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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

HOUSE COMMITTEE ON WAYS AND MEANS

ON

HOW THE INTERNAL REVENUE SERVICE SELECTS

AND AUDITS INDIVIDUAL INCOME TAX RETURNS

Mr. Chairman and Members of the Subcommittee:

Our testimony deals with the reviews we made of how IRS selects and audits individual income tax returns. Our reviews, undertaken at the request of the Joint Committee on Internal Revenue Taxation, resulted in two reports, one on the selection process dated November 5, 1976, and one on the audit process dated December 2, 1976.

The digests of both reports are attached to my statement. Details of the selection and audit processes are described in the two reports. Our statement highlights some of the major issues and problem areas in these processes.

Probably no Government activity affects more people than the collection of taxes. Thus, it is vital that the process be fairly and equitably administered.

We had one fundamental question in mind in undertaking these reviews: Do IRS' procedures for selecting and auditing individual income tax returns generally protect taxpayers against abuse and control against unwarranted tax assessments? Based on our review, the answer is yes. That does not mean, however, that IRS cannot improve its procedures for both selecting and auditing individual tax returns.

Returns can be audited by IRS service centers, where taxpayers file their returns, or by local district offices, where taxpayers have most of their direct contact with IRS. Of the 3.2 million individual income tax returns audited in fiscal year 1975, 42 percent were audited by service centers and 58 ent were audited by district offices.

SERVICE CENTER AUDITS

How are tax returns selected for audit at a service center? Most returns audited by IRS's 10 service centers are selected for audit because they involve relatively simple and readily identifiable problems that usually can be resolved by correspondence between the taxpayer and IRS. Many are selected because they have a special feature such as a deduction not permitted by law or the questionable use of the head of household tax rate.

Procedures for selecting tax returns for audit at a service center adequately protect against abuse in the selection process. Most of the returns and audit issues are identified by the computer or individuals

who have nothing to do with the audit process. Moreover, the criteria for selecting returns for service center audit are usually so specific that judgment plays only a minor role. In some cases, someone has to decide which returns and which issues on those returns should be audited but in those instances the decisions are made by someone other than the person who will be responsible for auditing the return.

Once a return is selected for service center audit, how does the audit proceed? Generally, service center audits involve sending the taxpayer a letter which notifies him of the problem the Service has with his return, advises him of the impact of the problem on his tax liability, and tells him what to do if he agrees or disagrees with IRS' finding. If the taxpayer agrees the audit is closed, if he disagrees he can

--submit information to support his contention which the service center staff will evaluate;

--request the case be transferred to a district office for examination; or

--take advantage of his appeal rights provided for by IRS procedures.

Generally, we found no major problems with IRS' audit of individual tax returns at service centers. We concentrated our efforts on audits completed under the "unallowables" program because that program accounted for over 70 percent of all service centers audits in 1975. Under this program items on tax returns which appear to be unallowable by law--such as utility taxes and gambling losses in excess of winnings--are identified

during initial processing of the return and are corrected through correspondence with the taxpayer. Some unallowable items are identified by IRS employees while others are computer identified.

We noted one basic problem with audits done under the unallowables program--service center personnel were sometimes making erroneous tax adjustments and taxpayers were agreeing to them. About 6 percent of the cases examined under this program at the two service centers where we did our work--Kansas City and Memphis--involved tax adjustment errors by service center staff. This is a significant error rate when you consider that most taxpayers in our sample who were overassessed because of a service center error agreed with the erroneous adjustment. IRS does have a quality review program by which it tries to minimize erroneous adjustments. Although quality review statistics indicate that error rates are decreasing, not all errors can be caught by quality review. Thus, some taxpayers may still be agreeing to erroneous adjustments.

To improve this situation, we recommended that IRS revise the form letter it uses to let taxpayers know that they have certain unallowable items on their returns and how correction of those items affects their tax liabilities. As written, the letter gives taxpayers the impression that they can do little about IRS' change. We recommended that IRS revise the letter to make it clearer that taxpayers can do something if they think IRS is wrong. IRS agreed to that recommendation.

DISTRICT OFFICE AUDITS

The process for selecting and auditing individual tax returns at IRS' 58 district offices is more complicated and therefore resulted in more problems that we believed needed correcting.

Most returns audited by the district offices involve issues that are not as readily identifiable or as easily resolved as those audited by service centers. Some returns may be randomly selected for district office audit in connection with special research programs while others may be specifically selected for any number of reasons. A return may be selected, for example, if it has a special feature that IRS is looking for, such as an unscrupulous preparer. Most returns, however, are selected for district office audit because IRS has determined, through computers, using sophisticiated mathematical formulas, that a return has good audit potential. This computerized system is called the discriminant function system, or DIF for short. Of the returns audited by district offices in fiscal year 1975, 69 percent were selected through DIF.

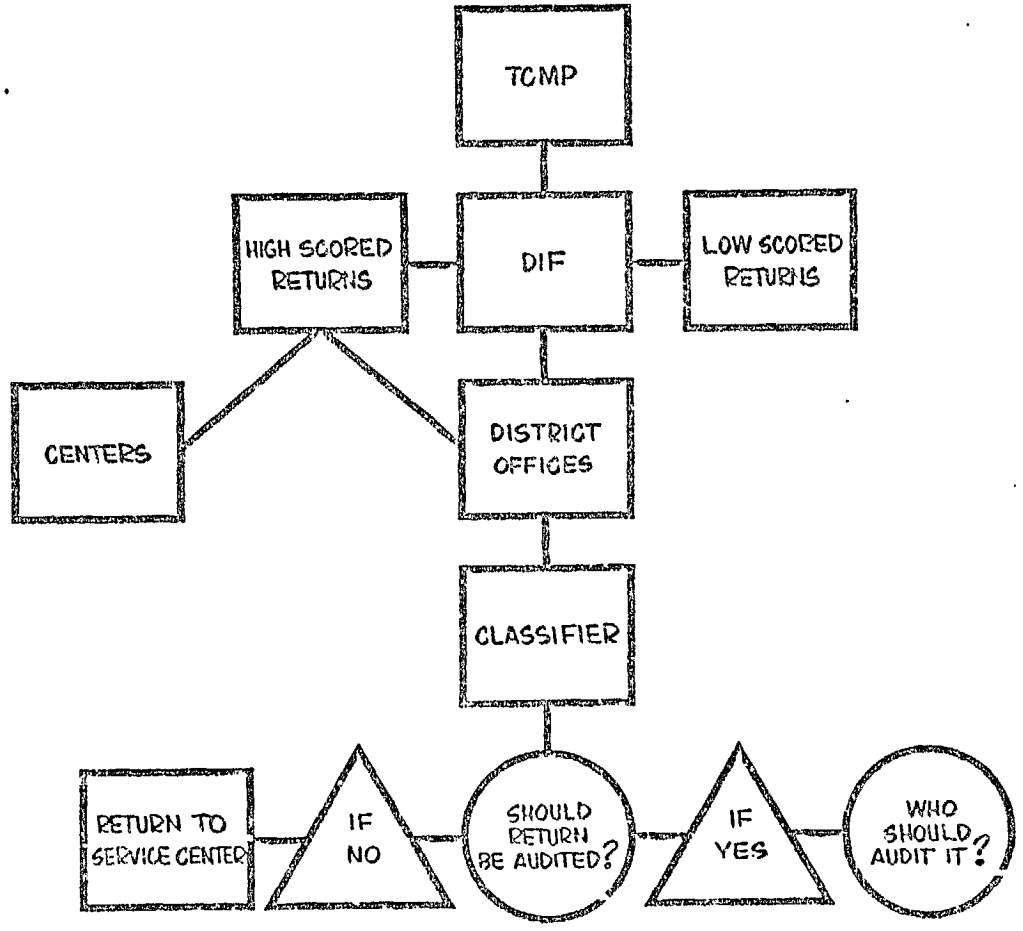
In most cases, decisions to select returns for audit are made by someone other than the person who will be auditing the return, which greatly limits the chances for abuse.

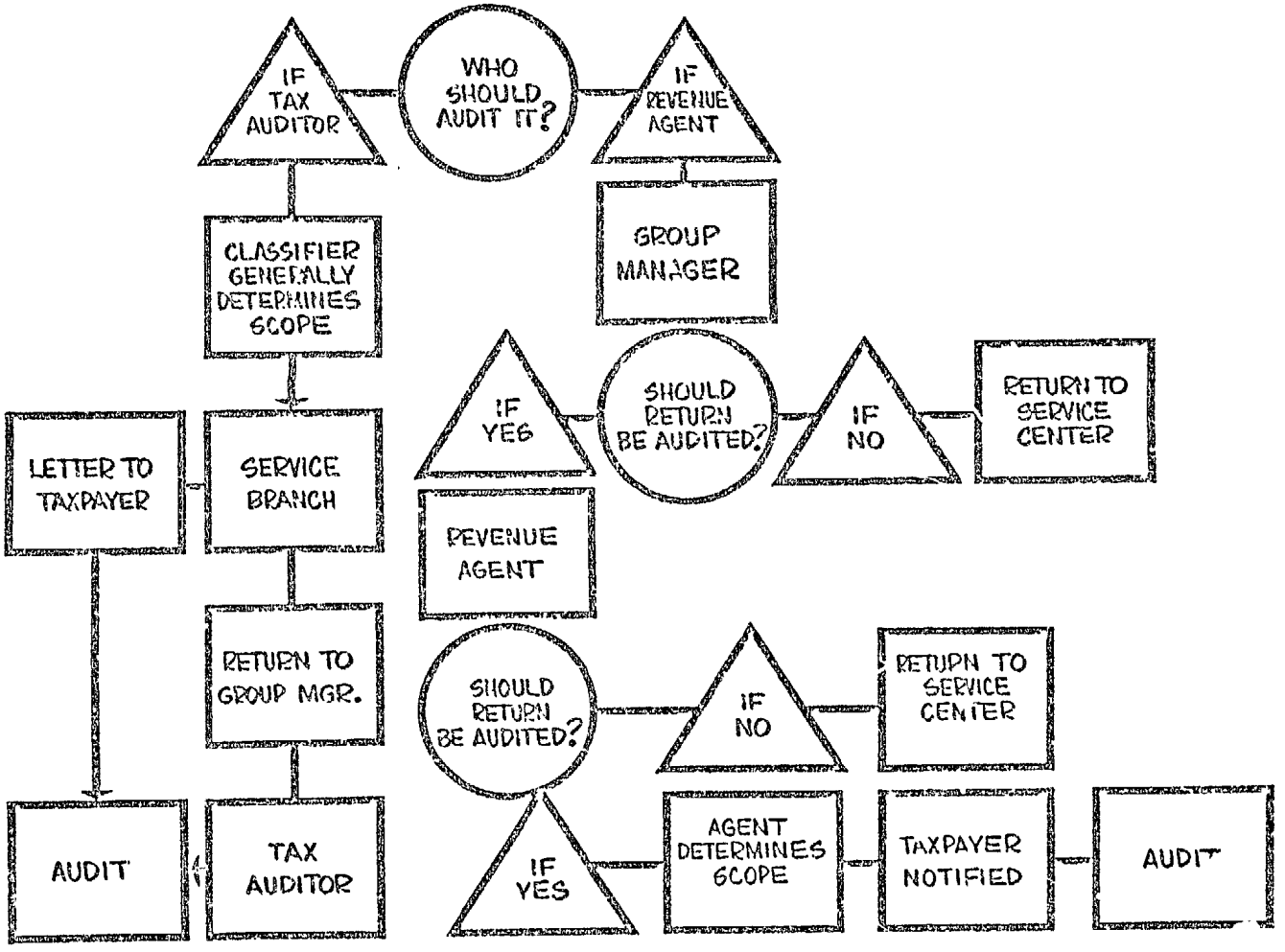
There is one notable exception however. Ten percent of the returns audited by district offices in fiscal year 1975 were selected directly by the examiner because he had determined that he needed to audit a return filed by a taxpayer for years other than the one being audited or a return filed by another taxpayer that might have a bearing on the return being audited. The requisition prepared by an examiner to get these returns contains no written explanation as to why he needs the return and thus gives management little basis for evaluating that need.

We recommended that IRS require its examiners to provide written explanations. IRS did not agree to make any immediate changes but said it would review the matter.

Adequacy of DIF

Since about 70 percent of the returns audited by the district offices are selected for audit through IRS' DIF system, we concentrated on that system during our review. To facilitate this portion of our testimony, we have prepared a flow chart that depicts this process. With your permission, Mr. Chairman, I would like to have the chart inserted in the record at this point.


TCMP
HIGH SCORED RETURNS
DIF
LOW SCORED RETURNS
CENTERS
DISTRICT OFFICES
CLASSIFIER
RETURN TO SERVICE CENTER
IF NO
SHOULD RETURN BE AUDITED?
IF YES
WHO SHOULD AUDIT IT?


WHO SHOULD AUDIT IT?
IF TAX AUDITOR
IF REVENUE AGENT
CLASSIFIER GENERALLY DETERMINES SCOPE
GROUP MANAGER
LETTER TO TAXPAYER
SERVICE BRANCH
IF YES
SHOULD RETURN BE AUDITED?
IF NO
RETURN TO SERVICE CENTER
REVENUE AGENT
RETURN TO GROUP MGR.
SHOULD RETURN BE AUDITED?
IF NO
RETURN TO SERVICE CENTER
AUDIT
TAX AUDITOR
IF YES
AGENT DETERMINES SCOPE
TAXPAYER NOTIFIED
AUDIT

The process begins with IRS' Taxpayer Compliance Measurement Program--known as TCMP. TCMP is a program for measuring and evaluating taxpayer compliance characteristics through specialized audits of randomly selected returns. IRS uses the data compiled from these audits to develop the mathematical formulas that the computer uses to assign weights to certain return characteristics. The sum of the various weights for a particular return represents the DIF score of that return. The higher the score, the greater the probability that an audit of that return will result in a tax change.

All individual income tax returns are scored in this manner. Different DIF formulas are used depending on the amount of adjusted gross income shown on the return and depending on whether the taxpayer had any business income.

If a return's DIF score is higher than the national cutoff score established by IRS headquarters, it is included in the inventory of returns available for audit under the DIF system. If its score is below the cutoff, the return will not be selected for audit under DIF but may still be selected for some other reason. Periodically, a district will order DIF returns for audit. It may order, for example, 500 medium income non-business returns in which case it will receive the 500 highest scored tax returns in that class filed by taxpayers in that district.

At the district office, the 500 returns will be screened by classifiers. These classifiers, who are revenue agents and tax auditors on temporary detail, use their experience and judgment to determine which of the 500 returns warrant audit and which do not. A return, for

example, may have received a high score because of an unusually large deduction but the classifier may see something the computer could not--such as supporting documentation attached to the return--and, based on that, will determine that the return does not warrant audit.

If the decision is made that a return warrants audit, the classifier must then decide whether the audit should be done by a revenue agent or a tax auditor. The basic criterion in making this decision is the complexity of the return--the more complex returns go to revenue agents. If the classifier decides that a revenue agent should do the audit, the return is forwarded to a group manager who may also look at the return to see if it warrants audit. If he decides that it does, he assigns it to a revenue agent. The agent will review the return, decide what issues he wants to cover during the audit, and then contact the taxpayer to make arrangements for the audit.

If the classifier determines that the audit should be done by a tax auditor, the classifier, rather than the auditor, will select the issues to be covered during the audit using judgment and experience as a guide. The return will usually then go to a central control group which mails a letter to the taxpayer advising him of the audit and its scope. After the taxpayer mails in his support or just before the taxpayer is due for his interview, a group manager will receive the return from the central control group and assign it to a tax auditor.

We evaluated the DIF system, and found it to be an effective way to select returns for audit. There is one unanswered question, however, namely: to what extent do classifiers affect the selection process?

Past evaluations of DIF have concentrated on the computer phase and virtually ignored the classifier. We did not evaluate the classifier's effect because we would have had to disrupt IRS' operations but, more importantly, because we believe that IRS is in a better position to make such an evaluation.

There is little doubt that the classifier influences the results obtained from auditing DIF-selected returns because he decides whether they should be audited and, in most cases, decides which issues should be covered during the audit. We therefore recommended that IRS measure the extent of this influence and while IRS appeared to recognize the need to measure the classifier's effect, they did not indicate a strong willingness to do so.

One basic problem we noted with the DIF system was that a person who overassesses his tax liability is less likely to have his return selected for audit than the person who underassesses his liability. This results in part because of a bias built into the DIF formulas but primarily because it is difficult for a classifier to identify an overassessor by looking at his return. Classifiers do not consciously ignore the overassessor; they just cannot identify him. IRS told us that it has taken steps to eliminate the bias in the formulas and plans to take others, directed at the classifier, to insure that a representative number of returns involving overassessments are audited.

The District Audit Process

No matter how a return is selected for audit, the district office audit process is the same. IRS notifies the taxpayer of the audit and its scope, examines his support, evaluates the adequacy of that

support, and advises him of the audit findings. Revenue agents usually conduct their audits at the taxpayer's residence or at his or his representative's place of business. Tax auditors usually conduct their audits at an IRS office. In fiscal year 1975, tax auditors did about 80 percent of all audits done at district offices.

IRS examiners generally used their authority with discretion. We did note certain practices, however, that warrant IRS' attention.

Inconsistent Treatment

In some cases, IRS' decision to assess additional taxes is based solely on the information in the return because the taxpayer failed to respond to IRS' letter notifying him of the audit and asking him to provide support for certain items. IRS is justified in disallowing deductions if the taxpayer ignores IRS' request for substantiation. What concerns us is how IRS knows whether the taxpayer is ignoring the request or simply never received it. We recommended that IRS, when adjusting a taxpayer's return in this type situation, make it clear to the taxpayer that IRS had sent him a previous letter asking for support for certain items, that the items are now being disallowed because he failed to provide the support, and that it will reconsider its findings if support is provided. IRS agreed with this recommendation.

After an examiner completes his audit, he has to decide whether the taxpayer owes more taxes, has paid too much and is due a refund, or has correctly prepared his return. If an examiner finds errors on the return but considers them insignificant from a tax standpoint, he can close the case "no-change," just like he would if he had found no

errors. IRS has no uniform criteria, however, for deciding if an error is insignificant. Thus examiners use their own discretion in making this decision.

Examiners' decisions in this regard are sometimes influenced by the amount of the taxpayer's income or reported tax liability and sometimes vary depending on whether the audit was conducted by correspondence or interview. Thus, two taxpayers in similar situations may be treated differently depending on who audits their returns. One taxpayer may be billed for additional tax while the other has his case closed no-change, or a taxpayer may or may not be billed for additional tax, depending on his income. Accordingly, we recommended that IRS establish uniform criteria and treat all taxpayers equally, regardless of their income or reported tax liability. IRS agreed.

Appeal Rights

IRS' procedures require an examiner, after completing an audit, to explain the basis of the proposed adjustments to the taxpayer and to attempt to obtain the taxpayer's agreement to those adjustments.

Every taxpayer has the right to appeal an examiner's findings. Some examiners, however, said they advise a taxpayer of his rights only if he disagrees with the findings--the assumption being that a taxpayer who agrees has nothing to appeal. This assumption is debatable.

We took a valid random sample of 1,175 of the 181,000 taxpayers in the Baltimore, Cheyenne, Los Angeles, and New Orleans districts whose audits were closed in 1973. About 800 taxpayers, or 72 percent, responded to the questionnaires we sent them. The responses indicated that only 42 percent of the taxpayers who agreed to district office audit findings did so because they understood why their returns had to be changed.

The responses also indicated that 25 percent of the taxpayers in the four districts who were audited by the district offices and who were told they owed more taxes were not advised of their appeal rights.

IRS' procedures require the examiner to advise the taxpayer of his appeal rights after the taxpayer indicates he disagrees with the findings. That procedure should be changed. The examiner should remind the taxpayer of his appeal rights before he attempts to obtain the taxpayer's agreement. Only then can IRS be sure that taxpayers are not agreeing simply because they are unaware of the alternatives.

The first avenue of appeal is meeting with the examiner's supervisor. This convenient and inexpensive procedure is being ignored by most taxpayers. Only about 6 percent of the respondents to our questionnaire who were told they owed more taxes indicated they had requested a meeting with the examiner's supervisor. A taxpayer may disagree with an examiner's findings but not have the time or money to use the more formal avenues of appeal--district conference, appellate conference, and the courts. But a meeting with the examiner's supervisor is more informal and can often be arranged the same day as the audit.

Therefore, we recommended that IRS inform all taxpayers of their appeal rights, especially the right to meet with the examiner's supervisor, after the examiner has explained his audit findings but before seeking agreement to those findings. IRS agreed to revise its instructions to require examiners to remind taxpayers of their right to meet with supervisors. IRS did not agree to remind taxpayers of their appeal rights before asking them to agree to the audit findings.

We also inquired into the post-audit review procedures of group managers and district office review staffs as a means of evaluating IRS' controls against unwarranted assessments. Although many audits are not subjected to post-audit review and although it is fair to assume that some erroneous adjustments are going uncorrected, we saw no need to recommend changes in IRS' review procedures. It would be impractical to expect group managers to review every completed audit considering all their other duties, and the purpose of the review staff is not to review every audit but rather to review enough audits to provide a statistically valid measure of the general quality of district audits. We believe that the problem of erroneous adjustments could be alleviated if taxpayers were advised of their right to meet wit the examiner's supervisor and if taxpayers took advantage of that right. Such a meeting would, in effect, cause a review of the examiner's findings by the supervisor.

IRS Audits - Taxpayer Point of View

Audited taxpayers who responded to our questionnaire generally reacted favorably as to how IRS treated them and the manner in which IRS conducted its audits.

Of the taxpayers who had district audits

--72 percent believed IRS gave them the benefit of the doubt or treated them fairly,

--82 percent felt that IRS treated them courteously or somewhat so,

--92 percent considered the time set for the audit reasonable,

--77 percent had their returns prepared by commercial or professional preparers,

--only 42 percent of those who agreed to all or part of the tax change resulting from audit, understood the need for the change, and

--audit practices in the 4 districts were generally uniform.

Our analysis showed several differences between taxpayers who experienced a service center audit and those who experienced a district audit. Taxpayers who had service center audits

--had smaller tax increases but fewer no change audits,

--were more likely to have prepared their own tax tax returns, and

--were more likely to understand why their returns were changed.

IRS' PLANNING PROCESS

Questions often arise as to how IRS allocates its audit effort among the various classes of individual taxpayers and whether a person's chances of being audited vary depending on where he lives. We addressed these questions through a review of IRS' long and short range planning process.

The basic decision as to how IRS' audit effort is going to be allocated among the various taxpayer classes is made when IRS prepares its 5 year long-range plan. During the period of our review, IRS was using what it termed a "balanced strategy" in preparing its long-range plans. This strategy called for improving voluntary compliance in those classes where compliance was low, such as the low income business class, and assigning remaining auditing staff to the rest of the classes on the basis of estimated tax yield.

Each year IRS prepares a national audit plan as a step towards meeting its long-range plan. The basic decision as to how IRS' audit

effort is going to be distributed geographically is made during this annual planning process. The national office allocates its plan to the seven regional offices based on the relative level of compliance in each region. Thus a region where compliance appears low would be allocated a larger portion of the planned audit work than one where compliance appears high. Under ideal conditions, IRS' allocation of its plan would be based entirely on compliance. IRS is forced, however, to adjust its compliance-based allocation to account for imbalances between the number of audits that should be done in a particular geographical area and the audit staff available to do them. Thus, in the end, some taxpayers are audited or not audited merely because of where they live.

Although IRS prepares its plans with the intent of improving compliance in those classes where it is low, it is not entirely successful in achieving that objective. As shown on the chart, IRS exceeded its total plan in both 1974 and 1975 and in some classes it exceeded its plan quite significantly. With your permission Mr. Chairman, I would like to have the chart inserted in the record at this point.

A U D I T S

PLAN VS. ACTUAL

Audit Class	Fiscal Year 1974 Number of Audits Plan	Fiscal Year 1974 Number of Audits Actual	Fiscal Year 1974 Percent of Plan	Fiscal Year 1975 Number of Audits Plan	Fiscal Year 1975 Number of Audits Actual	Fiscal Year 1975 Percent of Plan	Voluntary Compliance Level 1969	Voluntary Compliance Level 1973
Form 1040 - standard	1[illegible],031	232,053	119	187,560	220,909	118	95.2	93.7
Non business under $10,000 - itemized	472,359	561,421	119	485,010	551,393	116	88.5	85.3
Non business $10,000 under $50,000	504,886	606,363	120	675,290	689,459	102	96.1	95.7
Non business $5[illegible],000 and over	45,391	38,939	86	58,765	59,230	101	94.1	95.2
Business under $10,000	131,798	121,703	92	150,305	135,389	90	68.7	56.6
Business $10,000 under $30,000	57,679	72,304	125	76,105	97,544	128	87.8	86.0
Business $30,000 and over	57,082	53,902	94	73,565	74,634	101	91.2	90.6
Total	1,464,226	1,686,685	115	1,706,600	1,838,558	108	92.7	92.3

In both years, however, IRS failed to meet its plan in the low income business class which has the worst compliance level by far. In 1974, for example, tax auditors did 232,100 more audits than in 1973. Ninety percent of the additional audits were done in the medium nonbusiness class which has historically been the best complying class. The number of audits in the low income business class actually went down between 1973 and 1974. This is inconsistent with IRS' stated objective of improving compliance through audits. We know that IRS deviated from its 1974 plan to meet a commitment it had made to the Congress to increase audits and assessments if it received additional audit staff. We do not know what happened in 1975 to cause IRS to fall short of its plan in the low income business class.

Given (1) the need to assure equity in tax law administration and (2) IRS' previous deviation from its plan, we believe the Congress should discuss with IRS its decisions regarding audit coverage. To do this the Congress needs sufficient data. Therefore, we recommend that the Congress request IRS to provide it detailed information on its audit plans, probably as part of IRS' annual appropriation request.

Although IRS' planning process is basically sound, we recommended that IRS more fully consider service center audits in the planning process because, as it now stands, IRS virtually ignores these audits in deciding how it is going to achieve its compliance goals. Also IRS should accelerate its research into factors that influence compliance to determine if audit coverage is as significant a factor as IRS assumes in its planning process.

Although we saw no evidence of quotas for individual examiners, some examiners felt pressured to complete audits and felt that this pressure prevented them from doing a quality job. We believe that the annual plan, by calling for a certain number of audits to be completed in a certain number of staff years, could be the catalyst for this pressure if the time it allows for each audit is unreasonable. We have reason to believe that the time constraints built into the plan are unreasonable and we recommended that IRS look into it.

This concludes my prepared statement. We would be pleased to respond to questions.

ATTACHMENT I

COMPTROLLER GENERAL'S REPORT TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

HOW THE INTERNAL REVENUE SERVICE SELECTS INDIVIDUAL INCOME TAX RETURNS FOR AUDIT

Department of the Treasury

D I G E S T

Although no major problems were evident, the Internal Revenue Service can improve its procedures for selecting individual income tax returns for audit. Also, congressional oversight of the Service's audit activities would be enhanced by having the agency present the rationale behind application of its audit effort among the various classes of taxpayers.

WHY YOUR RETURN MIGHT BE SELECTED FOR AUDIT

Returns can be audited by IRS service centers, where taxpayers file their returns, or by local district offices, where taxpayers have most of their direct contact with IRS. Most returns are selected for audit by a computer or by persons other than the examiners who will be auditing them.

Criteria for selecting returns for service center audit are usually so specific that personal judgment is but a minor factor in the process. (See p. 11.) Some returns selected for district office audit are chosen randomly in connection with special tests; others are chosen because they have a special feature, such as having been prepared by an unscrupulous preparer. But most are selected because the computer or an individual has determined that the returns, in general, have good audit potential. (See p. 24.)

About 70 percent of returns audited by district offices are selected by a two-stage system. Returns first are "scored" as to their audit potential by a computer using sophisticated mathematical formulas. The highest scored returns then are manually screened to determine if an audit is warranted and, in most cases,

what items of income and deductions should be examined. GAO and IRS tests have determined that this system is effective, but these tests have concentrated on the use of the computer. Little has been done as yet to evaluate the effectiveness of the manual screener. (See pp. 28 and 41.)

Taxpayers who pay more taxes than they should are less likely to have their returns selected for audit under this system than are taxpayers who did not pay enough--primarily because it is difficult for the manual screener to identify those who have made overpayments. The mathematical formulas used to score returns are also biased against the overpayer. (See p. 34.)

To overcome this deficiency the Commissioner of Internal Revenue should direct IRS to measure the effect of the manual screener on the computerized selection system and determine ways to make sure that a representative number of returns involving overpayments are audited. (See p. 39.)

IRS told GAO it had taken steps to eliminate the bias in the mathematical formulas and planned to take others, directed at the manual screener, to better insure that a representative number of returns involving overpayments would be audited.

If IRS' plans are put into action, the manual screener's role in selecting returns for audit will be restricted, but he will continue to be responsible for determining the audit's scope. IRS apparently recognizes the need to measure the effect of the manual screener on the selection process and says it will consider ways to do it. (See p. 41.)

Since examiners usually do not select returns to be audited, there is little chance for abuse in the selection process. But one aspect of this procedure requires attention. A return can be selected for audit directly by an examiner if he determines that he needs to audit

--a return filed by a taxpayer for years other than the one being audited or

--a return filed by another taxpayer that may have a bearing on the return being audited.

To obtain such a return the examiner merely completes a requisition and indicates, by code, a general reason for wanting it. For example, code 40 means "prior year return" and code 50 means "partner." But the examiner does not have to provide additional explanation as to why he needs the return. (See p. 25.)

IRS believes that these codes sufficiently explain why the returns are being requested and that any questions about an examiner's need for a return can be asked by the supervisor before he approves the request.

GAO disagrees. There is no assurance that the supervisor will ask any questions and the codes alone do not explain to supervisors and other levels of management

--why the examiner wants the return,

--what he found in auditing the primary return that aroused his interest in a secondary return, and

--the significance of questions that the examiner wants to pursue on the requested return.

Answers to these questions are important if IRS wants to be sure that examiners are requesting returns for valid reasons. (See p. 26.)

The Commissioner of Internal Revenue should require examiners, when requesting specific returns, to explain on their requisitions why they need the returns so that the requests can be adequately evaluated. (See p. 25.)

IRS says it is making a comprehensive review of all its codes to insure that they are properly defined. GAO believes that in so doing, IRS should consider GAO's concerns.

IRS' AUDIT PLANS NEED TO BE IMPROVED AND NEED TO BE FOLLOWED

In developing its long-range audit plan for the 5 years ending with fiscal year 1979, IRS compared the value of three long-range audit plans--one designed to improve voluntary compliance with the tax laws, one designed to maximize the tax yield, and one designed to strike a balance between these two. It selected the balanced plan which called for improving compliance through increased audit coverage in classes of income where compliance was low, and for assigning remaining auditing staff to the rest of the classes on the basis of yield. (See pp. 46 to 51.)

While the long-range planning process is basically sound, it could be improved.

--IRS has virtually ignored the contribution of service center audits to the rate of compliance. These audits do affect compliance because the centers contact taxpayers about problems on their returns. By not taking such audits into account, IRS overestimates the staffing needs of district offices to meet compliance goals.

--IRS has done insufficient research to identify factors affecting taxpayer compliance. Preliminary research has indicated that audits may not be the most critical factor, but IRS has not aggressively pursued this. (See p. 51.)

IRS prepares an annual nationwide plan for the number of returns to be audited. Portions of this plan then are allocated to regional offices and on down to district offices. Some district offices allocate the plan to groups of examiners within the district. (See p. 61.)

Allocation to the regions is based on their proportion of returns with the greatest probability of tax error--an indication of each region's relative compliance level. Thus, a region where compliance is apparently low would be allocated a larger portion of the planned audit work than one where compliance is apparently high. But IRS has to adjust its nationwide plan to account for imbalances between the number of audits that should be done and the audit staff available to do them. Thus, some taxpayers are audited or not audited merely because of where they live.

Regions and districts do not always follow these same procedures for allocating workload and adjusting for imbalances.

To justify a request to the Congress for more examiners in fiscal year 1974, IRS committed itself to additional audits and tax assessments. Then, to carry out these commitments, IRS deviated from its fiscal year 1974 plan and directed more audits of medium income taxpayers--historically the best compliers with the tax laws--and less audits of other classes of taxpayers known to be of lesser compliance. (See p. 70.) This deviation was inconsistent with IRS' long-range compliance goals.

Because the annual plan calls for a specific number of audits, it often has been equated with a quota system. While GAO saw no evidence of quotas for individual examiners, some examiners told GAO they felt pressured to complete audits and felt that this pressure prevented them from doing a quality job.

Some examiners apparently believe that they are being pressured to adhere to unreasonable time constraints and that IRS is concerned with quantity to the detriment of quality. GAO does not believe that an annual plan, in and of itself, is the problem. A realistic plan can provide for a specific number of audits without sacrificing quality. But because IRS prepares its plan based on what was accomplished in the past rather than what

can reasonably be accomplished in the future, GAO questions whether the plan is realistic. (See p. 74.)

The Commissioner of Internal Revenue should not commit IRS to a specific number of audits or amount of additional tax assessments to justify requests for more audit staff. The Commissioner should direct IRS to

--consider service center audits in developing its long-range plans,

--try harder to uncover factors affecting taxpayer compliance,

--insure that regions and districts develop audit work plans consistent with the national plan, and

--study the efficacy of time constraints imposed on examiners. (See pp. 56, 68, 73, and 76.)

IRS does not provide the Congress with complete information during the appropriation process to justify its budget requests for additional audit staff. It does not clarify what alternative long-range plans are available or why a particular plan was selected. IRS does not, for example, point out that its long-range plan calls for different rates of compliance at different levels of income.

Given (1) the need to assure equity in tax law administration and (2) IRS' previous deviation from its plan, the Congress should discuss with IRS its decisions regarding audit coverage. But the Congress cannot do that unless IRS provides it sufficient data. (See p. 58.)

Therefore, GAO recommends that the Congress request IRS to provide detailed information on its audit plans. This information should be provided as a part of IRS' annual appropriation request. (See p. 60.)

IRS does not agree that it should consider the impact of all service center audits on compliance in developing its long-range audit plan because

--most of these audits do not fall within IRS' definition of "audit,"

--it would be difficult to estimate the workload that these audits would generate in any given year, and

--IRS doubts that these audits, in total, have the same overall effect on compliance as do district office audits.

GAO believes that IRS' definition of audit is too restrictive for planning purposes, IRS is seeking unnecessary preciseness in its planning process by claiming that it would be difficult to estimate workload, and there is ample reason to believe the effect of service center audits on taxpayer compliance is substantial. (See p. 57.)

IRS plans to continue searching for economical ways to assess the factors affecting taxpayer compliance and says it will consider the impact of service center audits in any such assessment. (See pp. 56 and 58.)

IRS agrees that more uniformity is needed in developing workplans and that it should refrain from committing itself to a specific number of audits or amount of revenue in justifying its requests for additional audit staff. IRS does not agree that a controlled study is necessary to evaluate the reasonableness of the time constraints imposed on its examiners. It has an alternative approach, however, that should help alleviate the apparently unreasonable pressure being felt by some examiners to close cases but, in GAO's opinion, falls short of assuring reasonable time constraints. (See pp. 69, 73, and 76.)

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

AUDIT OF INDIVIDUAL INCOME TAX RETURNS BY THE INTERNAL REVENUE SERVICE Department of the Treasury

D I G E S T

In 1975 the Internal Revenue Service (IRS) audited 3.16 million individual income tax returns out of 81.3 million filed, resulting in recommended additional tax and penalties of $1.4 billion.

IRS examiners have a difficult job considering that tax laws are complex and changing and that they must deal with all types of persons in an adversary atmosphere. They have to evaluate evidence furnished by taxpayers and decide what additional tax and penalties, if any, to recommend.

Generally, examiners use their authority with discretion. However, taxpayers are not always treated consistently. (See p. 22.)

Most taxpayers are assessed additional tax only after an examiner has reviewed their returns and supporting books and records. Some taxpayers, however, are assessed additional tax based solely on a review of their returns because they failed to respond to IRS' letter notifying them of the audit and asking them to provide certain support. Reasons given taxpayers for these assessments are vague and could result in their agreeing to assessments that they do not understand.

Examiners use varying criteria in determining whether their audit findings are significant enough to warrant assessment of additional tax. As a result, two taxpayers in a similar situation might be treated differently depending on who examines their returns.

Some examiners present their findings to taxpayers without advising them of their appeal rights. Thus, many taxpayers may be "agreeing" to audit findings that they

either do not understand or do not really agree with. (See pp. 22 through 24.)

Also, many taxpayers may be agreeing to incorrect service center audit adjustments because the letter used to notify them of these adjustments has an aura of finality that would tend to discourage disagreement. (See pp. 10 through 12.)

GAO recommends that the Commissioner of Internal Revenue:

--Revise the audit report or the accompanying letter sent a taxpayer who failed to respond to IRS' initial contact letter to make it clear that (1) IRS had sent a previous letter asking him to provide support for certain items, (2) the items are now being disallowed because he failed to provide the requested support, and (3) IRS will reconsider its findings if the taxpayer can provide the support.

--Establish uniform criteria for determining whether additional tax should be assessed or whether the audit should be closed "no change."

--Require examiners to inform taxpayers of their appeal rights, especially the right to meet with the examiner's supervisor, after explaining their audit findings to them but before soliciting their agreement to those findings.

--Consider revising the letter used to notify taxpayers of adjustments for unallowable items to better insure that taxpayers do not agree to erroneous adjustments. (See pp. 12 and 25.)

GAO asked 1,175 taxpayers to describe and evaluate their audit experiences. Overall, the 823 respondents reacted favorably to the way they were treated. Certain matters, however, bothered some taxpayers:

--Audits required some taxpayers to take time off from work without pay. GAO sees no easy solution to this problem.

--Some thought an excessive amount of effort was required to gather documentation. The point at which effort becomes excessive is a matter of judgment. GAO saw little to indicate that examiners were unreasonable in their requests for documentation.

--The major problem identified in the survey was the extent to which taxpayers "agreed" to audit findings that they did not understand or did not really agree with. GAO is recommending steps that could alleviate this problem. (See p. 48.)

IRS has taken steps and plans others to clarify the explanation given taxpayers who failed to respond to IRS' first contact letter. IRS plans also to revise the letter used to notify taxpayers of unallowable item adjustments and to revise its manual so that uniform criteria will be used in deciding whether to assess an additional tax or to close a case with "no change." (See pp. 13 and 26.)

IRS agreed to revise its instructions so that taxpayers are reminded of their right to discuss an examiner's findings with his supervisor. IRS needs to further revise its instructions so that taxpayers are reminded of this and other appeal rights before they are asked to agree to the findings.

IRS' current instructions require an examiner, upon completion of an audit, to explain the basis of his findings to the taxpayer and to attempt to obtain the taxpayer's agreement. If the taxpayer indicates disagreement with any of the findings, the examiner is to remind him of his appeal rights.

In GAO's opinion, the proper sequence would be for the examiner to explain his findings to the taxpayer, remind the taxpayer of his appeal rights, and ask the taxpayer whether he agrees. Only then can IRS be sure that taxpayers are not agreeing simply because they are unaware of the alternatives. (See pp. 26 through 28.)