DOCUMENT RESUME

03465 - [A2593728]

Internal Revenue Service Efforts to Detect Slush Funds in Large Corporations. September 13, 1977. 16 pp.

Testimony before the House Committee on Ways and Means: Oversight Subcommittee; by Victor L. Lowe, Director, General Government Div.

Issue Area: Accounting and Financial Reporting (2800); Tax Policy (1500).
Contact: General Government Div.
Budget Function: Miscellaneous: Financial Management and Information Systems (1002).
Organization Concerned: Internal Revenue Service; Securities and Exchange Commission.
Congressional Relevance: House Committee on Ways and Means: Oversight Subcommittee.

Under the Coordinated Examination Program, the Internal Revenue Service (IRS) audits corporations with assets over $250 million and financial institutions and utilities with at least $1 billion in assets and seeks to uncover secret slush funds used for such purposes as political contributions, bribery, lobbying, kickbacks, and diversions to personal use. Through the efforts of the Securities and Exchange Commission (SEC), approximately 400 corporations have made voluntary disclosures relating to such funds. In May 1976, IRS supplemented its audit instructions with a standard set of 11 questions. A sampling of 16 cases, including a series of compliance checks other than the 11 questions, was analyzed to identify areas where slush funds or illegal payments could be initiated. Only one of the compliance checks was successful in uncovering possible fraudulent activity. Slush funds were disclosed in 13 of the 16 cases examined; most of these were detected through SEC reports and use of the 11 questions. Payments were reflected on the books of the taxpayers as ordinary business expenses. Most of the questionnaire responses did not disclose whether payments were deducted on tax returns, and additional audit work was usually needed to determine tax or criminal implications. Revenue agents and case managers must decide appropriate action in cases of questionable payments; there appeared to be a lack of guidelines on what constitutes a prosecutable offense. (HTW)

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

FOR RELEASE ON DELIVERY
Expected at 8:30 a.m. EDT
Tuesday, September 13, 1977

STATEMENT OF

VICTOR L. LOWE, DIRECTOR, GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

HOUSE COMMITTEE ON WAYS AND MEANS

ON

INTERNAL REVENUE SERVICE EFFORTS TO DETECT SLUSH FUNDS IN LARGE CORPORATIONS

Mr. Chairman and Members of the Subcommittee:

Our testimony today deals with IRS' efforts to detect slush funds in large corporations and some of the problems associated with those efforts. Earlier this year we began a broad survey of IRS' corporate tax activities at the request of the Joint Committee on Taxation. Subsequently, the Oversight Subcommittee expressed interest in holding hearings on IRS audits of large corporations. At a series of May and June meetings between GAO staff and the staffs of the Joint Committee and the Oversight Subcommittee, we agreed to assist the Subcommittee by suspending our broad

survey work and concentrating on IRS efforts to detect slush funds in large corporations by reviewing a sample of audit cases.

Although our work has allowed us to make some tentative observations on IRS' efforts, I want to emphasize that the severe time constraints under which we worked permitted us to review only 16 large cases. Thus, our observations about the entire IRS effort in this area are obviously qualified.

In 1966, IRS established its Coordinated Examination Program to better audit complex and large corporations. Using a team audit approach, all corporations with assets over $250 million and all financial institutions and utilities with at least $1 billion in assets are audited under this program. It is in the course of such audits that IRS would look to uncover secret slush funds used for such purposes as corporate political contributions, bribery, lobbying, kickbacks, and diversions to personal use. The schemes sometimes involve conscious attempts to misrepresent corporate taxable income by claiming unallowable deductions or exclusions from income.

IRS' efforts to detect such secret funds and determine their tax consequences have developed rapidly since 1973--primarily as a result of revelations uncovered by the Watergate Special Prosecutor that many major corporations had been making illegal or improper payments through slush funds and other schemes not reflected in the corporations' books.

Few, if any, of these schemes had been uncovered previously by the IRS because they could not be detected using routine audit techniques.

Indeed, it has primarily been because of the efforts of the Securities and Exchange Commission that most corporations have revealed the existence of slush funds. SEC recognized that many of the corporate activities disclosed by the Special Prosecutor involved matters of significance to public investors and that nondisclosure might entail violations of Federal security laws. The Commission determined that the most appropriate means of obtaining corporate disclosure was for the corporations to conduct thorough, in-depth self-investigations. The technique worked and to date approximately 400 corporations have made voluntary disclosures to SEC.

As a result of such disclosures IRS, in August 1975, provided its field offices 11 additional audit checks designed to help identify corporate slush funds. In May 1976 these instructions were supplemented by a standard set of 11 questions to be asked on all corporation audits under the Coordinated Examination Program. The questions were to be directed to key corporate officials, who had to answer under the penalty of perjury.

The use of the 11 questions by IRS has generated much discussion and some opposition among the corporate and tax practicing community (lawyers and CPAs).

IRS guidelines have historically called for special checks to identify areas of noncompliance and fraud. Many of the schemes to accumulate slush funds and make illegal or questionable payments involved off-book transactions and/or the use of controlled foreign corporations located in countries not subject to U.S. tax laws. Since these transactions may well have U.S. tax consequences, IRS' focus on detecting the existence of slush funds appears proper.

To quote IRS, "The very difficult task of discovering slush funds in corporate examinations requires effective planning of in-depth probes and the use of imaginative audit techniques." IRS maintains its most productive technique to date to identify areas of possible noncompliance and questionable corporate payments has been the use of the 11 questions.

We believe IRS would have been remiss had it not developed techniques to expose the existence of slush funds. Our tax system is based on voluntary compliance and IRS' audit procedures are generally designed with the assumption that most taxpayers do voluntarily comply with our tax laws. But when evidence is available that certain pockets of noncompliance exist, the Service must be able to develop audit approaches to continually protect the Government's interest in insuring that all appropriate income is reported and the proper tax paid. To greatly restrict the Service's ability to use "imaginative" audit techniques when noncompliance is evident would, in our opinion, greatly undermine the Government's

ability to foster increased compliance with our tax laws. The extent to which slush fund disclosures can be detected by use of such techniques is illustrated by our sample results.

To select our sample cases, we analyzed the workload of the 58 IRS District offices responsible for auditing the 1,250 corporations which meet the large case criteria. Based on this workload analysis, we selected four IRS districts--Manhattan, Newark, Los Angeles and San Francisco--as our key districts since together they are responsible for 345 large case audits or over 25 percent of the program. Time constraints imposed allowed us to review a total of 16 cases, four in each district.

IRS develops a specific audit plan for each corporation. Each of the 16 audit plans in our sample included a series of compliance checks, other than the 11 questions, designed to identify areas where slush funds or illegal payments could be initiated.

Compliance checks can be stated in general terms, which might be applicable to any audit, or can be specifically tailored to meet a corporation's particular situation. A typical example of a compliance check noted in many of the audit plans was the examination of cancelled checks written by the corporation during a period of the tax year under audit. The checks would be examined for unusual amounts, payees, and endorsees.

The number of compliance checks listed in the audit plans we reviewed ranged from 3 rather general procedures to over 30 specific checks.

Of the 16 cases we reviewed, only one of the compliance checks--"identify and determine propriety of inventory write-downs and abandonment losses"--was successful in uncovering questionable transactions which may involve fraudulent activity. In that case, a write-down of ending inventory was made, increasing cost of goods sold and decreasing taxable income. Most slush fund disclosures in our sample cases were detected through SEC reports and through the use of the 11 questions.

Slush funds were disclosed in 13 of the 16 cases. The original sources of disclosure were as follows:

--6 cases from SEC reports;

--5 cases from IRS questioning of corporate officials;

--1 case from a Federal regulatory agency report; and

--1 case from an Intelligence informant.

The six corporate slush funds disclosed as a result of SEC reports covered the period from about 1971 to 1976. These reports provided the first evidence to IRS that questionable payments existed in those corporations.

The approximate amounts, nature, and purpose of the payments made by these 6 companies can be classified as follows:

--$15 million in fees, commissions, gifts, political contributions, and other payments to foreign government officials and agents to obtain sales, facilitate some favorable governmental action, or to maintain good will in countries in which the company conducts business.

--$9 million in payments such as commercial bribes, kickbacks or rebates to foreign firms to obtain business with those firms.

As explained in the SEC reports, some of the above transactions were not recorded in the companys' books or records. Those transactions that were recorded were usually charged to various expense accounts, such as commissions, advertising, or travel and entertainment.

Only one of the disclosures indicated the payments were treated as deductions on the company's U.S. tax return. IRS is investigating these disclosures to document the legality of the payments, determine the proper tax treatment, and uncover any additional payments that have not been reported. Although these investigations are still in process, it appears that several of the payments were legitimate business expenses and deducted; some were not legitimate but were not deducted for U.S. tax purposes; others were made by controlled foreign corporations, and while deducted on that corporation's books, had no U.S. tax effect. To date IRS has not proposed any related audit adjustments.

The 11 questions were asked in 15 of the 16 cases we reviewed. The remaining case was under joint investigation by IRS' Audit and Intelligence Divisions from an earlier date, and at the time of our review the 11 questions had not yet been posed.

In each case respondents selected to answer the 11 questions were those individuals considered by IRS in the best

position to have knowledge of illegal or improper corporate activities, or to have access to this type of information. The number of corporate officials to whom the 11 questions were asked varied from 4 on one case to 23 on another.

As a result, questionable payments covering the period from about 1972 to 1975 were disclosed for the first time in 5 of the 16 cases. The approximate amounts, nature, and purpose of the payments comprising these 5 disclosures can be classified as follows:

--$1.2 million in payments to foreign government officials, agents and political parties to obtain sales, facilitate favorable governmental action and promote good will in countries in which the taxpayer conducts business.

--$4 million in gifts and payments to customers and suppliers of services to encourage continued business.

--$187,000 in domestic political contributions at Federal, state and local levels.

The payments were reflected on the books of the taxpayers as ordinary business expenses. But most of the questionnaire responses did not disclose whether payments were deducted on the corporation's U.S. tax return. Additional audit work by revenue agents or Intelligence special agents was usually needed to determine the tax implications of disclosed payments and any potential criminal violations. To date a total of about $640,000 in audit adjustments have been proposed by IRS agents in four of these five cases.

IRS became aware of questionable payments through sources other than SEC reports and the 11 questions in two of the 16 cases. In one case, an investigation report from a Federal regulatory agency was revealed to IRS by corporate officials. This case involved approximately $20,000 in domestic political contributions which were deducted on the corporation's tax return. To date no audit adjustments have been proposed on this case.

The second case involved an Intelligence informant who initially disclosed questionable corporate payments. This case involved approximately $75,000 in domestic political contributions which were deducted as various types of business expenses on the corporate return. Approximately $11,000 in audit adjustments have been proposed to date on this case.

The audits of all 16 corporations are still underway. This means they are still subject to additional slush fund findings. But to date only 5 cases have resulted in audit adjustments being proposed because of slush fund disclosures. These adjustments range from about $5,000 to $540,000. To date, total proposed audit adjustments on the 16 cases, including those due to disclosure of slush funds, range from zero to $89 million.

As of August 19, the day we stopped our field work, the status of the 16 cases was as follows:

--Audits of three corporations have resulted in no disclosure of slush funds.

--Four of the 16 cases involve slush fund disclosures which have not been referred to the Intelligence Division for criminal investigation. Two of these cases, both of which involve disclosures made in questionnaire responses, were not referred because IRS considered the tax consequences insignificant. The remaining two cases involve disclosures made in SEC reports. These two cases have not been referred because Audit personnel have not had sufficient time to document their significance. These cases may ultimately be referred for criminal investigation.

--Nine of the 16 cases were referred to Intelligence. Two cases were rejected--one because the payments were considered immaterial; the other because the payments were made by controlled foreign corporations and had no U.S. tax impact. Seven cases were accepted for joint Audit-Intelligence investigation; however, Intelligence has withdrawn from two of these cases because either the questionable payments were not found to be illegal or they were not material enough to be considered for further investigative action. The remaining five are still under joint investigation.

OPINIONS OF IRS PERSONNEL

Case managers and team coordinators responsbile for the 16 large cases we reviewed generally considered questioning of corporate officials to be the most effective method for detecting slush fund activity. They noted that because the 11 questions are answered under the threat of perjury, the questionnaire format is a useful tool which provides information otherwise unobtainable. Normal audit and compliance procedures cannot be expected to uncover fraud. Therefore, the most direct way to obtain slush fund information is to ask people in a position to know of its existence.

Some case managers believe the effectiveness of the 11 questions in their present form will diminish in future audits--taxpayers will merely submit responses identical to those given previously. Their suggestions on how this procedure could be changed or supplemented to produce better results in future audits include:

--Reducing the scope of each question. A new questionnaire with a greater number of shorter, more specific questions would produce more meaningful and precise answers.

--Providing more assurance that the taxpayer is closely scrutinizing his own operations by adding a question on what actions were taken by the respondent to develop the information in his answers to the questionnaire.

IRS personnel believe the general level of audit effort devoted to compliance as it relates to slush funds is reasonable. This level includes reliance on informants, voluntary

disclosure, questionnaires, limited test checking of corporate transactions, and "luck." They said substantial increases in efforts to detect improper payments would be questionable because: (1) it is impossible to be completely assured that a slush fund does not exist, (2) slush fund transactions are often not recorded on the parent company's books at all, but are hidden in the accounts of foreign subsidiaries, and (3) the amounts involved are not material, which makes it impractical to spend larger amounts of time looking for indications of slush funds.

OBSERVATIONS

Although our work was limited, we were able to observe some aspects of the slush fund program in which potential problems may exist.

Disclosure

IRS, in asking its 11 questions and conducting follow-up investigations, is investing a significant amount of Audit and Intelligence resources in documenting questionable corporate practices which potentially may have tax significance. Despite the tax adjustments which may result, many of these transactions may also relate to the enforcement responsibilities of other Federal agencies. For example, there may be cases where IRS uncovers slush fund payments during its audits which have not been disclosed to SEC under its voluntary disclosure program. This lack of disclosure could be of interest to SEC in its enforcement of Federal security laws.

The disclosure provisions of the Tax Reform Act of 1976 preclude IRS from making information obtained from the taxpayer or his books and records available to other Federal agencies for nontax criminal purposes. To be granted access, the other agency must first know IRS might have some useful information and then obtain a court order from a Federal district judge.

The burden now rests on the other Federal agency to show why access is needed. Because of this, we understand that little, if any, potentially useful information developed by IRS is being provided to agencies in a position to take action against violators of nontax statutes.

Guidance

In doing audits, IRS revenue agents are often faced with a corporate taxpayer having numerous domestic and foreign entities and millions of dollars in sales and assets. When the issue of questionable or illegal payments arises the revenue agent and the case manager must decide the appropriate action to take. The agent is faced with determining the legality of the payments under current tax laws, the tax implications to both the corporation and the recipient, and the potential for criminal tax fraud prosecution.

Although IRS has stressed the identification of slush fund issues in its audits for the past two years, we noted a possible lack of consensus and absence of guidelines on what constitutes a prosecutable offense.

Most audit personnel believed only cases having a tax impact should be referred to Intelligence. Many of the disclosed payments were not deducted for Federal tax purposes. For example, many dealt with controlled foreign corporations and involved payments to foreign sales agents or foreign governmental officials. Since these foreign corporations do not pay U.S. taxes these disclosures are not being pursued.

However, there remains a question concerning whether the U.S. parent corporation can be prosecuted for filing false return information. Along with its tax return, a corporation is required to file an information return for each controlled foreign corporation. This return contains financial statements concerning the foreign corporation's operations. Included in these statements may be questionable or illegal payments improperly categorized or disguised. No one we spoke to was aware of any National Office guidance on whether a U.S. corporation could be criminally prosecuted for not appropriately disclosing questionable or illegal payments when U.S. taxes are not involved.

Items disclosed involving payments which were improperly deducted on the U.S. tax return should be adjusted by IRS and collected. While tax adjustments will be made where appropriate, there is a lack of National Office guidance as to what constitutes a prosecutable offense.

Initially most cases involving deducted payments were referred by IRS audit staff to its Intelligence Division for investigation as possible criminal tax fraud cases. However, Intelligence agents have ultimately withdrawn or declined to accept some cases which have apparent criminal potential. In the four such cases we reviewed, Intelligence personnel believed prosecution would be hampered because:

--"voluntary" disclosures from the SEC reports or IRS 11 questions would tend to eliminate intent to defraud on the part of the taxpayer, or

--a nominal tax deficiency was involved when viewed in light of the overall tax liability of the corporation. This would make it difficult to show these payments were deducted with the specific intent of evading the tax laws.

The only indication we found of guidelines being used by Intelligence agents was at one IRS district. Here, agents were consulting a Regional Counsel pre-referral report relating to one specific case as guidance for evaluating fraud referral cases. This report noted that understatement of tax liability must be "substantial" in order to prove a tax evasion case. According to this report, no court case has defined "substantial" in the context of a multinational corporation. The payments involved in this case were small when compared to the entity in question, and negligible when compared to the total corporate return. The Regional Counsel concluded, therefore, that the financial advantage of making the deduction was minimal, thus it would be very difficult to prove flagrant disregard for the tax law.

Penalties

IRS can impose a 50 percent civil fraud penalty or a 5 percent negligence penalty on all tax adjustments made during the corporate audit if the circumstances warrant. None of the cases we reviewed were close enough to completion to establish whether either penalty would be imposed.

From discussions with case managers and team coordinators, we were advised that essentially the same evidence is needed to assess the civil fraud penalty as to achieve criminal prosecution. Flagrant disregard for the U.S. tax laws would be extremely difficult to prove for reasons previously discussed.

Concerning the negligence penalty, audit personnel stated it might be appropriately assessed in those instances where payments were illegally deducted. The problem they foresee, however, is the 5 percent penalty covers all tax adjustments made during an audit and not just those relating to the improper deduction. On large case corporations, total tax adjustments can run into the millions of dollars, while the improper deduction may involve a nominal amount by comparison. Our impression is that IRS field agents will be reluctant to assess negligence penalties without stronger guidance.

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