnerships.

In 1979, IRS computerized six tax shelter identification criteria. Any partnership return, regardless of the audit class, identified by the computer as meeting one or more of the six criteria is to be scrutinized by personnel having special tax shelter expertise. Returns selected by these personnel as having good potential for change are to be given examination priority.

However, many of the returns being identified by the computer as meeting the tax shelter criteria are in what have been considered the traditional partnership audit classes. If the tax shelter specialists determine that a sufficient number of these returns have tax shelter potential, audits of traditional partnerships may be virtually eliminated.

Reports on delivery of returns to the 10 service centers for analysis of examination potential indicate that 76,800 returns processed in 1979 in the three traditional partnership classes were delivered for analysis by IRS personnel because they met one or more of the six tax shelter criteria. A breakdown of these deliveries by audit class and a comparison of the number of deliveries to the fiscal year 1980 planned examinations follows:

Traditional Partnerships

Audit class of return	Number of delivered returns meeting tax shelter criteria	FY 1980 planned examinations	Ratio of deliveries to plan
Loss of less than $25,000	26,693	4,594	5.8:1
Profit of less than $25,000	24,636	5,509	4.5:1
Profit of $25,000 or more	25,471	6,590	3.9:1
Totals	76,800	16,693	4.6:1

As can be seen, on a national basis there have been significantly more returns delivered because of tax shelter potential than are planned for examination in the fiscal year 1980 plan for the three traditional partnership classes.

We do not know if there were as many tax shelter potential returns in the three traditional partnership classes before 1979. However, we do know that prior to the 1979 processing year, returns in such classes were not analyzed on a routine basis for tax shelter potential by tax shelter specialists as is now the case. Such analysis will most likely result in more returns in these classes being examined for tax sheltering aspects than in the past. Thus, fewer audits of traditional partnerships will probably be performed.

CONCLUSIONS AND RECOMMENDATIONS

Much of IRS' examination effort on traditional partnerships in the 2-1/2-year period from October 1977 through March 1980 was unproductive. About one of every two examinations resulted in no change to the partnership return as filed. The high no-change rate can be attributed in part to IRS' having increased its audit effort for partnerships without having (1) sound data for use in setting appropriate examination goals and (2) an effective system in place for identifying those returns having the most audit potential.

IRS' process for setting the increased partnership examination goals for fiscal year 1978 may have been defensible given the lack of data available at the time. However, IRS has done little since then to gather the data needed to set appropriate goals and develop an effective system for selecting returns for examination.

Another problem is that while IRS' partnership program was established to cover both traditional and tax shelter partnerships, it is becoming increasingly difficult to distinguish between the two types on the basis of the present audit classes. IRS' computer-applied tax shelter criteria are indicating that many returns within the traditional partnership audit classes also have tax shelter potential. If this is the case and if such returns are given examination priority, traditional partnerships will not receive the intended level of audit effort.

Accordingly, IRS should reconsider its examination strategy for partnerships. To accomplish this, we recommend that you, as Commissioner of IRS, first decide whether the

partnership program should continue to address traditional partnerships. If the answer is yes, you should:

--Better distinguish between traditional and tax shelter partnerships so that respective goals can be set and accomplishments measured with more precision.

--Develop the voluntary compliance and cost/yield data necessary for establishing appropriate examination goals for traditional partnerships.

--Develop a system for more effectively identifying those traditional partnership returns having the greatest potential for change.

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This report contains recommendations to you on this page. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation and to other interested parties.

We appreciate the assistance provided us by your staff. We would be pleased to discuss these matters further with you or your staff if you think it would be beneficial.

Sincerely yours,

William J. Anderson
Director