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July 19, 1995

The Honorable Margaret Milner Richardson
Commissioner of Internal Revenue

Dear Mrs. Richardson:

In December 1994, we issued a report on the Internal Revenue Service's (IRS) progress in planning the Taxpayer Compliance Measurement Program (TCMP) for tax year 1994 returns.[1] In that report, we emphasized the importance of accurately showing income adjustments and consistently using causal codes, which IRS plans to use in the 1994 TCMP to identify reasons for noncompliance. We have just completed an analysis of a sample of 393 tax year 1988 TCMP returns and associated workpapers where IRS auditors made adjustments to the Other Income line of the Form 1040, Individual Income Tax Return.[2] Our analysis was done to determine whether auditors made proper adjustments to this line in accordance with IRS instructions and whether the causal codes can be used to clearly explain the reasons for noncompliance. This letter is to bring to your attention some procedural problems we observed as we did our analysis.

SUMMARY OF RESULTS

We noted that IRS auditors sometimes made adjustments to the Other Income line which either should have been made to other lines on the return or were inconsistent with TCMP audit instructions. In doing our analysis, we also attempted to apply the causal codes IRS plans to use in the 1994 TCMP to the adjustments auditors made to our sample cases. We found that the causal code definitions were difficult to use because they lacked specificity and IRS had not developed guidance or criteria on when each type of causal code should be applied.

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

[2]Enclosure I discusses how we selected our sample.

AUDIT ADJUSTMENTS MADE TO
THE OTHER INCOME LINE

The Other Income line is used to report income not reported elsewhere on the tax return. IRS instructions to taxpayers list examples of income types which may be reported on this line, including prizes, awards, gambling winnings, and Net Operating Loss Deductions. In practice, taxpayers report many types of income on this line in addition to the types listed in IRS' instructions. These reported Other Income types range from income received for providing services to deductions of income erroneously reported on Form W-2 wage statements.

Based on its 1988 TCMP, IRS estimated that 7.7 million taxpayers underreported income on this line by over $13 billion. This estimate of noncompliance, however, may be deceptive because IRS' auditors sometimes made erroneous audit adjustments to this line.

We reviewed 393 tax year 1988 TCMP sample returns where auditors made adjustments to the Other Income line. Of these adjustments, 49 or 12 percent inappropriately increased the noncompliance of the Other Income line while distorting the compliance levels of other line items on returns.

-- In 37 cases, adjustments were made to the Other Income line for income types that should have been reported on another line of the Form 1040. For example, in one case the auditor increased the Other Income line by over $10,000 because the taxpayer had not reported income from the distribution of an employee pension plan. This adjustment should have been made to the pensions and annuities line (line 17 of the 1988 tax return). In another case, the auditor adjusted the Other Income line when it was determined that the taxpayer failed to report a capital gain of over $200,000 from the sale of a house. This adjustment should have been made to the Schedule D, Capital Gains and Losses, not to the Other Income line.

-- In 12 other cases, taxpayers had inappropriately entered income amounts on tax return lines that should have been reported on the Other Income line. IRS auditors reclassified these amounts to the Other Income line, even though the TCMP instructions to auditors indicated that income was not supposed to be reclassified to that line. For example, in one case, the taxpayer reported nonemployee compensation as wages and the auditor reclassified it to the Other Income line. In several other cases, auditors reclassified income reported on the Schedule C to the Other Income line and reclassified the Schedule C expenses to the miscellaneous expense line of the Schedule A. These reclassifications increased the noncompliance for the Other Income line, even though the income had been reported by the taxpayer and the reclassification itself resulted in no additional taxes. When viewing the results of TCMP, this could cause the misconception that taxes were being underpaid.

Table 1 summarizes the adjustments found in our sample which could erroneously increase the amount of noncompliance attributed to the Other Income line of the tax return.

Table 1: Erroneous Adjustments Made To The Other Income Line

Type of income	Number of returns	Adjustment amount
Capital gain on sale of property	8	$556,572
Wages, tips, and commissions	7	73,612
Dividends	5	235,430
Partnership and S-corporation income	4	165,894
Farm income	4	94,296
IRA payments	2	1,690
Premature distribution of IRA	2	537
Interest	2	17,911
Other adjustments which could have been shown elsewhere	3	57,461
Reclassification of erroneously reported income	12	289,887
Total misleading adjustments	49	1,493,290
All other adjustments	344	21,282,074
Total all adjustments	393	$22,775,364

Source: GAO sample of TCMP returns with Other Income

We could not estimate how often auditors made erroneous adjustments to the Other Income line because our sample was not projectable to the TCMP universe. However, based on the unweighted sample data, it appears that this happened often enough to affect compliance rates for the Other Income line.

It is not clear why IRS auditors had problems with the Other Income line. However, one reason for some of the adjustments may be that TCMP instructions did not specifically address what kinds of income adjustments should be reported on this line. To prevent distorting the compliance level of the Other Income line as well as other tax return lines, it is important that auditors have specific instructions on when to make adjustments to the Other Income line.

USEFULNESS OF CAUSAL CODES

Unlike prior TCMP surveys, IRS plans to require auditors to identify the specific tax issue and determine the cause for most instances of noncompliance found during the 1994 TCMP by using causal codes. IRS' current list of 33 causal codes is presented in enclosure II. IRS officials believe, and we agree, that knowing the specific tax issue involved and understanding the causes of noncompliance should result in better programs to more effectively improve compliance. As we noted in our December 1994 TCMP report, the validity and usefulness of the causal codes will depend on auditors applying them uniformly. Uniform application will depend on IRS developing criteria and instructions, and training the auditors in how to apply the causal codes. At the time we did our analysis of the Other Income line, IRS had no criteria or instructions on the application of the causal codes.

Using the audit workpapers, we applied IRS' 33 causal codes to the adjustments auditors made to the Other Income line to determine how effectively they could be used. Because there were no criteria, we found it difficult to determine when a specific code should be used or, if two or more codes were applicable, which should take precedence. For example, it was not clear when the code for "intentional" instead of "inadvertent" omission of income should be applied. Similarly, a cause such as "inadvertent offset to income" could also be coded as "personal use of business assets", "lack of tax knowledge", "took advantage of gray area in laws or regulations", as well as several others. Without some criteria and instructions for the auditors to follow, IRS cannot be assured that causal codes will be consistently applied among districts or even among auditors within the same district.

We also found that causal codes may be more useful if they identified specific reasons for noncompliance. For example, we found specific causal codes could be useful for explaining certain types of Net Operating Loss Deductions (NOLD) adjustments. NOLDs can be carried back 3 years and carried forward 15 years. In the year an NOLD occurs, the taxpayer must either carry back the deduction for 3 years or attach a statement to the tax return showing that the taxpayer is choosing to forego the carry back period. If the statement is not filed on time, the taxpayer cannot forego the carry back period. Many carry forward NOLDs were disallowed, either fully or partially, for the TCMP year solely because taxpayers had failed to file the statement. Because the NOLDs were fully or partially deductible in earlier years, these adjustments increased the noncompliance on the Other Income line, even though the NOLD deductions were legitimate and allowed on other returns. A specific causal code for these adjustments, such as "The NOLD was adjusted because the taxpayer failed to elect to carry forward only" may provide more useful information for analysts using the TCMP data. Based on our analysis of adjustments made to the Other Income line, we developed 10 additional causal codes, which are listed in enclosure III.

We have discussed a draft of this letter with the IRS Research Division staff. These staff said that the list of 10 causal codes we developed would be added to IRS' list of 33 causal codes. They also said that training will be given to auditors on when to use the various causal codes. Given the corrective action promised, we are not making recommendations in this document. We plan to periodically follow-up on the status of these corrective actions as we do future TCMP related work. If you have any questions regarding this letter, please contact me at (202) 512-5407 or Ralph Block at (415) 904-2035.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy
and Administration Issues

Enclosures

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were (1) to determine whether IRS made proper adjustments to the Other Income line during its 1988 TCMP audits and (2) to evaluate whether the causal codes which IRS plans to use in its 1994 TCMP are adequate to clearly explain the reasons for noncompliance.

The data we used came from IRS' 1988 TCMP database and the audit workpapers associated with these files. The TCMP database is a stratified, nationwide sample that includes about 54,000 tax returns in 32 strata. The TCMP strata are defined by taxpayer income and type of return filed. IRS examiners audited each tax return selected for the TCMP sample to determine whether the correct taxes had been computed.

We focused on the 9,324 TCMP sample returns where data existed on the Other Income line, either as an amount reported by taxpayers or an amount entered on the line by IRS examiners during their audits. There were 8,294 returns where taxpayers reported amounts on the Other Income line. For the remaining 1,030 returns, taxpayers did not enter an amount, but IRS' examiners made an audit adjustment to the line.

We obtained files on 393 TCMP cases in which IRS made adjustments. For each of these cases, we reviewed the audit workpapers to determine whether IRS' examiners had shown the adjustment in accordance with IRS instructions. We also used these workpapers in an attempt to fit the cause of the noncompliance into one of the 33 causal code categories IRS plans to use in its TCMP for 1994 tax returns.

IRS DEFINED CAUSES

1. Taxpayer forgot about obligation.
2. Taxpayer was unaware of tax law.
3. Taxpayer was sick or died.
4. Taxpayer lacked education to complete return.
5. Taxpayer's records were inadequate.
6. Lack of time to prepare return.
7. Taxpayer relied upon a family member or friend's advice.
8. Taxpayer relied upon IRS' advice.
9 Taxpayer relied upon practitioner's advice.
10. Taxpayer received the information return late or not at all.
11. Taxpayer inadvertently omitted income.
12. Taxpayer intentionally omitted income.
13. Taxpayer inadvertently overstated offsets to income.
14. Taxpayer intentionally overstated offsets to income.
15. Taxpayer deducted a nondeductible expense.
16. Taxpayer entered income or expenses on the wrong form to avoid self employment tax.
17. Taxpayer made personal use of business assets.
18. Taxpayer took advantage of a gray area in the law.
19. Taxpayer's records were lost or destroyed.
20. Taxpayer made a timing error.
21. Adjustment was made because of passive loss limitation.
22. Income was not reported because it was from illegal activity.

IRS DEFINED CAUSES

23. Taxpayer omitted income or overstated deductions due to lack of money to pay tax liability.
24. Taxpayer procrastinated.
25. Taxpayer is a protestor.
26. There is no business purpose for income or expenses.
27. Adjustment to reported amount due to amended return.
28. Adjustment based on amended return.
29. Statutory adjustment.
30. Taxpayer failed to show up for audit.
31. Adjustment due to misclassification.
32. Adjustment due to a computation error.
33. Adjustment to reported amount due to input error at service center.

POSSIBLE ADDITIONAL CAUSAL CODES

1. The paid preparer made an error on the tax return.
2. The change was due to an adjustment in a prior year return--no negligence penalty assessed.
3. The change was due to an adjustment in a prior year return--a negligence penalty was assessed.
4. The NOLD was adjusted because the taxpayer failed to elect to forego carry back.
5. Unreported income was found through indirect methods--type of income is unknown.
6. Taxpayer omitted a constructive dividend.
7. Capital gains (losses) were changed due to a basis adjustment.
8. Case referred to Criminal Investigation because of potential fraud.
9. Error in allocation of partnership or S-corporation earnings.
10. The cause of the adjustment is unknown.

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