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GGD-76-33
4-16-76

REPORT TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION CONGRESS OF THE UNITED STATES

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Audit Of Fiduciary Income Tax Returns By The Internal Revenue Service

Department of the Treasury

An analysis of what the Internal Revenue Service has done and is doing to provide more effective audit coverage of income from estates and trusts.

GGD-76-33 ~~707337~~ 093759 APRIL 16, 1976

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

B-137762

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

This report, one of a series of reports in response to your Committee's request, addresses the audit of fiduciary income tax returns by the Internal Revenue Service.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Commissioner of Internal Revenue.

Comptroller General
of the United States

Contents

ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service
TCMP	Taxpayer Compliance Measurement Program

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

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

D I G E S T

Although in earlier years the Internal Revenue Service had audited very few fiduciary income tax returns (returns showing the income of estates and trusts), it substantially increased audit coverage during fiscal year 1975. (See pp. 2, 18, and 19.)

During the last half of fiscal year 1974, the Commissioner of Internal Revenue approved a plan to conduct a Taxpayer Compliance Measurement Program of fiduciary returns. This program should assist in

--determining the compliance levels and overall characteristics of fiduciary return filers,

--developing an effective returns selection system, and

--better allocating audit resources in the fiduciary tax enforcement area. (See pp. 4 and 19.)

Agents' lack of training and experience in dealing with fiduciary returns posed a problem, both in the extent of past audit emphasis and in planning the Taxpayer Compliance Measurement Program. The agents' lack of familiarity with fiduciary returns has also affected the selection of returns for examination.

The training course developed and initiated by the Internal Revenue Service late in 1974 should provide a basis for more effective and efficient selection and examination of fiduciary returns. (See pp. 5 and 19.)

The Internal Revenue Service concurred in GAO's findings and conclusions.

CHAPTER 1

INTRODUCTION

In a June 18, 1973, letter, the Joint Committee on Internal Revenue Taxation asked us to study Internal Revenue Service (IRS) policies and procedures established in connection with its taxpayer service program and its audit of tax returns.

We were asked to cover all facets of the audit of tax returns and to inquire into such matters as

--the basis for selecting all types of returns for audit and

--the adequacy of management controls to assure that employees do not propose unwarranted tax assessments.

This report on the audit of fiduciary income tax returns is one of a series in response to that request.

FIDUCIARY INCOME TAX

The income of estates and trusts, if not distributed or required to be distributed to beneficiaries, is subject to the fiduciary income tax.

An estate is a taxable entity which comes into being when a person dies. It exists until all property is distributed to the beneficiaries. Generally, estates are terminated within a short time and the property is distributed to beneficiaries directly or through trusts. However, some estates continue for several years, and the property may continue to earn income.

A trust is a taxable entity by which a grantor transfers property to a trustee for purpose of conservation of that property and receipt of income for the benefit of one or more individuals, other than the grantor. Trusts may be set up by a decedent's will or by a grantor during his lifetime. A simple trust is one which, under its governing instrument, is required to distribute all its income currently. All other trusts are known as complex trusts.

The principle that income should be subjected to taxation only once--either to the estate or trust or to the beneficiaries--is fundamental in taxing estates and trusts. Double taxation is avoided by treating the estate or trust as a conduit and allowing it to deduct distributions to beneficiaries, who, in turn, include these distributions on their individual income tax returns.

A fiduciary is an individual or a legal entity serving as trustee, guardian, executor, or administrator of an estate or a trust. A fiduciary is required to file a fiduciary income tax return for (1) an estate with a gross income for the taxable year of $600 or more, (2) a trust with any taxable income or with a gross income of $600 or more, or (3) any estate or trust which has a nonresident alien beneficiary. The return may be filed on a calendar or fiscal year basis. It is due 3-1/2 months after the close of the taxable year of the estate or trust.

FIDUCIARY TAX RETURN ACTIVITIES-- FISCAL YEARS 1971-74

For fiscal years 1971-74, IRS reported that the fiduciary returns filed and examined were as follows.

Fiscal year	Number of returns Filed	Number of returns Examined	Percent examined
1971	1,203,261	6,595	.5
1972	1,279,549	7,262	.6
1973	1,354,189	4,916	.4
1974	1,439,844	4,590	.3

These examinations resulted in the following recommended additional tax and penalties.

Fiscal year	Additional tax and penalties recommended Total	Additional tax and penalties recommended Average per return
1971	$19,395,469	$2,941
1972	18,433,333	2,538
1973	15,373,193	3,127
1974	15,318,832	3,337

SCOPE OF REVIEW

We reviewed sections of the Internal Revenue Code and the IRS policies, regulations, and procedures applicable to classifying, selecting, examining, and reviewing fiduciary returns. We also interviewed IRS officials with responsibilities in these areas. We reviewed 189 randomly selected fiduciary returns examined by IRS during fiscal year 1973.

Our review was made at (1) the national office in Washington, D.C., (2) the Jacksonville, Los Angeles, and Manhattan district offices, and (3) the IRS service centers at Chamblee, Georgia; Fresno, California; and Holtsville, New York.

CHAPTER 2

SELECTING RETURNS FOR AUDIT

Tax returns having audit potential are identified through a classification process, which entails visually inspecting returns by type and class. Return types include income, estate, gift, excise, and exempt organizations, while return classes are based on income or asset levels.

The primary objectives of the classification process are (1) to permit as many returns of all classes to be examined as needed to maintain a high degree of voluntary taxpayer compliance and (2) to select returns that will yield the highest revenues from the staff-hours spent on examination. The number to be selected and examined is set by audit and classification plans.

ANNUAL AUDIT AND CLASSIFICATION PLANS

Each district office develops annual audit and classification plans. The audit plan sets the number of planned examinations and the available staff-days for each type of return. The classification plan shows the estimated number of each type and class of return that will have to be screened to assure that enough returns are available to execute the audit plan.

Returns selected from sources other than the regular classification process may also be examined. Such sources include "related pickups" (returns requested and examined by an agent in conjunction with the examination of related returns selected through the classification process), refund claims, information reports, and requests for audit. These sources accounted for the major portion of fiduciary returns actually examined during fiscal year 1973. (See pp. 10 and 11.)

Before fiscal year 1975, fiduciary returns were not identifiable as a separate type of return but were traditionally included with individual income tax returns in the audit plans. Consequently, district audit divisions gave little or no audit emphasis to fiduciary returns.

Because the audit plans did not call for a specific number of fiduciary returns to be examined, it was left to each district to decide the extent of coverage. Some districts' classification plans provided for a specific number of returns to be classified; other districts' plans did not call for any fiduciary returns to be classified.

For example, the Los Angeles district's classification plan called for selecting 300 returns each year, about 0.4 percent of the annual filings during fiscal years 1971-73.

The Manhattan district's classification plan called for selecting 60 returns in fiscal year 1971, 75 returns in fiscal years 1972 and 1973, and 150 returns in fiscal year 1974--an average of about 0.08 percent of the annual filings. The Jacksonville district classified and selected some fiduciary returns during this period but did not provide a specific number in its classification plans.

In an attempt to increase its examination of fiduciary returns, IRS, in the 1974 and 1975 audit plans, required examination of 10,000 and 14,000 returns, respectively. However, resources were not specifically allocated to carry out the planned 1974 examinations.

For fiscal year 1975, the districts, pursuant to national office direction, planned to select and examine about 14,000 fiduciary returns--about 1 percent of the returns filed. To meet this goal, the national office, for the first time, made specific manpower allocations for examining fiduciary returns and provided a separate line for fiduciary returns in the examination plan. The Jacksonville, Los Angeles, and Manhattan districts allocated 3.2, 6.8, and 14.0 staff-years, respectively, for direct examination of fiduciary returns.

PLANS FOR TAXPAYER COMPLIANCE MEASUREMENT PROGRAM SURVEY

The national office indicated that the increased coverage called for in the fiscal year 1975 examination plan would not provide the necessary information to (1) determine the compliance levels and overall characteristics of fiduciary filers, (2) develop an effective returns selection system, and (3) better allocate audit resources in the fiduciary enforcement area. Therefore, during the first half of fiscal year 1974, IRS made a preliminary study to determine the feasibility of undertaking a Taxpayer Compliance Measurement Program (TCMP) survey. On the basis of that study, the Commissioner of Internal Revenue in April 1974 approved a plan developed by the IRS national office to conduct a TCMP survey of fiduciary returns, in which a sample of about 10,000 returns processed during 1975 was to be audited in detail.

An audit made under TCMP involves verifying all significant items on the selected returns, examining related returns, and tabulating results to evaluate taxpayer compliance characteristics. TCMP data is then used to improve returns selection procedures and the effectiveness of compliance activities.

IRS started the TCMP examinations in the middle of 1975. The final results are scheduled to be tabulated by September 1977.

IRS recognized that revenue agents needed additional training in examining fiduciary returns if districts were to meet their examination goals and effectively implement the scheduled TCMP survey. The national office, therefore, developed and initiated a 7-day course designed to train agents to effectively and efficiently examine fiduciary returns. The first training was given to selected agents in the various districts during September and October 1974.

Two of the three districts reviewed had also provided or planned to provide limited local training in the fiduciary area as a result of the increased emphasis called for in the fiscal year 1975 examination plan.

Before the introduction of the fiduciary training course, revenue agents received only a limited overview of estate and trust taxation, consisting of a few hours of instruction during the first-year basic revenue agent training course. IRS supervisors told us that this training was not sufficient to enable an agent to make a quality examination of a fiduciary return.

CLASSIFICATION PROCEDURES

After receiving the fiduciary income tax returns, service center employees prepare the data for computer processing. They correct mathematical and other errors, transcribe the data from the returns to magnetic tape, and prepare the returns for classification.

The classifier visually inspects the returns for audit potential and decides which to select for audit. For classification purposes, fiduciary returns are categorized as automatic--returns reporting $50,000 or more total income--and nonautomatic--all others. All automatic returns must be classified. Nonautomatic returns are classifed on a sample basis.

Although there are many features peculiar to fiduciary income tax returns, such as authorization for charitable deductions, treatment of income received after the date of death, and distributions to beneficiaries, classifiers usually selected fiduciary returns for examination on the basis of income and deduction items similar to those on individual income tax returns.

Since January 1974, the Jacksonville and Los Angeles districts have developed guidelines to help classifiers select fiduciary returns for audit; however, the Manhattan district has not done so.

IMPROVEMENTS IN THE CLASSIFICATION PROCESS

Before calendar year 1974, automatic returns were to be identified during initial service center processing. However, the service centers did not properly sort the returns, and, therefore, the automatic returns could not be readily identified and selected for examination. For example, the failure to properly sort returns for the Manhattan district may have affected the type of fiduciary returns selected for examination in fiscal year 1974. The district selected 34 automatic and 129 nonautomatic returns rather than the planned 100 automatic and 50 nonautomatic returns.

In January 1974, IRS converted from a manual to a computerized system to identify automatic returns and make them available for classification. Under this system, identifying data from the return is transcribed during computer processing at the service center and placed on tape. This tape is sent to the national computer center where related processing includes producing tapes that contain identifying data for each automatic return processed during the month for each district. About once a month the tapes are sent to the service centers, where they are used to identify and remove the automatic returns from the files.

A computer report showing the number of automatic returns identified during the current processing cycle and cumulative since the start of the calendar year is prepared monthly for each service center. This report is issued to each service center audit division and each district office audit division serviced by the service center as an aid in monitoring the classification program.

Before calendar year 1974, fiduciary returns were held in the files at the service center pending classification, which was generally conducted annually. The classification was performed by district revenue agents who were temporarily detailed to the service center for that purpose.

Under the revised procedures, automatic returns identified by computer are either sent monthly to the district for classification or retained for periodic classification at the service center. Nonautomatic returns are classified periodically at the service center on a sample basis until the objectives of the plan are achieved. Classification at the service center may be performed by district revenue agents or revenue agents permanently assigned to the service center, depending on the volume of returns available.

The revised procedures for processing returns for classification eliminate the earlier processing problems and should improve the classification process by providing an identification and monitoring system to assure that all automatic returns are classified. In addition, the revised procedures permit fiduciary returns to be classified on a more current basis.

CLASSIFICATION ACTIVITIES--FISCAL YEARS 1972-74

The results of the districts' classification activities in fiscal years 1972-74 follow.

	Fiscal year	Number of returns Classified	Number of returns Selected	Planned selection
Jacksonville	1972	(a)	191	(b)
	1973	2,368	59	(b)
	1974	1,427	179	(b)
Los Angeles	1972	4,716	141	300
	1973	7,145	170	300
	1974	19,685	592	512
Manhattan	1972	1,346	41	75
	1973	4,166	75	75
	1974	10,213	163	150

a/Not available.

b/Not specified.

The small number of returns selected by the Manhattan district during fiscal year 1972 and by the Jacksonville district during fiscal year 1973 was attributed to the service centers' failure to properly segregate automatic returns. We were informed that the Los Angeles district probably did not meet its goal for fiscal years 1972 and 1973 because of limited emphasis on fiduciary returns and an apparent lack of coordination between the district and the service center. Each apparently thought that the other was responsible for assuring that sufficient returns were selected to meet the objectives of the plan.

OBSERVATION OF RETURN CLASSIFICATION

We observed the classification of fiduciary returns by Los Angeles and Manhattan district agents during 2-day periods at the service centers in Fresno and Holtsville and discussed with the classifiers and service center officials the reasons for and criteria used in selection.

Most of the classifiers were experienced revenue agents. However, they had had little or no audit exposure to fiduciary returns. The Los Angeles classifiers used classification guidelines, but they generally based their selection on subjective judgment and experience. Fresno service center officials indicated that, before the development of guidelines in January 1974, district agents selected returns based entirely on their subjective judgment.

Manhattan district classifiers at Holtsville said that they selected returns primarily on their subjective evaluation of the error potential, gained through experience and knowledge of general income tax law. They stated that because fiduciary returns contain items of income and expense that are basically the same as on individual returns, the potential errors or adjustments are similar and therefore similar selection criteria could be applied.

Classifiers selected returns for various issues, such as the verification of (1) capital gains and losses, (2) depreciation schedules, (3) business income and expenses, (4) charitable deductions, and (5) legal and administrative expenses.

When a classifier selects a return for examination, he may prepare a classification checksheet and attach it to the return. The classification checksheet is a preprinted form on which the classifier indicates the item(s) or reason(s) why the return was selected. It helps supervisors screen returns before assignment, indicates to examiners the particular items to be considered in the examinations, and helps management evaluate the classification program. Since the national office has not prescribed a uniform classification checksheet, its format varies among districts.

The use of classification checksheets is optional for fiduciary returns. Jacksonville and Los Angeles classifiers generally attached checksheets to selected returns; Manhattan classifiers infrequently did so. For the fiscal year 1975 classification program, the Jacksonville classifiers were given a recently developed classification checksheet designed for use with fiduciary returns. The checksheet lists items peculiar to fiduciary returns and indicates the applicable sections of the code and regulations. The form was developed by the IRS central region and revised and adopted by the Atlanta service center. The classification checksheet previously used was general and was not specifically geared to any particular type of return.

CHAPTER 3

AUDIT OF RETURNS

After classification, returns selected for audit are sent to the district office audit groups. A computer-prepared examination record card used to control the return during examination and to report the case's disposition is forwarded with each return.

At the district office, the returns program manager is responsible for controlling the returns and distributing them to the audit groups.

MOST FIDUCIARY RETURNS SELECTED FOR AUDIT WERE NOT EXAMINED

At the three districts reviewed, most fiduciary returns selected through regular classification were closed without examination--in many cases, for reasons other than lack of audit potential. Even when returns are assigned to the audit groups, an audit group manager may close a case before assignment to an agent if, in his judgment, no examination is warranted.

For fiscal years 1972 and 1973, the three districts selected for examination through regular classification an annual average of 339 returns. During fiscal year 1973, however, the three districts closed only 79 regular classified returns after examination.

At the Manhattan district, for example, district officials cited the following reasons for the small number of classified returns examined:

--Group managers failed to requisition fiduciary returns.

--Audits of these returns were unproductive relative to other types of returns.

--The main emphasis was on examining corporate returns.

They also stated that most agents preferred to avoid examining the returns because they were not familiar with them.

To promote examining classified fiduciary returns, the Manhattan and Jacksonville districts were not placing classified fiduciary returns in inventory, as was done with other types of returns, but forwarded them directly to the audit groups. This procedure was followed because it was considered unlikely that fiduciary returns would be requisitioned by group managers.

Before July 1974, the Manhattan district placed classified returns in a centralized inventory maintained by the audit service branch and distributed them only on request by group managers. Most of these returns were disposed of by surveys made periodically to remove from inventory unassigned prior year returns exceeding the district's audit requirements. These surveys were made by clerks in the audit service branch. After the survey the returns were sent to the disposal unit to be closed and returned to the service center.

At the Los Angeles district, returns were placed in inventory but, because group managers rarely requested fiduciary returns for examination, some were also included with individual returns requested by the group managers.

SOURCE OF EXAMINED RETURNS

Most fiduciary examinations result from sources other than regular classification. These sources include

--claims for refund or amended returns classified at service centers;

--referrals or requests, generated either from inside or outside IRS, indicating a need to examine particular returns filed or to be filed;

--pickups of prior or subsequent years' returns of taxpayers under examination (multiyear audits); and

--related pickups (returns requested for examination by agents when adjustments to returns under examination could affect the tax liability of related fiduciary returns).

The sources of fiduciary returns examined and closed by the three districts reviewed, and nationwide, during fiscal year 1973 follow.

Source	Number of examinations			
	Jacksonville	Los Angeles	Manhattan	Nationwide
Regular classification	42	31	6	649
Claims	24	15	16	624
Multiyear audits	17	40	-	451
Referrals or requests	9	15	13	406
Related pickups	102	130	62	2,235
Information returns	55	11	-	238
Other	8	50	2	313
Total	257	292	99	4,916

EXAMINATION PROCEDURES

The agent analyzes assigned returns and supporting documentation for audit potential. Either he concludes that an audit of the return would result in no material change in tax liability, whereupon it is closed as a result of his analysis, or he outlines those items which should be examined. Group managers are required to review all returns closed without examination to insure that the closing is justified and in accordance with IRS requirements.

If the agent determines that examination is warranted, he contacts the taxpayer either by form letter or by telephone to set up an appointment for the examination. The examination will normally be conducted at the fiduciary's or his tax representative's place of business.

The audit scope and techniques depend on the composition of the return. An agent is expected to audit all unusual and questionable items. He is expected to pursue the examination until he can reasonably conclude that he has considered all items necessary for a proper determination of the tax liability.

In deciding the extent to which he must pursue an issue, the agent is expected to consider the time necessary to develop the issue in relation to the potential results and exercise judgment in deciding when the examination should be terminated. In some cases, an extensive audit is necessary to determine the proper tax liability, while in other cases the examination can be completed after inquiring into a few items.

The auditing techniques used to verify the accuracy of items of income and deductions for income tax purposes are basically the same for all types of taxpayers. These techniques include examining documents and records, such as books of account (general and subsidiary ledgers, cash receipts and disbursement books, and general journals), bank statements, canceled checks, checkbooks, and brokers' statements and advices.

For an estate, a copy of the related estate tax return should be obtained to (1) identify the income-producing assets, (2) verify the estate's basis of assets for reporting capital gains, and (3) verify any income or expenses in respect of the decedent and the allowable deduction for the estate tax attributable to such income.

In examining tax returns of a trust, the agent should study the governing instrument (will or trust instrument). The governing instrument usually provides information on which the agent's tax determination will be based, such as the parties to the trust and their relationship, provisions for distributing principal and income, authorization for charitable contributions, allocation of income and expense items to principal or income or between beneficiary and fiduciary, and provision for terminating the trust.

When the examination is completed, the agent explains the basis of the proposed tax adjustments to the taxpayer or his representative and seeks agreement to the proposed tax liability.

When appropriate, the agent cites the provisions of the law, regulations, published rulings, and tax court and other court decisions on which he has based his conclusions. If the taxpayer disagrees with any of the proposed adjustments, he should be informed of his district conference and regional appeal rights, as well as his right to pay any deficiency and file a claim for refund.

REPORTING PROCEDURES

At the conclusion of the examination, the agent prepares an examination report, called the revenue agent's report. The taxpayer and his representative are provided copies.

Since the agent explains the adjustments at the end of the examination, the report does not contain detailed explanations unless necessary to understand the adjustment or requested by the taxpayer or his representative. If the taxpayer concurs in the proposed adjustment, he signs an agreement to the assessment, subject to acceptance of the report by the district director.

In cases in which partial agreement is reached, the taxpayer is encouraged to execute a waiver of restrictions on assessment for the agreed tax issues or years. By signing the waiver, the taxpayer consents to immediate resolution of agreed deficiencies or overassessments as shown on the waiver form. The signed waiver stops the running of interest

30 days from date of receipt but does not preclude IRS' assertion of a further deficiency or a taxpayer request for further consideration of the issues.

If the taxpayer does not agree with the proposed assessment, he does not, of course, sign an agreement to the assessment. Also, the agent does not furnish the taxpayer a copy of the report. Instead, a copy is sent to the taxpayer after it has been reviewed and cleared by the district office. In addition, the agent prepares for internal use a report which summarizes the unagreed issues and presents confidential information (allegations of fraud, remarks concerning the taxpayer's integrity or motives, and information obtained from informants).

EXAMINATION OF CASES AUDITED BY IRS

To test the examination process, we reviewed 189 audited returns closed by the Jacksonville, Los Angeles, and Manhattan districts during fiscal year 1973.

The scopes of the audits ranged from verifying or adjusting a single item to examining all items on the return. The scope depended, to some extent, on whether the return was selected for examination through the classification process or picked up as the result of issues raised during the examination of a related return.

Agents generally examined a higher percentage of reported income and expense items per return on regular classified returns than on returns from other sources. The scope of the examination of related pickups and referrals was limited mainly to adjusting the fiduciary return for the issues identified during the examination of the related return or from other information. According to several group managers, the scope in such cases was usually limited because of time constraints or the lack of materiality of the remaining items on the return. Agents, however, are given flexibility in determining the audit coverage, and in some cases the audit may be expanded to include verifying other items on the return.

Claims are frequently filed by a fiduciary for protection purposes when the tax liability on the fiduciary return of an estate or a trust is contingent on the settlement of a disputed issue on a related return (generally, an estate tax return). In these cases, the agent must wait for the settlement of the disputed issue to determine the disposition of the claim. The scope of the audits of claims for refund was generally limited to determining the validity of the claim and did not extend to examining or verifying other items on the return. This examination concept is in accordance with the Internal Revenue Manual for those cases assigned for audit only because of the claim issue.

The aggregate scope of the audits varied considerably among the three districts. Overall, agents at the Jacksonville district examined a higher percentage of items on the returns than at the Los Angeles and Manhattan districts. Jacksonville agents more frequently expanded the audit beyond the items identified by classifiers or identified from related returns or referrals. At the Manhattan district, examinations generally consisted of (1) adjusting the returns, if warranted, for the tax issue or issues identified from the examination of a related return or (2) ascertaining the validity of refunds claimed. In most cases agents did not pursue the examination beyond those items which were previously identified for adjustment or which were required to verify the claim.

The examination case files varied widely as to the extent of documentation, but, in most cases, they contained adequate statements, computations, and conclusions supporting examination results. In some cases, however, the case files did not include workpapers, or the workpapers were filed with a related return.

The following cases illustrate the scope of IRS examinations of fiduciary returns and the issues resulting in additional assessments or overassessments.

Case 1

This audit of an estate's fiduciary returns for tax years 1969 and 1970 was initiated because of a referral from the regional appellate division. The examination covered eight of nine items reported on each return. The most significant adjustment was to decrease the basis of stock sold during 1970 to agree with the basis established as a result of the prior examination of the related estate tax return. This adjustment increased the reported long-term capital gain for 1970 by $53,948.

Other adjustments (1) eliminated tax deductions of $5,310 and $5,650 claimed erroneously on the 1969 and 1970 returns, respectively, (2) eliminated a deduction of $1,033 on the 1970 return for State estate taxes and personal property taxes on property not owned by the estate, and (3) allowed a deduction of $77 for interest expense on the 1969 return that was previously overlooked by the fiduciary. These adjustments resulted in additional assessments of $1,020 on the 1969 return and $22,691 on the 1970 return.

Case 2

This estate's 1971 fiduciary return was selected through regular classification for audit because it included a long-term capital loss carryover. The agent's workpapers showed that the capital loss was actually short-term and was fully deductible against long-term capital gains realized in 1971. All other items on the return were examined and verified by the agent against supporting records. Other adjustments removed tax-exempt interest income from reported income and allocated and eliminated a portion of the custodial fee deduction applicable to the exempt income. A minor adjustment increased the basis of securities sold and thereby reduced the reported capital gain. The adjustments resulted in a tax reduction of $4,032.

Case 3

The potential issue identified during regular classification of this trust's return was the amount of the charitable deduction claimed by the trust. The agent reviewed the trust instrument and a prior audit of the related estate tax return. In addition to ascertaining the intent of the trust instrument regarding charitable contributions, the agent verified the amount of the contribution, all income items (dividends, interest, and capital gains), and the other deductions. The agent found no deficiencies, and the return was accepted as filed.

DISTRICT REVIEW PROCESS

After the examination, an audit case is sent to the group manager for review. Certain cases are forwarded to the district review staff, which serves as management's primary control point to determine that revenue law is correctly and fairly applied. The review staff is composed of experienced revenue agents who usually serve for about 2 years.

Two types of reviews are performed--procedural and technical. A procedural review is made of all cases to insure that the agent followed prescribed procedures and that the audit file contains the required documents and forms properly completed so the case can be processed. A technical review is made of certain cases to insure that relevant facts have been developed and explained and that findings are adequately supported by law, regulations, published rulings, and court cases.

Fiduciary cases are included with, and subject to technical review on the same basis as, individual income tax returns. The following criteria apply.

--All unagreed cases receive a technical review. A technical review is also mandatory for certain types of cases, designated as mandatory review cases. Included in this group are TCMP cases, fraud cases, and cases involving refunds of $100,000 or more.

--Agreed and no-change cases are selected for technical review together with individual returns on a random sample basis. The sample rate is determined by the district's estimated workload for these types of returns and statistical tables developed by the national office. During 1974 the sample rates were 1 in 6 for the Jacksonville district, 1 in 30 for the Los Angeles district, and 1 in 11 for the Manhattan district.

When errors are detected in an examination report or workpapers, the case is returned to the audit group with instructions and recommendations for corrective action. However, agreed cases or issues are normally not reopened, nor are new issues raised by the reviewer, unless the grounds for such action are substantial and the potential effect on the tax liability is substantial or benefits the taxpayer.

The review staff communicates with audit groups through a reviewer's memorandum, which must first be approved by the Chief, Review Staff. Two types of memorandums are issued--inquiry and advisory. Inquiry memorandums are issued when corrective action is required, and advisory memorandums are issued to advise the agent of matters requiring no correction or having no impact on the proposed tax liability.

After a reviewer's memorandum has been issued and the agent has responded, the responsible reviewer goes over the agent's response and either agrees with the actions taken or issues a supplemental memorandum. All differences between the agent and reviewer must be resolved; the Chief, Audit Division, has final power to resolve disputes.

A reviewer's memorandum had been issued in only one of the cases we reviewed. The Los Angeles district review staff issued an inquiry memorandum involving the audit of several related fiduciary returns. The reviewer indicated that the agent should

--pursue an item identified during the examination of a gift tax return for a related estate and

--look into the intent of splitting a single trust into a multiple trust as a possible tax avoidance issue since the trust instrument had specified that a single trust be established.

The agent concurred in the review comments and, in responding to the memorandum, indicated his proposed adjustments.

AUDIT RESULTS

Additional tax and penalty assessments proposed after auditing fiduciary returns varied considerably between districts and from year to year within the same district. Nationwide, the total additional taxes and penalties declined steadily from fiscal years 1971 through 1974. The average per return, however, increased from about $2,900 to $3,300 over that same period.

The following table shows the relative productivity, in terms of additional tax and penalty assessments proposed, for the various types of returns closed by district audit divisions during fiscal year 1973.

Type of return	Additional assessments (note a) Per return	Per staff-hour	Total staff-hours expended	Total returns examined
Individual:				
DIF classified (note b)	$ 310	$ 79	2,940,697	746,199
Other	1,331	175	4,988,001	657,474
Average or total	788	140	7,928,698	1,403,673
Fiduciary:				
Regular classified	3,527	246	9,293	649
Other	3,066	299	43,701	4,267
Average or total	3,127	290	52,994	4,916
Corporate	25,179	536	5,727,882	121,882
Excise	890	235	366,245	96,620
Employment	1,101	263	296,657	71,004

[a]Additional assessments and penalties proposed by the district audit divisions and subject to adjustment if protested to the regional appellate conference or the courts.

[b]Discriminant function (DIF) is a mathematical technique, using a computer, to identify returns for examination.

The above statistics indicate that examinations of regular classified fiduciary returns are relatively productive as compared with most other types of returns. Due to the few fiduciary returns examined, the overall statistics can be distorted, however, by a few large assessments. For example, while the additional assessments for the 31 regular classified returns closed by the Los Angeles district amounted to $821,505, an average of about $26,500 per return, one return accounted for $767,010, about 93.4 percent of the total.

In the audit of fiduciary income tax returns there has been a historically low rate of coverage and relatively high productivity in terms of additional revenue. Increasing the rate of coverage by selecting and examining more regular classified returns will probably result in a somewhat lower average recovery per return. Nevertheless, meeting the IRS objectives of optimizing (1) the voluntary filing of correct tax returns and (2) the additional revenue disclosed on incorrectly filed returns seems to justify the additional audit coverage of fiduciary returns.

Beginning in fiscal year 1975, the districts are reporting examination statistics for fiduciary returns separately from individual returns to monitor the audit plan. In previous years, examination statistics for fiduciary returns were combined with and obscured by individual return statistics, so that the number of examinations and the relative productivity of fiduciary returns were not generally known. Accounting for fiduciary returns separately, coupled with providing for a specific number of examinations in the audit plan, should provide better information for selecting and examining such returns.

After we completed our fieldwork, IRS reported that in fiscal year 1975 it audited 11,757 fiduciary returns and recommended $21,275,159 in additional taxes and penalties. This is an increase of 7,167 returns and $5,956,327 over fiscal year 1974. However, the recommended additional tax and penalty per return examined was $3,337 in fiscal year 1974 as compared to $1,810 in fiscal year 1975, a decrease of $1,527.

CHAPTER 4

CONCLUSIONS AND AGENCY COMMENTS

While IRS' past level of effort regarding the audit of fiduciary returns has been limited, it is taking steps to significantly increase its effort in this area--an increase in 1975 of about 156 percent over the previous year.

In conjunction with its increase in audit coverage of fiduciary returns, IRS is making a TCMP survey to provide a firmer basis for determining the level of compliance, selecting returns for examination, and establishing an appropriate level of examination coverage.

IRS is now giving revenue agents special training in auditing fiduciary returns. This training should help overcome the lack of familiarity which agents have had with this type of return and provide a basis for more effective and efficient examinations, including a more comprehensive scope of examination. It should also assist in qualifying personnel to provide filing assistance to fiduciary taxpayers.

IRS has also revised its procedures for the classification of fiduciary returns to provide for the classification of all high income returns. In addition, two of the three districts reviewed had developed guidelines to help classifiers identify and select returns having a greater potential audit yield.

The expanded coverage under the TCMP survey and the special training provided to agents should result in continued improvement in classifying fiduciary returns. As additional expertise is developed in this area, the national office should be alert to opportunities to provide districts with information on the level of compliance and audit potentials for fiduciary returns.

The Commissioner of Internal Revenue, in commenting on a draft of this report, said that IRS agreed with our findings and conclusions. (See app. I.)

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

Commissioner

FEB 24 1976

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

Dear Mr. Lowe:

As requested, we have reviewed the General Accounting Office's draft report to the Joint Committee on Internal Revenue Taxation entitled "Audit of Fiduciary Income Tax Returns by the Internal Revenue Service". We found this report to be both comprehensive and objective.

With the minor exception of the few discrepancies which have already been corrected through the cooperation of both our staffs, we agree with your findings and conclusions.

With kind regards,

Sincerely,

Donald C. Alexander
Commissioner

Enclosures

PRINCIPAL OFFICIALS RESPONSIBLE

FOR ADMINISTERING ACTIVITIES

DISCUSSED IN THE REPORT

	Tenure of office	
	From	To
SECRETARY OF THE TREASURY:		
William E. Simon	Apr. 1974	Present
George P. Shultz	June 1972	Apr. 1974
COMMISSIONER OF INTERNAL REVENUE:		
Donald C. Alexander	May 1973	Present
Raymond F. Harless (acting)	May 1973	May 1973
Johnnie M. Walters	Aug. 1971	Apr. 1973
ASSISTANT COMMISSIONER (COMPLIANCE):		
Singleton B. Wolfe	Mar. 1975	Present
Harold A. McGuffin (acting)	Feb. 1975	Mar. 1975
John F. Hanlon	Jan. 1972	Jan. 1975
John F. Hanlon (acting)	Nov. 1971	Jan. 1972

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