UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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GENERAL GOVERNMENT
DIVISION

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November 9, 1977

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

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Dear Mr. Kurtz:

As you know, the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Government Operations Committee, plans to hold hearings on the proper accounting for corporate expenditures made for political advertising. While preparing for these hearings, we noted that the Internal Revenue Service (IRS) has done little, if anything, to address apparent problems in this area which were surfaced as early as 3 years ago.

In May and June 1974, the Senate Commerce Committee held hearings on the deductability of political lobbying expenses under section 162 of the Internal Revenue Code. Testimony presented indicated that public utilities as well as other energy related industries may be improperly treating costs associated with certain political advertising and that utilities may be passing these costs along to consumers in the form of increased rates. The testimony also pointed out that questionable tax deductions may be occurring and that clarification of both the Federal Power Commission (FPC) and IRS regulations may be required.

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After these hearings, we issued, at the request of Senator Stevenson, a report entitled, "Auditing of Political Advertising by Electric Utilities and Gas and Oil Companies" (EMD-76-2, July 16, 1976). The report, released by the Senator on October 3, 1977, presented, in part, our concerns over the lack of clear criteria for public utilities and FPC auditors to use in classifying and auditing political advertising expenses. The report also expressed our opinion that the instructions IRS has furnished its auditors contain little guidance to aid them in making judgments about the political nature of advertisements claimed as deductions by corporations.

FPC agreed to implement our recommendations to:

--Clarify the description of advertising transactions to be recorded in its prescribed accounts.

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--Furnish its auditors with additional guidelines on controversial subjects relating to political advertising, including the identification of certain themes of such advertising to help auditors make judgments on classifications.

--Revise its examination program to expand audit coverage.

Conversely, IRS has taken little, if any, action to improve its guidance to taxpayers and its own auditors. For example, the "Audit Technique Handbook for Internal Revenue Agents" still merely advises the auditor:

"Advertising charges are relatively simple to check. The principal things for which an examiner should look are: * * * Nondeductible expenditures claimed in connection with campaigns of political candidates or for the promotion or defeat of legislation."

We reviewed several other IRS documents which instruct auditors regarding the way possible grass-roots lobbying expenses should be detected and analyzed. These documents included pertinent regulations, the "Field Audit Case Managers' Handbook," basic revenue agent training material on lobbying expenses, and various audit technique handbooks for specialized industries. In general, the instructions in these documents are no more specific or helpful to the auditor than the instructions contained in the revenue agent audit technique handbook.

For example, the specialized audit technique handbook for public utilities contains two sections which deal with determining the proper allocation of advertising expenses. Those sections are appropriately entitled, "Advertising Expense," and "Lobbying Expense." Under the section dealing with advertising expense the handbook says:

"Certain charges to advertising expense are nondeductible under section 1.162(c)(1) of the Regulations. This would relate to expenses such as certain outside advertising expenditures which could be considered as being of a propaganda or political nature. If the utility is Federally regulated and has followed the Commission's instructions (e.g. the Federal Power Commission), a detail of such questionable items can generally be found in the annual report. * * * "

The section on lobbying expenses is a little more detailed. It notes that in the course of auditing utility tax returns the auditor should be aware of deductions claimed for lobbying expenses involving

attempts to influence legislation or aid political candidates. It further notes that these nondeductible expenditures may be found in various utility accounts. The section also defines properly deductible expenses--institutional or good will advertising--as those which keep the company's name before the public, such as sponsoring news and weather reports or encouraging contributions to charitable organizations.

It goes on to point out that after tax year 1962 the companies may deduct expenses involved in the submission of information to and appearances before the legislature of Federal, State, and local governments. It also provides a broad explanation that certain other expenses pertaining to the general area of lobbying which are not deductible include political campaigns at all levels, influencing the public to support or reject a measure in referendum or law, and support or defeat of legislation.

These definitions are no more specific than the regulations defining section 162 of the Internal Revenue Code. They do not provide any specific guidance to the auditor as to how he or she should exercise judgment in determining whether or not advertising is for grass-roots lobbying purposes and therefore nondeductible.

Except for a limited survey done to prepare for the pending hearings, IRS has not systematically reviewed the advertising or grass-roots lobbying practices of various industries, identified any potential pockets of noncompliance that may exist regarding the classification of related expenditures, and determined what, if any, appropriate audit action is needed. Moreover, IRS apparently has not researched the problem sufficiently to determine why taxpayers might improperly classify advertising expenses and, consequently, not developed the information needed to rewrite regulations or instructions to make more accurate the taxpayers' initial determinations regarding the allowability of deducting certain advertising expenses. We believe that IRS should do so.

To insure the continued success of one of the basic principles underlying our tax system, self-assessment, it is essential that IRS make the regulations which the taxpayers must follow as clear as possible. It is also essential that IRS auditors have definitive criteria for measuring the extent to which proper self-assessment is being achieved.

We recognize that there are many specific corporate accounts. Given IRS' primary mission of protecting the revenues, it would seem natural for the Service to focus on those accounts that have the most

potential for tax adjustment. Thus, in the absence of specific National Office instructions, it would not be surprising to find that auditors devote relatively less effort to accounts that, although important from a public policy standpoint, lack significant adjustment potential.

The extent to which public policy concerns about possible areas of noncompliance should override cost/benefit concerns in determining the emphasis IRS should give to auditing accounts that may not generate substantial tax adjustments is a decision which should be made at the national level. A recent example of a National Office determination that a public policy concern was overriding is the issuance of detailed audit instructions to be followed and specific compliance checks to be performed in detecting corporate slush funds.

We see nothing to indicate that similar IRS action is not warranted to clarify for taxpayers and its own auditors the provisions of Code section 162 as they relate to political advertising. FPC acted to correct the related confusion, misunderstanding and noncompliance which existed within its own jurisdiction and it seems that IRS should take similar action.

Acccordingly, we recommend that IRS:

--Clarify existing regulations in the area of political advertising and grass-roots lobbying to provide taxpayers and auditors with better definitions for classifying such expenses for income tax purposes.

--Systematically test the practices followed by various industry groups in the area of advertising and lobbying expenses to determine the extent of noncompliance that exists and what corrective action, if any, is warranted.

--Provide more specific audit criteria for IRS agents to follow in deciding whether to select corporate accounts relating to political advertising and lobbying expenses for examination.

--Develop additional guidance, such as a listing of advertising themes, for auditors to follow in separating grass-roots lobbying and advertising expenses from allowable deductions in computing taxable income.

We would appreciate your comments on these recommendations by December 9, 1977. If you or your staff want to discuss these matters further, feel free to call me on 566-6503.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Associate Director