

GAO

Briefing Report to the Joint Committee  
on Taxation, Congress of the United  
States



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September 1986

TAX  
ADMINISTRATION

IRS' Backlog of Tax  
Returns With Tax  
Shelter Issues Awaiting  
Settlement



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# GAO

United States  
General Accounting Office  
Washington, D.C. 20548

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General Government Division

B-223786

September 12, 1986

The Honorable Bob Packwood  
Chairman, Joint Committee on  
Taxation

The Honorable Dan Rostenkowski  
Vice Chairman, Joint Committee on  
Taxation  
Congress of the United States

By letter dated January 28, 1986, you asked us to evaluate the Internal Revenue Service's (IRS) settlement of tax shelter issues and its efforts to curtail the promotion and sale of abusive tax shelters. We recently briefed your staff on that portion of our work concerning IRS' increasing backlog of tax returns with tax shelter issues and the additional taxes and penalties that have been assessed as a result of IRS' efforts. Your staff subsequently asked us to provide you with a report setting forth the basic focus of our briefing.

Our briefing was focused around the information presented in the five tables shown in appendix I. We obtained this information at the IRS National Office from various management information systems. Each table shows the specific source of information. We did not attempt to verify the data due to the amount of time that doing so would have required. Our work was performed during the period February 1986 through July 1986.

As you know, tax shelters involve investments or transactions through which taxpayers defer or reduce tax liability. Some tax shelters, however, lack economic purpose other than the generation of tax benefits. IRS contends that such shelters constitute an abuse of the tax laws. Accordingly, IRS has established a tax shelter program the objective of which, according to the Internal Revenue Manual, is to

" . . . identify, examine and, in appropriate cases, investigate those tax shelters utilizing improper or extreme interpretations of the law or the facts to secure for investors--taxpayers--substantial tax benefits which are clearly disproportionate to the economic reality of the transaction."

As of December 1985, IRS, through its tax shelter program, had identified over 22 types of tax shelter investment promotions or transactions. The Examination Division's workload as of December 1985, broken out by tax shelter type, is shown in table I.1.

As with any tax issue, IRS' examination of a tax shelter issue can result in a recommendation that the tax shelter deduction and/or credit either be accepted as filed or that an adjustment be made. Taxpayers can accept

the examination adjustments, contest them through an IRS Appeals Office, or bypass the appeals process by filing a petition with the U. S. Tax Court. Thus, it is possible that the IRS' examination of a tax shelter issue can result in an increase to the workload of several IRS functions, including appeals and litigation, as well as the Tax Court.

IRS has devoted considerable effort to identifying tax returns with tax shelter issues and to settling tax shelter cases. Even so, the overall backlog has continued to increase in IRS' examination, appeals, and tax litigation functions. Although the number of tax shelter returns closed each year by the examination process has increased, the increase in the receipt of new returns with tax shelter issues has been greater; and, as shown in table I.2, this has led to an increased backlog in the examination inventory. Further, as shown in table I.3, most taxpayers have disagreed with the tax adjustments made by the Examination Division. For example, taxpayers disagreed with the adjustments in 86,218, or 61 percent, of the shelter returns closed by the Examination Division during fiscal year 1985. This has contributed to the backlog of cases in IRS' Appeals and Tax Litigation Divisions, as shown in table I.4.

The total dollar increase in federal revenues that will be produced in additional taxes and penalties stemming from IRS' examination of tax shelter issues is not known. As shown in table I.5, although IRS assessed about \$8.2 billion in additional taxes and penalties for tax shelter returns examined and closed during the period October 1982 through December 1985, about \$7.4 billion, or 91 percent, of these adjustments were contested. The contested percentage has been at least 90 percent for each year shown in the table. The amount of the additional taxes and penalties that will actually be assessed and collected for the contested dollar amounts will not be known until the cases are settled.

As requested by your office, we did not obtain official comments from IRS. However, IRS Examination, Appeals, and Tax Litigation Division officials reviewed a draft of our briefing document, and we considered their comments in preparing this final product. Also, as arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this document until 3 days after its issue date. At that time, we will send copies to interested parties and make copies available to others upon request.

If you have questions regarding this briefing report, please call me on (202) 275-6407.

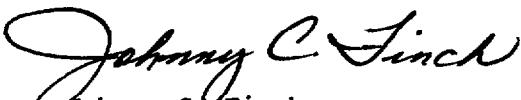
  
Johnny C. Finch  
Senior Associate Director

Table 1.1  
Types of Tax Shelters that Comprised  
the Examination Division's Workload  
as of December 1985

<u>Shelter type</u>	<u>Number of returns</u>
Oil and gas	25,803
Real estate	40,455
Farming	14,303
Movies	12,683
TV/video tapes	6,003
Coal	10,740
Commodities	19,647
Master recordings	17,783
Leasing	44,716
Books	3,306
Cable T.V.	3,478
Treasury bills	19,879
Contributions	3,005
Foreign trusts	486
Mining	13,808
Patents	1,728
Lithographs	3,122
Research & development	15,282
Energy	9,785
Historic structure	787
Special projects	41,615
Other <sup>a</sup>	<u>105,251</u>
Total	<u>413,665</u>

<sup>a</sup>Includes shelter types not listed above and returns which had not been classified as to type of shelter.

Source: IRS' Audit Information Management System.

Table I.2  
Increase in Examination  
Division's Tax Shelter Workload

<u>Fiscal year</u>	<u>Opening inventory</u>	<u>Returns received</u>	<u>Returns closed</u>	<u>Ending inventory</u>	<u>Increase</u>
1981	174,244	124,058	49,474	248,828	74,584
1982	248,828	107,793	71,793	284,828	36,000
1983	284,828	145,719	95,998	334,549	49,721
1984	334,549	145,898	114,488	365,959	31,410
1985	365,959	153,576	141,423	378,112	12,153
1986a	378,112	67,711	32,158	413,665	35,553

<sup>a</sup>From October 1, 1985, to December 1985.

Source: IRS' Audit Information Management System and Tax Shelter Management Information System.

Table I.3  
Percentage of Tax Shelter Returns Closed  
by the Examination Division for Which  
Taxpayers Disagreed with the Adjustments

<u>Fiscal year</u>	<u>Total returns closed<sup>a</sup></u>	<u>Returns agreed<sup>b</sup></u>	<u>Returns unagreed<sup>c</sup></u>	<u>Returns unagreed as a percentage of closed returns</u>
1982	71,793	24,946	41,906	58
1983	95,998	35,923	53,433	56
1984	114,488	40,519	68,872	60
1985	141,423	46,776	86,218	61
1986 <sup>d</sup>	32,158	9,900	20,435	64

<sup>a</sup>Includes examined returns for which there was no adjustment to the tax liability reported by the taxpayers.

<sup>b</sup>Includes returns for which the taxpayer agreed to pay additional taxes and penalties as adjusted by the Examination Division.

<sup>c</sup>Includes returns for which the taxpayer did not agree to pay additional taxes and penalties as adjusted by the Examination Division.

<sup>d</sup>From October 1, 1985, to December 1985.

Source: IRS' Audit Information Management System and Tax Shelter Management Information System.

Table I.4  
IRS' Overall Backlog  
of Tax Shelter Cases

<u>Fiscal year</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986<sup>e</sup></u>
Examination <sup>a</sup>	174,244	248,828	284,828	334,549	365,959	378,112	413,665
Appeals <sup>b</sup>	-	-	16,086	18,217	22,635	25,683	31,072
Tax Litigation <sup>c</sup>	3,503	8,572	15,105	18,287	21,034	28,500 <sup>d</sup>	30,000 <sup>d</sup>

<sup>a</sup>Each tax year return with a tax shelter issue is counted as a case. For example, if taxpayer X has tax shelter issues on returns filed for 1981, 1982, and 1983, this would be counted as three cases in Examination's inventory.

<sup>b</sup>For tax shelter cases, one case equals one taxpayer regardless of the number of tax years involved. For example, if taxpayer X has tax shelter issues on returns filed for 1981, 1982, and 1983, this would be counted as one case in Appeal's inventory. Appeals did not maintain records of tax shelter cases in 1980 and 1981.

<sup>c</sup>Cases to be tried can consist of one or more taxpayers with 1 or more tax years. For example, taxpayer X with tax shelter issues on returns filed in 1981, 1982, and 1983 can be included with taxpayers Y and Z if the tax shelter issues are the same and if they file a single petition with the court. Taxpayer X can also choose to file a separate petition for each of the 3 tax years.

<sup>d</sup>The number of tax litigation cases are IRS estimates.

<sup>e</sup>From October 1, 1985, to December 1985.

Source: IRS' Audit Information Management System, Tax Shelter Management Information System, Appeals Tracking System, and Tax Litigation Program Statistics.

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Table I.5  
Examination's Adjustments for  
Tax Shelter Returns Closed

Fiscal year	Total adjustmentsa	Unagreed amountb	Average amount for unagreed returns	Amount agreedc	Average amount for agreed returns	Unagreed amount as a percentage of total dollars
1982	\$ 954,175,135	\$ 868,897,813	\$20,734	\$ 85,277,322	\$3,419	91
1983	1,784,672,242	1,608,587,625	30,105	176,084,617	4,902	90
1984	2,187,144,080	1,986,929,778	28,850	200,214,302	4,941	91
1985	2,509,632,162	2,279,500,042	26,439	230,132,120	4,920	91
1986d	<u>721,347,773</u>	<u>672,086,833</u>	32,889	<u>49,260,940</u>	4,976	93
Total	<u>\$8,156,971,392</u>	<u>\$7,416,002,091</u>		<u>\$740,969,301</u>		91

aThe additional tax and penalty amounts assessed by the Examination Division.

bThe additional tax and penalty amounts assessed by the Examination Division for those cases in which the taxpayer did not agree to pay.

cThe additional tax and penalty amounts assessed by the Examination Division for those cases in which the taxpayer agreed to pay.

dFrom October 1, 1985, to December 1985.

Source: IRS' Audit Information Management System and Tax Shelter Management Information System.

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