BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

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IRS Can Improve Its Process For Deciding Which Corporate Returns To Audit

IRS' process for determining which corporate income tax returns to audit could be more effective and equitable.

IRS could improve the process for determining how many returns to audit by (1) minimizing significant changes from one year's audit plan to the next and (2) acquiring better information on such factors as the time needed to do a quality audit.

IRS could improve the process for deciding whether a particular corporate return should be audited by providing better guidance to employees screening returns and by revising its screening procedures.

UNITED STATES GENERAL ACCOUNTING OFFICE

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the Internal Revenue Service's selection of corporate income tax returns for audit, including the development of long- and short-range audit plans. We made this review because of congressional interest in the Service's corporate audit activities which produce a significant amount of tax revenue. The report points out that the Service does not have adequate assurance that the corporate returns most in need of audit are selected for audit or that the most productive issues are being addressed during those audits. The Commissioner of Internal Revenue generally agreed with our recommendations for making the selection process more equitable and effective.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Commissioner of Internal Revenue.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

IRS CAN IMPROVE ITS PROCESS FOR DECIDING WHICH CORPORATE RETURNS TO AUDIT

D I G E S T

A vital part of IRS' program for auditing corporate tax returns is the process for deciding which ones to audit. Because IRS does not have unlimited audit staff, it must have a way of identifying returns most in need of audit while maximizing revenue, treating taxpayers equally, and promoting voluntary compliance.

During fiscal year 1978 IRS audited 150,000 corporate returns, or about 8 percent of the 2 million filed in calendar year 1977. Those audits accounted for about 30 percent of IRS' fiscal year examination time and $3.3 billion (53 percent) of the additional tax and penalties recommended as a result of all audits.

IRS' PLANNING PROCESS

The first step in selecting corporate returns for audit is the development of long- and short-range plans for determining how many to audit and where those audits should be done. The process is highly scientific. Using data on yield, cost, and compliance, IRS develops an annual plan that generally results in larger corporations having a better chance of being audited than smaller corporations. Recent plans, for example, have called for IRS to audit all returns filed by the largest corporations, which account for less than 1 percent of all corporate returns filed, and about 10 percent of the returns filed by the smallest corporations. (See pp. 4 to 15.)

Although the planning process is conceptually sound, the annual plan could be enhanced if more definitive data were available to assess

--the relationship between audit coverage and voluntary compliance,

--the validity of examination rates, which specify the average number of returns that can be audited in a direct examination staff-year and which form the cornerstone of the annual plan, and

--the adequacy of audit attention to miscellaneous corporate returns, such as those filed by life insurance companies and homeowners associations. (See pp. 18 to 24.)

In addition, field offices would be better able to meet the annual plan if IRS provided a smoother transition from one year's plan to the next and gave the field time to adjust their operations to changing program objectives. (See pp. 15 to 18.)

IRS CAN ENHANCE THE EQUITY OF ITS SELECTION SYSTEM

IRS has developed a system directed at identifying those returns most worthy of audit. A primary concern with any such system is whether it adequately protects against returns being audited or not audited for reasons other than audit potential. IRS has made recent advances in that regard but needs to do more.

Many corporate returns (generally those reflecting assets of less than $1 million) are selected for audit through a two-stage process known as the discriminant function system. Returns first are scored as to their audit potential by a computer using mathematical formulas. The highest scored returns are then screened by experienced examiners, called classifiers, to weed out those that do not warrant audit. Most returns that are not computer scored are also looked at by classifiers to select those with the greatest audit potential.

In either case the system adequately protects against abuse because selection decisions are made by persons other than those who will audit the returns. About 30 percent of the corporate returns IRS audits, however, are selected directly by examiners. To obtain those returns, an examiner prepares a requisition which must be approved by his immediate supervisor. To justify his request, the examiner is required only to put a code on the requisition. The code gives management little basis for evaluating the examiner's request because it indicates only that the requested return is part of a multiyear audit or is somehow related to another return. (See pp. 33 and 34.)

Until about a year ago, some field offices were using filing systems that resulted in returns being assigned for audit in sequences that bore no relation to their comparative audit potential. Also, a corporation's chances for audit were predicated on return filing and assignment procedures that varied from district to district.

In June 1978, IRS issued guidelines directed at correcting these inequities and inconsistencies. Some returns are still not being filed properly, however, because of an oversight in the guidelines. Other returns are being assigned for audit on a first-in, first-out basis, a procedure which is called for in the guidelines but which is so unrelated to audit potential that IRS has no assurance returns being assigned for audit are the best available. (See pp. 39 and 40.)

Filing procedures would matter little if every return in the files were eventually audited. However, field offices often end up with more returns in inventory than they need and resort to mass surveying--a procedure whereby returns deemed to warrant audit but excess to needs are purged from the files. This purging can result in returns with very good audit potential going unaudited. (See pp. 40 and 41.)

IRS believes the answer to such problems lies in more effective inventory controls and has taken steps toward that end. But as long as IRS requires that most corporate returns not scored by the computer have to be manually screened for audit potential, its inventory controls will not be fully effective. Districts will continue to encounter excess inventories and will have to continue purging good audit potential returns from the files. (See pp. 41 and 42.)

MANUAL SCREENING PROCESS NEEDS IMPROVEMENT

A major aspect of the corporate selection system, whereby classifiers evaluate returns for audit potential, has not been very effective. IRS has little assurance that the corporate returns most in need of audit are being audited or that the most productive issues are being addressed during the audits.

The Director of IRS' Examination Division told GAO that no-change rates, which indicate the extent to which audits have resulted in no change in the taxpayer's reported tax liablility, are key indicators of classifier effectiveness. GAO reviewed no-change rates for fiscal years 1976 through 1978 and found that 33 percent of the returns identified by classifiers as having good audit potential proved unproductive when audited. (See p. 49.)

Another statistic that can be used to assess classifier effectiveness is the number of returns selected for audit by classifiers but rejected by examiners or their supervisors because of low audit potential. IRS has not used such information to assess the classification process because its management information system does not provide data which discriminates between returns rejected because of low audit potential and those rejected because of excess inventory. (See pp. 49 and 50.)

One reason the classification process has not been effective is its subjective nature. GAO conducted tests in which it had 721 corporate returns classified twice. Those tests showed classifiers disagreeing 37 percent of the time on whether a return should be audited. (See p. 52.)

These disagreements occurred because classifiers often

--concentrated on screening only certain parts of the returns, ignoring other potentially productive areas;

--had opposite opinions on the productivity of certain issues;

--used materiality standards which varied according to corporation size, the amount of taxes paid, geographic location, or the grade of the classifier;

--were unaware of IRS' policy on how returns scored by the discriminant function system should be screened or disregarded the significance of such scores as indicators of audit potential;

--felt they lacked sufficient time to properly screen returns; and

--were unfamiliar with certain kinds of returns because they had had little or no audit experience with them. (See pp. 53 to 60.)

IRS could eliminate some of that subjectivity if it provided better classification guidelines and training and if it improved its classification review and feedback procedures. (See pp. 60 to 68.)

Another reason the classification process has not been effective is that IRS procedures preclude classifiers from identifying all significant audit issues on the returns they select for audit and because classifiers do not adequately explain the issues they do identify. By allowing a more detailed classification, IRS would better insure that examiners received the best returns for audit and understood what the classifiers had seen that had caused them to select the returns for audit. (See pp. 68 to 73.)

GAO can only speculate about how much more IRS could get out of its classification process if classifiers spent more time identifying and explaining audit issues. IRS argues that having classifiers identify all potential audit issues would be time consuming and duplicative because an examiner will be reviewing the return completely during preaudit analysis.

GAO believes that concerns about spending too much time classifying returns are misplaced. The classification process is one of the most important aspects of the corporate audit program because it determines which returns are to be audited. The amount of Federal revenue generated through the program is directly affected, then, by the classifier's success in identifying the best returns for audit.

GAO RECOMMENDATIONS AND IRS COMMENTS

GAO is making several recommendations to the Commissioner of Internal Revenue. Chief among these are that IRS

--define a quality audit and then determine the time required to do such an audit in each corporate asset class;

--modify its planning process by limiting changes from year to year;

--require examiners, when requesting returns, to adequately explain in writing why they need the returns so that the requests can be properly evaluated;

--reconsider its criteria for deciding which noncomputer-scored returns have to be manually screened for audit potential;

--revise its management information system to generate data, such as the number of returns rejected by examiners and their supervisors because of low audit potential, that would help management assess the effectiveness of its classification process;

--issue detailed guidelines to help classifiers select corporate returns for audit;

--revise its procedures to require that classifiers scrutinize the entire return and note all significant audit issues; and

--require classifiers to explain the issues they have identified.

These and other recommendations can be found on pages 26, 45, 77, and 78 of the report.

IRS generally concurred with GAO's recommendations. It did not agree, however, that examiners should be required to provide written justifications when requesting returns. IRS felt that its system of codes was sufficient. GAO disagrees. The codes provide no specifics as to why the examiner thinks the requested return warrants audit. In the absence of such information, there is little assurance that the examiner has a valid basis for his request.

Some actions IRS plans to take in response to GAO's recommendations need to be modified or more thoroughly considered. In particular, GAO is concerned about changes IRS plans to make in the procedures for screening computer-scored returns. If those changes are implemented, classifiers will no longer be identifying audit issues on those type returns. This is contrary to the role GAO thinks classifiers should play in the selection process. (See pp. 80 and 81.)

C O N T E N T S

ABBREVIATIONS

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

CHAPTER 1

INTRODUCTION

In November 1976, we reported on how the Internal Revenue Service (IRS) selects individual income tax returns for audit (GGD-76-55, Nov. 5, 1976). This report discusses IRS' policies and procedures for selecting corporate returns for audit.

THE CORPORATE INCOME TAX

U.S. taxation of corporate income began in 1894, was declared unconstitutional in 1895, and resumed with enactment of the Payne-Aldrich Tariff Act of 1909, which called for each corporation to pay a tax of 1 percent of net income exceeding $5,000. In the case of Flint v. Stone Tracy Co., 220 U.S. 107 (1911), the Supreme Court found the Tariff Act constitutional, and corporate income taxation was here to stay.

The corporate income tax has been an increasingly important source of Federal revenue. Corporate returns filed for 1909 yielded taxes of $21 million, or about 2 percent of Federal revenues, whereas returns filed in fiscal year 1978 accounted for $60 billion, or about 17 percent of total revenues. This amount is even more impressive considering that $180 billion in taxes was collected in fiscal year 1978 from about 87 million individual income tax returns while the $60 billion in corporate taxes was collected from only about 2 million returns.

The most common method used by U.S. corporations to report their income taxes is the form 1120, which we define in this report as the "basic" corporate return. A copy of this form is contained in app. II.

Because of their unique characteristics or because IRS needs specific information to satisfy tax law provisions, certain organizations file special versions of form 1120. These versions, which we refer to as "miscellaneous" returns, include 1/:

--1120F: filed by foreign corporations to report U.S. income tax;

1/A version of the form 1120 that is not included in our list of miscellaneous returns is the 1120S filed by qualifying small business corporations. We excluded those returns because IRS looks at them more like partnership returns than corporate returns.

--1120H: filed by homeowners associations;

--1120L: filed by life insurance companies;

--1120M: filed by mutual insurance companies;

--1120POL: filed by certain political organizations;

--1120 Consolidated: filed by affiliated corporations that want to combine their financial data in one return;

--1120 Inactive (assets under $1 million): filed by corporations that have not engaged in business during the tax period in question;

--1120 Final (assets under $1 million): filed by corporations that have permanently ceased operations;

--1120 Short or Initial Period (assets under $1 million): filed by corporations that are reporting their financial data for a period less than the normal 12-month business cycle including new corporations and corporations that have changed accounting periods, such as from a fiscal to a calendar year;

--1120 Personal Holding Company: filed by corporations that are owned by a small number of shareholders and that derive a large portion of their income from sources other than the active operation of a business, such as dividends, interest, rent, and royalties.

IRS' AUDIT ROLE

IRS strives, as administrator of the tax law, to encourage the highest possible degree of voluntary compliance--that is, the ability and willingness of taxpayers to accurately report their tax liability. IRS communicates the law's requirements to the public, determines the extent of noncompliance, and enforces the law. Its enforcement activities include auditing returns, collecting delinquent taxes and penalties, and recommending prosecution of individuals and corporations that evade their tax responsibilities. Of all enforcement activities, IRS considers the audit of returns to be the greatest stimulus to voluntary compliance. IRS' audit and related activities are carried out by the national office Examination Division in Washington, D.C.; 7 regional offices; 58 district offices; 10 service centers; and the National Computer Center in Martinsburg, West Virginia.

Although audits of individual returns are the most significant in sheer volume, audits of corporate returns are most significant when considering their impact on Government revenues and IRS audit resources. During fiscal year 1978, for example, IRS audited about 150,000 corporate returns, about 8 percent of the 2 million filed in calendar year 1977. Those audits accounted for about 30 percent of IRS' fiscal year examination time and 53 percent, or $3.3 billion, of the additional tax and penalties recommended as a result of all IRS audits.

A vital feature of IRS' corporate audit program, and indeed its audit program in general, is the process for deciding which returns to audit. This process, which we refer to as the selection process, is vital because IRS does not have unlimited audit resources and thus must have a way of identifying those returns most in need of audit while satisfying its objectives of maximizing revenue, fostering taxpayer equity, and promoting voluntary compliance.

Chapter 2 discusses the first phase of the selection process--developing long- and short-range examination plans. During the planning phase IRS determines how many corporate returns to audit in any one year and how that number is to be apportioned geographically. Chapter 3 discusses the second phase of the selection process--the system for identifying returns for audit. Chapter 4 discusses the most important aspect of that system--the manual screening of returns. Each of those chapters discusses how IRS can make the selection process more equitable and/or more effective.

The scope of our review is discussed in chapter 5.

CHAPTER 2

IRS COULD DO MORE TO ENHANCE THE PRODUCT OF ITS AUDIT PLANNING PROCESS

The first step in IRS' selection process is the development of long- and short-range plans for determining how many corporate returns to audit and where those audits should be done. IRS uses data on yield, cost, and compliance to arrive at plans that address two sometimes conflicting objectives--maximizing yield and fostering voluntary compliance.

This highly scientific planning process provides a sound framework for allocating audit resources and apportioning workload. The annual examination plan emanating from that process could be enhanced, however, if IRS minimized significant changes from one year's plan to the next. If such changes are not minimized, IRS can expect its field offices to continue having problems achieving the plan--at least in the corporate area. Also IRS needs to (1) insure the validity of certain data used during the process, (2) assess the adequacy of the process as it relates to miscellaneous returns, and (3) consider expanding ongoing research to take advantage of its broader planning implications.

THE FIRST STEP IN THE PLANNING PROCESS: FORMULATING A LONG-RANGE PLAN

IRS' mission is to promote the highest possible degree of voluntary compliance with the tax laws and regulations. An important step in furtherance of this mission is IRS' allocation of resources among its various functions. The long-range planning process is the framework IRS uses to accomplish that allocation.

Annually, each major IRS organizational unit provides direct input for the long-range plan including its program objectives and estimated resource needs. IRS analyzes, modifies, and consolidates these submissions in an attempt to formulate a 3-year plan which is (1) economic in that, taken as a whole, the recommended programs have a revenue impact which exceeds their costs, (2) realistic, in that proposals do not exceed IRS' ability to recruit, train, and absorb employees or to test, acquire and install equipment, and (3) mission oriented, in that programs reduce the gap between the amount of tax owed and the amount voluntarily assessed by taxpayers.

The largest segment of IRS' long-range plan relates to the audit program. To allocate examination resources and manage its audit program, IRS groups taxpayers by the types of returns they file, such as individual or corporate, and then further groups corporate taxpayers into asset classes. Corporations with assets of less than $100,000, for example, are grouped separately from corporations with assets of between $100,000 and $1 million. Because audits of individual and corporate tax returns constitute the most significant element of the examination program--accounting for about 80 percent of the additional tax and penalties recommended as a result of all IRS audits--a major task in developing the long-range examination plan is deciding how best to allocate audit resources between and among individual and corporate taxpayers.

The long-range examination planning process is highly scientific--involving such factors as estimated filings, past audit results, current and proposed staffing, current and acceptable levels of voluntary compliance, and marginal yield/average cost ratios. These factors are measured, adjusted, and compared through extensive computer applications which result in projected audit coverages for each class of individual and corporate taxpayer.

Objectives of the long-range examination plan

IRS' objectives in developing the long-range examination plan are to produce high direct revenue from the audit of tax returns and maintain high voluntary compliance. The most measurable of these sometimes conflicting objectives is the direct revenue derived from audits. Thus, IRS' long-range plan is based primarily on yield/cost data, but is modified by voluntary compliance considerations and is restrained by the number of audit personnel IRS can reasonably expect to absorb over the planning period. These factors are combined to arrive at the planned audit coverage for each class of individual and corporate taxpayer.

Yield/cost considerations

Constrained by such factors as the number of audit personnel it can recruit, train, and absorb over the long-range planning period, IRS calculates the level of audit coverage for each class of individual and corporate taxpayer which will produce the most revenue for the dollars spent. This calculation involves equalizing marginal yield and average cost among the individual and corporate classes.

IRS defines "marginal yield" as the amount of additional tax obtained from the audit of one more tax return. IRS uses marginal yield, rather than average yield, because computation of marginal yield enables the Service to determine when it would no longer be economical to audit returns in a particular class. This is the point at which the cost of auditing a return would be higher than the additional tax assessed.

The cost component in the marginal yield/average cost ratio is the average cost of performing an audit in each class. The average cost is a function of the average grade of agents assigned to the audits, the cost per staff-year, the number of returns audited, and the time spent on those audits.

For returns of corporations having less than $1 million in assets, the relationship between coverage and yield is derived from the results of audits done under IRS' Taxpayer Compliance Measurement Program (TCMP). TCMP is a long-range research program for measuring and evaluating taxpayer compliance through specialized audits of randomly selected returns. IRS uses TCMP data to improve existing operations in such matters as allocating resources and selecting returns for audit--primarily through development of computerized mathematical formulas to score a return's audit potential. This computerized scoring process, known as the discriminant function (DIF) system, is used to score the audit potential of every individual return and most corporate returns reflecting assets of less than $1 million. DIF is more fully discussed in chapter 3.

IRS schedules TCMP audits every few years to measure changes in voluntary compliance; each round of audits is referred to as a cycle. IRS has completed two TCMP cycles in the corporate area--the first covering returns processed in 1969 and the second covering returns processed in 1973--and has a third cycle, covering returns processed in 1978, in progress. The first two TCMP cycles covered basic returns of corporations with assets of less than $1 million. The most recent cycle covers basic returns of corporations with assets of up to $10 million and no-balance-sheet returns. 1/ Returns reflecting assets of more than $10 million have not been subjected to TCMP because IRS believes they are too variable and too complex to produce results suitable for application to an entire asset class.

TCMP audits, unlike other audits, involve a thorough review of the entire return. Examiners are instructed to review every item, regardless of the dollar amount, and to be especially alert to discovering unreported income and to allowing additional deductions or credits to which taxpayers are entitled.

IRS uses TCMP data as a starting point in making its yield computations in the corporate low-asset classes because TCMP audits are more thorough than regular audits and because TCMP-audited returns, unlike other audited returns, are selected randomly. The nature of the data emanating from such audits allows IRS to develop yield estimates for any level of audit coverage and provides a statistically reliable way of measuring how yield will be affected by an increase or decrease in audit coverage.

However, because TCMP returns are selected randomly and because TCMP audits are so thorough, TCMP yield data is not representative of actual operating experience. Therefore, IRS adjusts the TCMP yield data, using the results of regular audits, so that its estimates of yield will more accurately reflect actual experience.

Yield figures for corporate asset classes of $1 million and over are based on regular audit results because TCMP audit data is not available. For returns showing assets of $1 million to $100 million, average yield is first computed by using the amount of additional tax recommended as a result of audits during an 11-year base period. These figures are then adjusted by the audit results for the most recent 4 years to obtain marginal yield for each asset class. For returns

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1/No-balance-sheet returns are returns that reflect no year-end balance sheet. Included in this category are the final returns of liquidating or dissolving corporations that have disposed of all their assets, the final returns of merging corporations whose assets have been reported in the returns of the acquiring corporations, and the part-year returns of corporations that have changed accounting periods.

showing assets of $100 million or more, IRS computes an average yield by averaging the audit results for the past 4 years. Because of the high audit coverage and average additional tax recommended as a result of audits in this class, IRS assumes that marginal yield equals average yield.

In all asset classes, IRS further adjusts its yield computations to account for the fact that taxpayer appeals sometimes cause the amount of additional tax assessed to be less than the amount recommended by the examiner.

Once IRS develops the various yield/cost factors, it determines how many returns should be audited in each class to equalize the marginal yield/average cost ratios among classes. By equalizing the ratios, IRS determines what allocation of resources would result in the highest total yield. In developing a recent long-range plan, for example, IRS specified the following corporate audit coverages based strictly on equalized yield/cost considerations.

Asset class	Estimated number of returns to be filed	Percent of filed returns to be audited
No balance sheet	138,000	6.0
Under $50,000	747,000	1.2
$50,000 under $100,000	287,000	.4
$100,000 under $250,000	371,000	3.1
$250,000 under $500,000	213,000	9.2
$500,000 under $1,000,000	132,000	17.7
$1,000,000 under $5,000,000	113,000	24.7
$5,000,000 under $10,000,000	18,000	21.3
$10,000,000 under $50,000,000	22,000	34.2
$50,000,000 under $100,000,000	4,356	100.0
$100,000,000 and over	4,448	100.0
Total	2,049,804	a/5.9

a/This percent coverage for corporate returns was higher than the 4.1 percent coverage planned for individual returns.

As can be seen, the equalization of yield/cost ratios tends to produce uneven audit coverage levels. This unevenness is due to the relatively high costs and low yields associated with auditing certain corporate asset classes and the relatively low costs and high yields associated with auditing others. Thus, if yield were the only criterion, IRS would allocate very few resources to those asset classes which produce little revenue compared with the cost of auditing them. But IRS is also concerned with maintaining and improving compliance.

Voluntary compliance considerations

Voluntary compliance is the comparison of the amount of tax liability reported by persons who have filed returns with the amount those persons should have reported. For planning purposes IRS uses 90 percent as an acceptable level of compliance in the individual and corporate income tax areas.

By projecting the results of the random audits done under TCMP, IRS develops measures of voluntary compliance for individual taxpayers and for corporate taxpayers with assets of less than $1 million. As the following table shows, voluntary compliance for low-asset corporations decreased from 1969 to 1973.

	Percent voluntary compliance for corporate returns processed in	
	1969	1973
Under $50,000	60.7	52.6
$50,000 under $100,000	74.4	a/73.4
$100,000 under $250,000	85.0	78.7
$250,000 under $500,000	83.9	a/83.2
$500,000 under $1,000,000	88.4	a/86.0
Total	83.7	80.5

a/According to IRS, the decreases in these asset classes are statistically insignificant.

IRS has no comparable measure of voluntary compliance for returns of corporations with assets of $1 million or more because TCMP data is not available for those returns. IRS' estimates, based on regular audit results rather than the more scientific TCMP approach, indicate that voluntary compliance in each of those asset classes is higher than 90 percent.

IRS' long-range planning process calls for adjusting the audit coverages generated by the yield-maximization approach when voluntary compliance is below 90 percent in any asset class. IRS contends that audit coverage adjustments to combat low compliance are necessary for taxpayer equity. In IRS' opinion, it would be inequitable for the low-compliance classes to be subject to limited audit coverage just because audits in those classes produce the least revenue.

Put simply, the lower the compliance below 90 percent, the more audit coverage is increased. IRS has a point, however, beyond which it will not extend audit coverage to combat low compliance. This point is where the marginal yield/average cost ratio falls below 1 to 1. At that point, it would cost more to perform an audit than the amount of additional tax generated.

Using the same example as on page 8, IRS adjusted its audit coverages to divert resources from high to low compliant classes as follows:

Asset class		Estimated number of returns to be filed	Percent of filed returns to be audited: Before adjustment	Percent of filed returns to be audited: After adjustment
No balance sheet		138,000	6.0	5.5
Assets of at least	but less than			
$1	$50,000	747,000	1.2	6.7
$50,000	$100,000	287,000	.4	6.4
$100,000	$250,000	371,000	3.1	6.7
$250,000	$500,000	213,000	9.2	8.4
$500,000	$1,000,000	132,000	17.7	16.6
$1,000,000	$5,000,000	113,000	24.7	23.4
$5,000,000	$10,000,000	18,000	21.3	20.6
$10,000,000	$50,000,000	22,000	34.2	32.2
$50,000,000	$100,000,000	4,356	100.0	100.0
$100,000,000		4,448	100.0	100.0
Total (note a)		2,049,804	5.9	9.1

a/Compared with the overall increase in planned coverage in the corporate area, planned coverage in the individual area was lowered from 4.1 to 3.8 percent.

As the table shows, the plan calls for low coverage for lower-asset returns, even after IRS adjusted for low compliance. This pattern has always existed; the highest-asset returns always have been given the most coverage.

THE SECOND STEP IN THE PLANNING PROCESS: FORMULATING AN ANNUAL PLAN

With input from the national, regional, and district offices, IRS develops an examination plan for the coming fiscal year, the first step toward meeting its long-range goals. Because of tax return inventories and staffing levels, IRS cannot always move totally in the direction of the long-range plan. The ultimate goal, however, is to come as close as possible to achieving the coverages specified in the long-range plan while maintaining a viable plan for each district.

Developing an optimal plan

The first phase of the annual planning process is computerized formulation of an optimal plan by the national office. An optimal plan specifies the number of returns to be audited by each district for the coming fiscal year. The key to devising an optimal plan is computing examination rates, which specify the average number of returns that can be examined in a direct examination staff-year. 1/

IRS computes an examination rate for each district for each corporate asset class up to $100 million. To compute the rates for fiscal year 1979, IRS took each district's rates for the previous 4 years, eliminated 1 year's rate, and averaged the remaining 3 rates. To decide which 3 years would be used in computing the average, IRS subjected the rates to a trend test. If the rates for the 4 years showed a continuous chronological trend, either up or down, IRS discarded the oldest year's rate and computed an average using the rates for the most recent 3 years. If a continuous trend was not present, IRS discarded either the highest or lowest rate (called the aberration rate), depending on which was farther from its adjacent rate in magnitude, and used the other three rates to compute an average.

According to IRS, the process for computing rates for fiscal year 1980 was even more involved. If the rates showed a trend, IRS computed an average using only the two most recent rates; if the rates showed no trend but did show a distinct grouping pattern of two high rates and two

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1/A direct examination staff-year is the time one staff member actually spends examining returns during the year. The remaining time is spent on activities such as leave or training.

low rates, IRS computed an average using all four rates; and if neither of the first two conditions existed, IRS discarded the aberration rate and computed an average using the other three rates.

For returns of corporations with assets of $100 million or more, figures on staffing and number of returns to be audited are supplied directly by the district offices. The national office feels that district personnel directly involved in the audits can best estimate the audit time and resources required. In effect, because each of these audits is so complex and, in many ways, unique, historical data is not very useful in estimating future needs.

Computation of examination rates often produces significant differences among districts in rates for the same asset class. Although IRS has not been able to quantify the reasons for these differences, it attributes them to such factors as the complexity of the industries being audited, the geographic dispersion of corporate subsidiaries, the experience of a district's audit staff, and the extent to which a district emphasizes the effective use of audit time.

To make the district rates more comparable, IRS applies an "improvement" factor to the lowest rates. This factor is based on the premise that districts with low rates should be required to improve their examination efficiency; that is, they should perform more audits in the time allotted. The improvement factor applied to a particular rate in a particular district ranges from 0 to 6 percent depending on where that district's rate ranks among all districts' rates. For example, if a district's examination rate in a particular asset class is 100 returns per staff-year and that rate is the lowest among the 58 districts, IRS would increase it to 106 returns per staff-year.

After determining examination rates, the national office computes the number of audits that have to be done in each corporate asset class to meet the coverage objectives in the long-range plan. The national office then allocates these audits to the districts.

For returns of corporations having assets of less than $1 million, the plan is allocated on the basis of historical data and DIF cutoff scores. To illustrate, assume that the fiscal year 1979 plan calls for auditing 150,000 corporate returns in the $50,000 to $100,000 asset class. Using historical data, the national office determines how many of the 150,000 returns can be expected to enter the audit stream from sources other than the DIF system and subtracts that number from the total. The remainder (say 100,000 returns in this example) is then allocated on the basis of DIF cutoff scores.

The national office, by reference to the DIF scores for returns filed in 1977 in the same asset class, determines the score to which it must go to get the 100,000 returns needed. This is referred to as the cutoff score. If the cutoff score is 200, the national office, by reference to district DIF scores for 1977, determines the number of returns in each district with scores of 200 or above. The 100,000 returns are then allocated to each district in the same proportion that the number of returns in the district at or above the cutoff score bears to the number of returns nationwide at or above that score. To each district's share of the 100,000 returns is added the number of returns it can expect to receive for audit from sources other than DIF. The total represents that district's share of the annual plan in that asset class.

For returns showing assets of $1 million or more, the plan is allocated to each district in the same proportion as the percentage of returns in each asset class filed in that district. For example, if 5 percent of all returns in the $10 million to $50 million class are filed in the Manhattan district, then 5 percent of the audit plan for that asset class will be allocated to Manhattan.

The number of direct examination staff-years required in each district in each class is then calculated by dividing the district's examination rate for that class into the number of returns to be audited in that class by that district.

Revising the optimal plan to arrive at a final examination plan

The optimal plan thus formulated shows the number of returns that would be audited in each corporate asset class and in each district office if everything were ideal. In reality, the national office is forced to revise its optimal plan due to staffing imbalances and field input.

The optimal plan is predicated on an assumed balance between the number of audits to be done in each district and the audit staff available to do them--an assumption that is often inconsistent with reality. To account for imbalances between the work to be done in a location and the staff available, the national office must adjust the optimal plan. This, in turn, results in some corporations being audited or not audited because of their geographic locations, without regard to the relative audit potential of their returns.

The national office determines if staffing imbalances exist among districts by analyzing current district staffing levels, the number of taxpayers filing returns in each asset class in each district, and the distribution of the DIF inventory, by score, among the districts. For example, data collected by IRS in developing its fiscal year 1979 plan showed a decrease in the total number of corporate return filings in the Manhattan district. Because the number of audits to be done in each district for asset classes above $1 million is based on filings, the decrease in corporate filings in Manhattan meant that Manhattan's optimal fiscal year 1979 plan called for fewer corporate returns to be audited than in fiscal year 1978.

According to IRS records, this decrease would have necessitated a reduction in Manhattan's revenue agent staff-years from 1,075 to 1,006. Because IRS tries to achieve staff reductions through attrition, however, and because the 69 staff-year reduction was not achievable through attrition, IRS had to revise the optimal plan to reflect a more realistic reduction--to the point that its final plan called for a reduction of only 42 staff-years. This revision caused an increase in the number of corporate audits planned for Manhattan. Thus, in effect, some corporate taxpayers in Manhattan and districts like it have been and will be audited simply because they filed in a district that had more staff than it should have had under ideal conditions.

IRS further revises its optimal plan based on input from the field. The national office solicits such input to insure that the final examination plan is realistic in terms of the field's ability to achieve it. Field input has a significant impact, for example, on the development of examination rates.

Once the national office calculates the rates, as discussed earlier, it sends them to the field for comment. Each district office prepares written comments on whether it considers the rates reasonable and forwards them to the responsible regional office. The regional office reviews and consolidates the district comments and forwards them to the national office, which makes any changes to the rates it considers justified.

The district comments generally relate to circumstances that would tend to distort the rates computed by the national office or that are not adequately provided for by the averaging technique used by the national office in computing the rates. In developing its fiscal years 1979 and 1980 annual plans, for example, IRS decreased the rates for each corporate asset class up to $10 million in response to district comments on the impact of time-consuming TCMP audits. The extent of the decrease, which gave districts more time to do their audits, was based on the number of TCMP returns scheduled to be audited in relation to the total number of audits planned nationwide. The decrease in rates, by class, was the same for all districts.

The process by which the national office solicits field input, the field offices provide input, and the national office makes whatever changes it deems justified is repeated several times--continuing from the time the national office first computes examination rates until the final examination plan is issued. The process as it related to the fiscal year 1978 plan, for example, lasted from March to December 1977, during which time the districts provided input at least five times.

OPPORTUNITIES TO IMPROVE THE END PRODUCT OF THE EXAMINATION PLANNING PROCESS

IRS' examination planning process provides a sound framework for allocating resources and apportioning workload. IRS could better implement the annual plan generated by that process, however, if it minimized significant changes from year to year. IRS also needs to insure the reasonableness of the examination rates that form the backbone of the annual plan, develop the information necessary to assess the adequacy of the planning process as it relates to miscellaneous corporate returns, and consider the overall corporate planning implications of ongoing research.

IRS needs to minimize significant changes in its audit plans from year to year

IRS' planning process is directed at determining the number of audits that should be done in each district and each asset class to best achieve its yield and compliance objectives. Thus, IRS looks to each district to achieve its share of the annual plan, not just in total but by asset class. As shown below, IRS generally completed the total number of corporate audits called for in recent examination plans but the results varied significantly among asset classes and district offices. IRS could achieve better results if it minimized significant changes in its audit plans from one year to the next.

	Percent of plan accomplished (note a)							
Asset class	Nationwide		District 1		District 2		District 3	
	1977	1978	1977	1978	1977	1978	1977	1978
No balance sheet	142	138	108	195	151	185	77	108
Under $100,000	87	89	63	105	74	99	89	79
$100,000 under $1 million	102	103	97	131	79	96	112	87
$1 million under $10 million	108	106	114	126	114	96	128	120
$10 million under $100 million	112	126	91	168	100	133	124	155
$100 million and over	95	101	53	51	72	85	171	210
Total	101	102	89	121	88	100	108	97

a/According to IRS officials, any percent accomplishment between 95 and 105 is considered acceptable.

Some IRS field personnel have indicated that effective implementation of annual audit plans has been impaired by the national office's inability to finalize those plans in a timely manner. The fiscal year 1979 audit plan, for example, was issued about 3 months after the start of the fiscal year; the 1978 plan was issued 2 months late; and the plans for fiscal years 1975, 1976, and 1977 were issued from 1 to 4 months late. It should be noted, however, that the national office does issue a tentative annual plan to guide field activities until issuance of the final plan.

In our opinion, the basic problem IRS must address is not the timeliness with which it issues a final plan but the extent to which its plans contain significant changes from one year to the next. At a recent conference of IRS regional commissioners and district directors, concern about such changes was characterized as causing audit managers to "* * * engage in desperate acts in an attempt to turn the Queen Mary around twice in the Potomac." According to IRS, that criticism related to the view that insufficient consideration is given to work in process in formulating a current year's audit plan.

The consideration of work in process is vital when dealing with corporate returns, because inventories of such returns have a low turnover rate--as compared to individual returns, for example. In other words, it takes districts more time to audit corporate returns and thus more time to react to significant changes from one annual plan to the next as indicated by the following examples.

One district had audited 235 returns in the $10 million to $100 million asset classes during fiscal year 1977. The fiscal year 1978 plan called for only 165 audits in those classes. The district's Returns Program Manager 1/ told us that the district could not "gear down" to the 165 figure and thus ended up exceeding the plan by 33 percent. In the $10 million to $50 million asset class, the district had accomplished 100 percent of its plan by March 1978--only halfway through the examination year. A Returns Program Manager in another district told us that, considering audits already closed and in process, his district had already met its 1978 plan in early December--just 2 months after the beginning of the fiscal year--causing excess inventories and a large number of surveyed returns. 2/

1/Returns Program Managers are the Examination Division personnel responsible for developing and administering return selection programs at the district level.

2/Surveyed returns are returns that have been selected for audit but are not audited. A major reason for surveying returns is to eliminate excess inventories--situations in which districts have more returns awaiting audit than they need to meet their audit plans.

The national office attributes significant changes in plans from year to year to major changes in IRS policy affecting audit coverage. For example, IRS decided to significantly increase its coverage of partnerships in fiscal year 1978 due to its concern over tax shelter schemes. As a result, the audit plan for that year called for large reductions in corporate return coverages from those specified in the 1977 plan. Some districts protested that they could not adequately adjust their audit workloads to meet the increased partnership coverages. Nevertheless, the national office decided that the need to immediately address the tax shelter problem outweighed the cost of disrupting the corporate program. But it could have reduced such disruption by making more carefully planned changes to the corporate program in consideration of such factors as work in process.

IRS needs to assess the reasonableness of its examination rates

Examination rates are the cornerstone of an annual audit plan. We discussed the computation of those rates in our report on how IRS selects individual income tax returns for audit. Our concern, as expressed in that report, was whether the rates provided enough time for examiners to do a quality audit. We recommended that IRS conduct a controlled study to evaluate the reasonableness of its rates. In doing so, we envisioned a study of what constitutes a quality audit and how long, on the average, it takes to do one in each audit class.

IRS responded by noting that it had changed its method for computing rates to the 4-year averaging method discussed in this report which, according to IRS, made a controlled study unnecessary. In commenting on IRS' response in our earlier report, we said:

> "This approach should produce more reasonable revenue agent examination rates * * *. We are not convinced, however, that the newly computed rates accurately reflect the time needed to conduct a quality audit since there is no assurance that examiners, in any of the past 4 years, were ever afforded adequate time to do such an audit. In other words, the newly computed rates might just be averages of previously unreasonable rates."

Examination rates are still a subject of some disagreement within IRS. One district, for example, took issue with several of the proposed corporate rates computed by the national office for fiscal year 1978. The district felt the national office had failed to consider the fact that two large corporations in that district had each decided to file a consolidated return, instead of letting each subsidiary file its own return as had been done in the past. The shift to consolidated returns resulted in only two returns being filed instead of the several hundred that used to be filed.

The district contended that this change was not reflected in the historical data used by the national office in computing its rates and that those rates were unrealistically high. The district, therefore, proposed revised rates which, except for one asset class, were lower than the national office's rates--in one case as much as 26 percent lower. As a result of the district's comments, the national office lowered the examination rates, but not as much as the district had proposed. The national office felt that the district had not sufficiently justified any further reduction. As discussed before, the national office has since revised its rate computation methodology which, it says, will lead to more realistic rates in the future.

Because examination rates are still a subject of disagreement in IRS, because the newly-revised methodology for computing examination rates is still based on historical data, and because allowing examiners enough time to do a quality job is important, we reiterate our belief that a controlled study is necessary.

Before IRS can conduct such a study, however, it has to define audit quality. A February 1979 report by an Examination Division task force pointed out that because the Division had no audit quality objectives, it could not measure quality. The task force recommended that the Division define quality and how it would be measured. We endorse that recommendation.

National office officials correctly pointed out that the task force report was the product of only 3-1/2 days of discussion among task force members and that most of the report's recommendations emanated from the background each of the members brought to the task force. It is significant, nonetheless, that their backgrounds in IRS led them to conclude that IRS needed to define audit quality.

IRS has insufficient information to assess the adequacy of its planning process as it relates to miscellaneous returns

Most corporations file a basic form 1120. For various reasons, however, certain corporations file returns that differ from the basic 1120. IRS statistics indicate that those nonbasic returns, known collectively as miscellaneous returns, accounted for about 0.7 million, or 19 percent, of the 3.6 million corporate returns filed in 1977 and 1978, as follows:

Type of miscellaneous return	Number of returns filed 1977	1978
1120L	1,747	1,814
1120M	1,165	1,716
1120F	3,129	4,425
1120 Consolidated	36,178	38,274
1120 Personal Holding Company	21,002	22,230
1120 Inactive (low asset)	58,092	69,514
1120 Final (low asset)	37,941	43,993
1120 Short or Initial Period (low asset)	160,603	186,755
1120 POL/H	7,939	12,978
Total	327,796	381,699

IRS uses asset size as the common denominator in developing its corporate audit plans. As such, it does not prescribe specific audit coverage requirements for miscellaneous returns. The Examination Division believes that the number of miscellaneous returns is too small to warrant special planning attention. We believe IRS needs more information before it can make such an assessment.

Although it does not separately provide for miscellaneous returns in its audit plans, IRS does require that field offices screen certain miscellaneous returns for audit potential. IRS has no statistics, however, on how many audits result from those screenings. For other miscellaneous returns, IRS has no screening requirement. Although some of those returns do get screened for one reason or another, IRS again has no statistics on how many are audited.

IRS also has no data to indicate how many miscellaneous returns should be audited. It does not know how much revenue is generated by audits of miscellaneous returns or the compliance levels associated with such returns 1/--the two basic data elements in its planning process. IRS thus has little assurance that miscellaneous returns are getting the audit attention they warrant and that the planning attention directed at them is adequate.

IRS has efforts underway that could enrich the corporate planning process

IRS has matters under consideration that have long-range planning implications. Two of these matters--categorizing corporations in a way that is more indicative of audit complexity than is the dollar amount of their assets and tracking audit results through the appeals process to better relate yield to cost--are being considered only as they relate to the largest corporations. A third matter--identifying and evaluating factors affecting compliance--is restricted to individual returns. Although we understand the need to restrict the scope of these matters at this stage, IRS should ultimately consider the broader corporate planning implications.

Using factors in addition to gross assets to categorize corporate returns

IRS has traditionally categorized corporations by the dollar amount of their assets to measure compliance and allocate audit resources. This procedure is designed to segregate the more complex returns from the simpler ones under the assumption that the larger corporations have more complex returns.

IRS has recently given further thought to how to identify the largest and most complex corporations. One IRS study group made a comprehensive review of IRS' audit efforts directed at large corporations and observed in its September 1977 report that assets alone were not valid indicators of complexity. A second study group, formed to implement recommendations made by the first group, agreed

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1/Although the number of returns involved is probably too small for IRS to develop statistically reliable estimates of compliance through TCMP, IRS could use regular audit results to develop compliance estimates as it now does for asset classes above $1 million.

with the first group's observation and added, in its June 1978 report, that any criterion using a fixed dollar value over a period of years was misleading due to inflation and did not measure complexities to the extent originally intended.

To remedy this situation, the study groups proposed a "complexity factor" system to identify large corporations warranting 100-percent audit coverage. Each of various factors, including gross assets, gross receipts, and number of operating entities, would be assigned a specific range of scores. For example, a corporation could receive from one to five points depending on whether its gross receipts were less than $1 billion or more than $5 billion. IRS tested this system nationwide. A report on the results concluded that the system provided an appropriate means to determine a case's complexity and recommended that cutoff scores be established to designate large cases. IRS intends to start doing that in fiscal year 1980.

Most IRS field personnel we talked with felt that asset level alone was not a valid indicator of a return's complexity and that additional criteria could also be used to categorize returns of smaller corporations. They pointed out that some low-asset returns (such as those filed by service companies) could have very complex transactions while some high-asset returns (such as those filed by financial institutions) might not be complex at all. Items such as gross receipts, sales, and type of industry were seen as relating more directly to tax complexity than the amount of assets.

Use of assets alone may foster taxpayer inequity. As noted before, the level of audit coverage increases as the dollar amount of corporate assets increases. A corporation with assets of between $500,000 and $1 million, for example, is almost twice as likely to be audited as a firm with assets of between $250,000 and $500,000. Because assets like land, buildings, equipment, material, and supplies cost more today than they did in past years, similar firms could find themselves in different asset classes (and thus with different chances of being audited) only because one may have started business more recently or replaced its assets more frequently.

Therefore, IRS should consider using a scoring system to assess the complexity of all corporate returns, not just those filed by the largest corporations. Although that might cause some administrative difficulties, those difficulties could be outweighed by improvements to corporate audit planning and resource allocation. Also, the scoring system for smaller corporations does not have to be as involved as the one being set up for large corporations, which would help limit administrative difficulties.

Tracking corporate audit results

IRS has been testing a system to evaluate the examination results of its largest corporate audit cases. The system's specific purpose is to determine the audit productivity of certain issues through the various levels of administrative and judicial appeals. The system is expected to generate information on

--adjustments that were long term or permanent versus short-term timing adjustments recaptured by the taxpayer in a few years, which will allow a comparison of issue productivity;

--results of unagreed issues eventually settled at the administrative appeals level, which will help identify issues that generate the most controversy or complexity;

--the amount of time spent on audit issues in each case, which will help identify which issues can be expected to yield the most per examination hour spent.

IRS is considering issue tracking for national adoption but only for the largest corporate audit cases. If this information were generated for other corporate cases, the planning process could be enhanced through more accurate and timely yield figures and resource allocation could be enhanced through more detailed information on the audit results associated with individual industries.

Identifying factors affecting compliance

Although one of IRS' audit objectives is to improve voluntary compliance, it does not really know if or by how much compliance is affected by changes in audit coverage or if changes in compliance are due to other factors, such as geographic location or tax law complexity.

In our report on how IRS selects individual returns for audit, we recommended that IRS devote more research to finding out if the amount of audit effort actually was a critical factor in promoting compliance with the tax laws. IRS has since contracted with a private firm to identify factors affecting compliance for individual taxpayers and to determine how to assess their relative impact. Contract completion is scheduled for March 1980. Successful completion of this project could have widespread implications, such as expansion of the study to include corporate returns, even though evaluation of corporate compliance seems more difficult.

Knowledge of the factors affecting corporate compliance might lead to better allocation of resources, producing an optimal mix of productivity and compliance. For example, the costs of auditing smaller corporations are relatively high compared with tax yield. If IRS found that noncompliance by low-asset corporations was due primarily to the complexity of the tax laws or forms, it could allocate additional audit resources to the more productive high-asset categories and rely more on nonaudit techniques, such as taxpayer service, to improve compliance in the low-asset classes.

CONCLUSIONS

IRS' planning process provides a highly scientific framework for allocating limited audit resources and apportioning workload. The annual plan emanating from that process could be enhanced, however, if IRS minimized significant changes from year to year and if more definitive data were available to assess (1) the relationship between audit coverage and voluntary compliance, (2) the validity of examination rates, and (3) the adequacy of audit attention directed at miscellaneous returns.

In developing its examination plans, IRS first allocates its resources to maximize yield. Although IRS later adjusts that allocation to increase audit coverage in the low-compliant asset classes, it still emphasizes yield by refusing to allow that adjustment to go below the point where the marginal yield/average cost ratio is 1 to 1. Because one of IRS' planning objectives is to maximize yield, its resource allocation strategy generally results in a corporation's chances for audit increasing as the amount of its assets increases.

IRS' emphasis on yield conflicts with its mission of promoting the highest possible degree of voluntary compliance. The relationship between audit coverage and yield is much easier to measure and demonstrate, however, than the relationship between coverage and compliance. Unless and until that latter relationship can be better measured we cannot fault IRS for emphasizing yield in developing its examination plans.

IRS' current study on the factors affecting compliance by individuals represents a significant attempt to measure the coverage/compliance relationship. Depending on the study's success, IRS should consider expanding it to corporations. The results could prompt basic revisions to the planning process to the point of causing IRS to shift its emphasis from yield to compliance.

Another inequity evolves from staffing imbalances which cause some taxpayers to be audited or not audited because they file in a district that is over- or understaffed in relation to other districts. IRS attempts to minimize those imbalances through attrition, but, in truth, imbalances will never be completely eliminated unless IRS starts moving personnel from district to district as needs dictate. In our opinion, however, moving significant numbers of staff around the country is too expensive in terms of money and staff morale to be considered a viable alternative to staffing imbalances.

The most controversial aspect of the planning process is the national office's development of examination rates. That controversy is understandable because examination rates dictate the number of returns a district will be expected to audit in the coming year. In the interest of an effective audit program, it is important that IRS establish rates that pressure district offices to produce while allowing enough time to do a quality job. We are not convinced, however, that IRS' rates adequately satisfy both objectives.

Disagreements between headquarters and the field might be alleviated if the national office were in a better position to demonstrate the reasonableness of its examination rates. The national office will not be in that position, in our opinion, until it defines a quality audit and then conducts a controlled study to determine the time needed to do a quality audit in each asset class. IRS should not rely on the historical data it now has in developing rates or in demonstrating their validity, because past rates may have been unreasonable and because districts can always meet plans based on unrealistic rates simply by reducing quality.

IRS also needs to generate data that will enable it to assess the adequacy of its planning process as it relates to miscellaneous returns. Such returns account for about

19 percent of all corporate returns filed, but IRS does not know how many are audited, how productive those audits are, or how compliant the taxpayers that file those returns are.

For planning purposes, IRS now categorizes corporations by the dollar amount of their assets. With more data on miscellaneous returns, however, IRS might see a need to provide separate audit coverages for some or all of the various types of miscellaneous returns. In that regard, IRS has studies underway that could also provide information on the efficacy of using factors other than asset size to categorize corporations--especially if those studies are expanded.

No matter what IRS does to enhance its planning process, all will be for naught unless it minimizes significant changes in examination plans from one year to the next. Such changes, especially in audit classes with low turnover rates, make it difficult, if not impossible, for field offices to meet their plans. In this regard, IRS could time major policy changes and phase in their implementation to minimize their impact on field activities and could modify its planning process by building in limits on year-to-year changes on the basis of inventory turnover rates.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that IRS

--define a quality audit and then conduct a controlled study to determine how long it takes to do a quality audit in each corporate asset class;

--assess the adequacy of its planning process as it relates to miscellaneous returns by generating necessary evaluative data such as the number of miscellaneous returns audited and their productivity;

--time major policy changes to minimize their impact on field activities and modify its planning process by limiting changes from year to year, especially in audit classes with low turnover rates; and

--consider expanding its ongoing efforts for (1) using factors in addition to gross assets to categorize corporate returns, (2) tracking corporate audit results, and (3) identifying factors affecting voluntary compliance to take advantage of their broader planning implications. IRS should consider expanding the latter effort to the corporate area only after it has assessed its success in the individual income tax area.

IRS COMMENTS AND OUR EVALUATION

In a May 17, 1979, letter (see app. I), the Commissioner of Internal Revenue concurred with each of our recommendations. The Commissioner noted, among other things, that IRS

--would attempt to develop a more comprehensive definition of audit quality even though "quality audit is defined in our [IRS'] Manual;"

--would attempt to develop a study to determine as much as possible about the relationship between the amount of time spent on audits and their quality;

--would limit changes from one year's audit plan to the next, starting with development of the plan for fiscal year 1980 and, unless faced with overriding considerations, time major policy changes so that field offices can adjust their activities in furtherance of the plan;

--planned to study how corporate returns are categorized after the current corporate TCMP cycle is completed;

--planned to expand its issue-tracking efforts when additional computer capacity becomes available; and

--would consider identifying the factors affecting voluntary compliance in the corporate area after assessing the results of its study in the individual area.

Although IRS' comments are responsive to our recommendations, we should reemphasize that audit quality is not adequately defined in IRS' manual. IRS defines the term in at least two places in the manual, but both definitions differ and neither definition is sufficiently comprehensive.

In agreeing to study how corporate returns are categorized, IRS indicated that the categorization should be based on a single, rather consistent, return characteristic. We see no reason for not basing the categorization on a combination of factors or characteristics similar to the complexity factor system IRS plans to use to identify large corporations warranting 100 percent audit coverage as discussed on page 22.

CHAPTER 3

IRS NEEDS TO MAKE ITS SELECTION

SYSTEM MORE EQUITABLE

IRS' examination plan calls for 100 percent audit coverage of those corporations in the highest asset classes--which account for less than 1 percent of all corporate returns filed. IRS does not have nearly enough resources to audit all corporations in the other classes. Thus it has developed a system for identifying those returns most worthy of audit attention. The primary concerns with any such system are whether it works equitably and whether it identifies the best returns for audit. This chapter addresses the system's equity. The second concern is addressed in chapter 4.

IRS' selection system is equitable in that it adequately protects against circumstances that would cause a return to be audited or not audited for reasons other than audit potential. The system is not without its shortcomings, however. Some returns' chances for audit have been affected by improper or inconsistent filing practices and by inadequate inventory controls. IRS has taken steps to alleviate some of these problems, but it could do more.

WHY A CORPORATE RETURN MIGHT BE SELECTED FOR AUDIT

Some corporate returns are randomly selected for audit and others are selected because they have special features that IRS is looking for. But most are selected because a computer and/or a manual screener have determined that the returns, in general, have good audit potential.

The reasons a corporate return might be selected for audit are divided into the following six major categories, as illustrated for fiscal year 1978.

Selection category	Number of returns audited	Percent of total returns audited
Computer identified	74,102	50.3
Multiyear audits	27,729	18.8
Related pickups	19,234	13.1
Claims	10,127	6.9
Research and reference	7,464	5.1
Other	8,684	5.9
Total	147,340	

Computer-identified returns

About half the corporate returns audited in fiscal year 1978 were categorized by IRS as computer identified. These included returns identified as having good audit potential by a computerized scoring process known as the discriminant function (DIF) system and returns meeting certain defined criteria, such as assets in excess of a specified dollar amount. For these latter returns, the term "computer identified" is misleading because the computer plays no real role in identifying or selecting them for audit.

Computerized scoring

During the 1960s IRS began using the DIF system to evaluate the audit potential of individual income tax returns. In 1973 IRS expanded it to include low-asset basic corporate returns.

Under DIF each basic corporate return reflecting assets of less than $1 million is scored by a computer using a mathematical formula that assigns weights to certain predetermined characteristics on the return. The sum of the weights represents the return's DIF score; the higher the score, the greater the return's audit potential. At the time of our review, IRS had the following five formulas for scoring corporate returns:

DIF formula	Returns scored by formula
1	Basic corporate returns reflecting assets of less than $50,000
2	Basic corporate returns reflecting assets of $50,000 but less than $100,000
3	Basic corporate returns reflecting assets of $100,000 but less than $250,000
4	Basic corporate returns reflecting assets of $250,000 but less than $500,000
5	Basic corporate returns reflecting assets of $500,000 but less than $1,000,000

The characteristics and weights that make up the DIF formulas are based on Taxpayer Compliance Measurement Program results. In this regard, the ongoing TCMP of corporate returns processed in 1978 has, as one of its objectives, development of DIF formulas for no-balance-sheet returns and returns of corporations with assets between $1 million and $10 million.

Periodically a district office orders a specific number of DIF-scored returns from the service center where they are filed. The returns are usually ordered by formula. The service center pulls the highest scored returns in inventory for the formula or formulas ordered and sends them to the district, where they are manually screened by classifiers (revenue agents assigned to screen returns) to eliminate those that do not warrant auditing. 1/

In other words, the computer evaluates the audit potential of every basic corporate return showing assets of less than $1 million and, by assigning scores, separates those with a high likelihood of change from those with less likelihood. Then classifiers, using judgment based on experience, evaluate the high-scored returns and eliminate those that do not warrant auditing. A return, for example, may have received a high score because of certain unusually large deductions. The classifier, however, upon reviewing the return, may see what the computer could not see--detailed schedules in support of the deductions--and, in the absence of other questionable items, will determine that the return should not be audited.

To assess DIF's effectiveness in identifying good audit potential returns, we (1) examined IRS' procedures for conducting two tests in which DIF would be expected to prove superior if it were meeting its objectives and (2) conducted our own analysis in which we measured the correlation between DIF scores and no-change rates. 2/ IRS' two tests, which we

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1/IRS uses the term "classifier" when referring to non-DIF-scored returns and "screener" when referring to DIF-scored returns. We see no need to make that distinction and thus, in this report, the terms "classifier" and "screener", "classification" and "screening", and "classify" and "screen" are used interchangeably.

2/The no-change rate refers to the percent of audits that result in no change to the tax liability reported by the taxpayer.

found to be procedurally sound, and our independent analysis showed DIF to be effective. Details on the tests and analysis are provided in app. III.

Because manual screening is a vital part of the DIF system and IRS' selection system in general, we evaluated it in depth. Our findings are discussed in chapter 4.

Other computer-identified returns

IRS includes other returns in the computer-identified category even though the computer plays no role in their selection for audit. IRS refers to these returns as automatics and specials and requires that they all be manually screened. The decision to select such a return for audit is made solely by a classifier; the computer merely identifies the return as an automatic or a special. This is unlike the DIF system, where the computer actually has a role in evaluating a return's audit potential.

In general, automatics constitute corporate returns not covered by DIF. Specials are returns that meet one or more of the specific conditions that IRS has identified as warranting audit consideration. For example, any corporate return reflecting international transactions or claiming foreign tax credits exceeding $25,000 is identified as a special and must be classified. If the special also is a DIF-scored return, it still must be classified no matter how low its score.

We could not determine how many of the 74,102 returns categorized as computer-identified in 1978 were DIF identified and how many were automatics or specials. We do know, however, that at least 24,734 (or 33 percent) of those returns were not DIF identified because they were returns showing assets of $1 million or more and no-balance-sheet returns--neither of which are covered by the DIF system.

IRS further clouded the distinction between DIF returns, automatics, and specials when it recently changed the name of the computer-identified category to "DIF source returns". Now, in effect, the management information system shows about 50 percent of the corporate returns being selected for audit through DIF when the actual percent is closer to 35. Because IRS uses its management information system as a source of data for program evaluations, congressional hearings, and responses to congressional and public inquiries, the system should be more precise in its terminology.

Related pickups and multiyear audits

During an audit the examiner may find it necessary to review additional returns affecting the income and deductions of a corporation to ascertain whether the corporation correctly determined its tax liability. For example, an examiner may want to review a return filed by a subsidiary of the corporation being audited to see how inter-company transactions were reported. IRS refers to the audits of such returns as related pickups.

Also the examiner may consider it necessary to audit returns filed by the same taxpayer in earlier or later years to determine, for example, whether loss carrybacks or carryforwards are proper and whether adjustments to the return being audited might apply to other years' returns. IRS refers to audits of prior and subsequent years' returns as multiyear audits. As a general rule, IRS procedures provide that examiners, when auditing a corporation, should inspect the taxpayer's subsequent year's return and determine if it warrants audit. If appropriate, that return is examined concurrently with the originally assigned return. Because of a desire to keep its audit inventories relatively free of "old year" returns, however, IRS does not require examiners to audit taxpayers' prior years' returns. In general, the expected audit results have to be very significant to warrant going into a prior year.

To obtain a related return or a subsequent or prior return, the examiner prepares a requisition which must be approved by his immediate supervisor. After the requisition is approved, the service center forwards the return directly to the examiner. Our report on how IRS selects individual returns for audit noted that

> "The requisition prepared by the examiner to obtain these returns contains a code but no written explanation why the examiner needs the return and thus gives management* * * little basis for evaluating that need."

We recommended that IRS require written explanations because we felt that, compared with other selection procedures, the procedures for selecting these returns were susceptible to abuse.

IRS did not agree that written explanations should be required and felt that its system of codes was sufficiently comprehensive to permit a supervisor or reviewer to determine why the return had been requested. In that regard, the instructions associated with the form now being used by examiners to requisition returns still do not call for a written explanation when the examiner is requesting a prior or subsequent year's return or a related return.

During our review of the corporate selection process, we looked over some of the requisitions filled out by examiners and approved by their supervisors. Even though they were not required, examiners were providing written reasons why they wanted the returns. But the reasons were generally not very descriptive and often were no more descriptive than the codes. The requisitions at two district offices, for example, contained such reasons as "related to 1120 of [taxpayer]" and "subsequent year". Those reasons are insufficient to enable management to determine what issues the examiner intends to pursue on the requested return and whether those issues are significant enough to pursue.

Claims

When IRS receives a claim for a refund or an adjustment in taxes, the original return may be classified to determine if the effort needed to substantiate the claim is warranted.

For classification purposes, claims are categorized into three types:

--Category A. These claims and related returns are classified before the refunds are processed. Examples include claims involving refunds of $200,000 or more and those involving a determination of employer/employee relationship for employment tax purposes.

--Category B. These cases are classified after the refund is processed. Examples include claims involving carrybacks of losses and investment credits.

--Category C. This category basically involves all claims not covered by the other two cateogories. Any classification is done after the refund is processed.

According to service center officials, 100 percent of the corporate claims in categories A and B and 10 percent of those in category C are classified.

Research and reference

Most of the returns in this category are audited under TCMP. Whereas other returns are selected for audit on the basis of audit potential, those audited under TCMP are selected randomly. IRS' Statistics Division determines sample sizes and sampling rates and translates those rates into a series of ending digits of taxpayer identification numbers to insure random selection. Based on the sample design, a computer system is developed which selects the random sample as the returns are filed.

Other

This category is the catchall for returns not specifically falling into other categories. Of the returns covered by this category, the most important in terms of volume are:

--Those selected for audit because of suspected fraud. This includes regular fraud cases and audits done in conjunction with IRS' participation in the Government's enforcement efforts against organized crime and narcotics trafficking.

--Those selected as a result of referrals from other IRS components such as the Collection and Criminal Investigation Divisions.

--Those selected on the basis of information reports. When an employee in the Examination Division receives information, from an audit or a third party, that a return filed or to be filed will result in an additional or delinquent tax liability, he is to prepare an information report. This report, containing the source and nature of the information, is submitted to the employee's immediate supervisor for approval. The supervisor is to approve the report only if it appears that the required audit effort would generate a material amount of additional or delinquent tax. The report is then reviewed by a classifier, who determines whether an audit is warranted.

HOW A CORPORATE RETURN FLOWS THROUGH IRS' SELECTION SYSTEM

The process by which a corporate return is selected for audit involves much more than the screening of that return by a computer and/or classifier. The following description, which is illustrated by the flow chart in app. IV, is generally typical of what was happening at the service centers and district offices we visited.

Service center processing

All corporate returns are initially received and processed at 1 of 10 service centers throughout the United States. A return's first stop is the service center's Receipt and Control Branch, which (1) separates returns with payment attached from those with no payment, (2) numbers each return with a unique 13-digit number used to locate the return during processing, and (3) groups returns by district offices.

Returns are then forwarded to the Examination Branch, where they are reviewed for legibility, coded, and otherwise prepared for computer processing. This Branch identifies miscellaneous or special returns and codes them as such. The Data Conversion Branch then enters information from the returns and related documents into the computer, which, in turn, produces magnetic tapes that are transferred to the National Computer Center.

The Computer Center (1) posts the information from the magnetic tapes to each taxpayer's account and (2) uses the information to score the audit potential of every low-asset basic corporate return using one of the five corporate DIF formulas. The Center also maintains three computerized inventories of corporate returns filed during the year--one covering DIF-scored returns, one covering basic returns showing assets of $1 million or more, and one covering all those returns not included in the other two inventories (i.e., miscellaneous returns). Separate inventories are kept for each district.

When a district wants corporate returns to audit, it prepares an order showing quantities and asset levels desired. (When ordering miscellaneous returns, a district does not specify asset level because the miscellaneous returns inventory is not maintained by asset level.) The National Computer Center, using its inventory records for that district, generates a printout showing which returns should be pulled from inventory to fill the order. The sequence in which returns are pulled depends on the type of return. DIF-scored returns are pulled in score sequence; the highest scored returns in inventory at the time of the order are pulled first. Other returns are pulled according to the amount of taxable income or loss--returns reflecting the highest taxable income are pulled first while returns reflecting the largest loss (negative taxable income) are pulled last. The Computer Center sends the printout to the appropriate service center, which pulls the returns and forwards them to the district office or to the service center Classification Branch, depending on where the returns are to be classified. Although it varies somewhat from one area of the country to another, district offices generally classify DIF-scored returns while service centers classify all others.

The Classification Branch classifies each return on a first-in, first-out basis and either selects it for audit or accepts it as filed. Each selected return is accompanied by a checksheet identifying issues on the return that caused the classifier to select it for audit.

The classified returns may then be subjected to a quality review to insure that the classifiers satisfied all procedural requirements and that their classification decisions were sound. After any problems are resolved, the Audit Control Section forwards accepted returns to Central Files and sends selected returns to the appropriate district office.

District office processing

A district office receives two types of returns from the service center--those already classified "select" by the service center's Classification Branch and those needing classification at the district (generally high DIF-scored returns).

Returns already classified are placed in the district's unassigned inventory. The other returns are screened by classifiers, assigned to the district's Returns Program Management Staff, who decide whether to select the returns for audit or accept them as filed. As at the service center, selected returns are accompanied by a checksheet and classifiers' decisions can be subjected to a quality review. After the returns have been classified and any quality review has been completed, the selected returns are placed in unassigned inventory and the accepted returns are sent back to the service center for filing.

As needed, returns are pulled from unassigned inventory and assigned to audit groups. The group manager may screen the returns to satisfy himself that they warrant audit. If he believes a return should not be audited, he sends it back to the service center; if he agrees that a return should be audited, he assigns it to a revenue agent.

A revenue agent, upon receiving a return from the group manager, conducts a preaudit analysis to verify the return's audit potential. If he thinks the return does not warrant audit, he can recommend that the group manager return it to the service center; if he agrees that the return warrants audit, he contacts the taxpayer and proceeds.

If a return's DIF score or taxable income is too low to cause it to get pulled from inventory in response to a district order or if a return is pulled from inventory but is deemed not to warrant audit by a classifier, group manager, or examiner, it can still enter the audit stream for one of the other reasons previously discussed. The flow of these returns into the audit stream differs from the just-described process as follows:

--TCMP returns are identified by the computer, pulled from the files, and shipped to the district where they are audited without classification.

--Returns selected as related pickups or as part of a multiyear audit are requisitioned by the examiner, retrieved from the files, and forwarded to the examiner without classification.

--Other returns, such as those relating to referrals from other divisions or claims filed by taxpayers, are pulled from the files by the service center and joined with the referral documents or claims. The service center then classifies and further processes those returns along the normal processing path.

IRS HAS IMPROVED THE SELECTION SYSTEM BUT NEEDS TO DO MORE

IRS has taken action to streamline its selection system and to make it more equitable through improved filing procedures and ordering controls. Equity could be enhanced even more if IRS further revised its filing procedures and took steps to better insure effective implementation of its ordering controls.

Centralized classification should streamline the selection system

Responsibility for classifying returns is divided among service centers and district offices. During 1976 and 1977 IRS' southeast region tested the feasibility of classifying all returns for four district offices at the Atlanta service center. The region wanted to determine whether more returns could be classified at less cost and whether more management control could be achieved if the classification process were centralized.

The study concluded that centralization was a viable concept that had many administrative advantages. In September 1978 the Deputy Commissioner of Internal Revenue approved the Examination Division's recommendation that centralized classification be adopted by all regions and implemented in all service centers. As of June 1, 1979, only the southeast region was using centralized classification. Nationwide implementation is not expected until late 1979.

IRS needs to further enhance the equity of its procedures for filing returns awaiting audit

Before June 1978 IRS had no guidelines on how district offices were to file non-DIF returns awaiting audit or in what order those returns were to be assigned for audit. At the same time, its procedures for filing DIF returns were not always being followed. This lack of guidance and failure to follow existing guidance caused taxpayer inequities in that (1) some districts were using filing systems that resulted in returns being assigned for audit in sequences that bore no relation to their comparative audit potential and (2) a corporation's chances for audit were predicated on filing and assignment procedures that varied from district to district.

For example:

--One district was interfiling negative and positive DIF-scored returns even though the DIF system is based on the premise that a positive-scored return has greater audit potential than a negative-scored return.

--Another district was filing low-asset returns without DIF scores behind low-asset returns with DIF scores, as if the audit potential of a non-DIF-scored return were lower than that of a DIF-scored return--an erroneous premise.

--One district was filing high asset returns and pulling them for audit alphabetically, while another district was filing such returns and assigning them for audit on a first-in, first-out basis.

In June 1978 the national office reminded each field office by memorandum that DIF returns were to be filed in "strict" score order, starting with the highest positive-scored return and ending with the highest negative-scored return, and further directed that non-DIF corporate returns be assigned generally on a first-in, first-out basis. The national office also gave each district the option of using a grading system to determine the assignment priority of non-DIF returns.

After the memorandum was issued, we again reviewed district filing procedures and found them consistent with the procedures required by the national office. None of the districts visited were using the optional grading system; one had been using such a system before June 1978 but had found it unworkable.

The memorandum did not address one specific filing problem that could result in low-asset miscellaneous returns not receiving their fair share of audit consideration. The DIF system scores the audit potential only of basic corporate returns showing assets of less than $1 million. Although low-asset miscellaneous returns are not scored, the system is programed to print a zero on the control document attached to the return in the same place the DIF score is normally printed. As a result, districts are filing those returns after the positive scored DIF returns--as if they really had a zero DIF score. Our review of two districts' files in November 1978, for example, disclosed many miscellaneous low-asset returns misfiled in this way. We reviewed 100 of those misfiled returns and found that they included potentially productive ones like consolidated returns and returns filed by personal holding companies.

Because returns with a zero DIF score are so low in the order of audit priority, these miscellaneous returns have little chance of being pulled for audit. In effect, then, the audit attention directed at such returns is being dictated not by their audit potential but by how they are filed.

IRS' controls over its ordering process will not be fully effective unless accompanied by other changes

A district's filing procedures would be of little consequence if every return in the files were eventually audited. In fact, however, district offices often end up with more returns in inventory than they need, causing them to resort to mass surveying--a procedure whereby returns that have been deemed to warrant audit but are excess to needs (otherwise known as excess inventory) are sent back to the service center unaudited. One regional office, for example, in an April 1978 memorandum to each district in that region, noted that the districts had significant inventories of corporate tax returns and that many of those inventories were unrealistic. The region recommended that survey action be considered in any case in which a district's inventory substantially exceeded its needs. As a further example, one district office in another region mass surveyed about 2,500 corporate returns in 1978.

A related problem involves spreading the selection process ratably over the year so that returns have the same chance of being selected for audit no matter when they are filed. One service center, for example, had stopped classifying low-asset short and initial period corporate returns for one district as of April 30, 1977. As a result, the 1,000 short and initial period returns filed before April 30 were subjected to audit consideration while the 1,650 filed afterwards were not.

Both these problems--overordering and uneven ordering--cause taxpayer inequities and waste limited resources. IRS believes the answer lies in more effective inventory controls and, towards that end, it implemented a nationwide base inventory system in October 1977. The basic purpose of that system is to keep management advised of how much work in process is necessary to achieve the examination plan ratably over the year and to provide the data district management needs to determine how many returns it should order for classification considering (1) the number of returns it still has to audit to meet its plan, (2) the number of audits ongoing, and (3) the number of returns already at the district awaiting classification or awaiting assignment for audit.

The benefits to be derived from such a system were demonstrated in December 1978. In a memorandum to the regions, the national office expressed its concern about the large number of surveyed returns reflected in the base inventory reports for fiscal year 1978. During that year the regions had surveyed 116,477 corporate income tax returns which the national office attributed, at least in part, to excessive ordering.

IRS officials said that a district's unassigned inventory should not exceed 6 month's workload but that some districts had been exceeding that criterion. The November 1978 base inventory report, for example, showed that one district had 7.7 months of work in its unassigned and unstarted inventory for the "Under $100,000" asset class--a situation that will almost certainly produce mass surveys at the end of the examination year. IRS hopes to avoid this type of situation through the monitoring capabilities provided by the base inventory system.

IRS officials have acknowledged, however, that excess inventories and mass surveys cannot be reduced until nonratable ordering practices are eliminated and controls over the number of returns ordered are established. Examination Division officials at the national office said that procedures are being written to provide for ratable ordering which "* * * will enable districts to react to changes in the examination plan from year to year without ending up with excessive inventories that will have to be surveyed." (In this regard, our comments in chapter 2 on the need to minimize significant planning changes from year to year seem pertinent.)

IRS officials generally recognize also that it is easier to manage inventories of DIF-scored returns because the number ordered and put in inventory can be controlled. That should make IRS' efforts particularly effective in the individual income tax area because all such returns are DIF scored. To the contrary, a significant number of corporate returns (about 30 percent of those filed in 1977) are not DIF scored. Many of those returns are considered automatics that have to be classified and, if selected, have to be included in district inventories. One Returns Program Manager cited automatics as the major contributor to large unassigned corporate return inventories in his district. Another IRS employee, responsible for overseeing the classification activity and monitoring the base inventory system nationwide, thought the objectives of that system would be better served in the corporate area if IRS reduced the number of automatics--and thus their impact on inventories--in any one year.

CONCLUSIONS

A basic goal of IRS' selection system is to identify for audit those returns evidencing the most audit potential. A primary concern with any such system naturally revolves around its equity. IRS has recently enhanced equity by reemphasizing and revising its filing procedures and by instituting inventory controls.

IRS' reemphasis and revision of filing procedures should provide more assurance that (1) DIF-scored returns will be assigned for audit in relation to their audit potential and (2) non-DIF-scored returns will be assigned for audit consistently throughout the country. Taxpayer equity would be enhanced even more if the procedures were further revised to require that low-asset miscellaneous returns be filed separately rather than intermingled with DIF-scored returns.

Although the first-in, first-out method of filing and assigning non-DIF-scored returns does provide consistency, it is so unrelated to audit potential that IRS has no assurance that the returns being assigned for audit are the best available. A much sounder method, at least in concept, would be one that involved ranking returns by their relative audit potential and filing and assigning them for audit accordingly. IRS has apparently recognized the merits of ranking or grading returns by giving its districts the option of adopting that technique.

The reason we can comment on the soundness of ranking only in concept and probably the reason IRS has chosen to leave its use to local discretion is that ranking is currently unworkable. Ranking will continue to be unworkable until IRS revises its manual classification process, which is the logical source of data IRS would need to rank returns by audit potential. This process, our recommendations for improving it, and its impact on IRS' ability to rank returns are discussed in chapter 4.

IRS' efforts to promote more ratable ordering and more manageable inventories should improve equity, provided those functions are aggressively monitored through the base inventory system. Even with aggressive monitoring, however, IRS' efforts in the corporate area will be seriously impeded by the inventory uncertainties posed by the large number of automatics. That impediment will not be effectively eliminated unless and until IRS revises its requirement that most non-DIF-scored returns be classified.

The impact of automatics may be alleviated if the current corporate TCMP cycle, which will be completed by about 1981, results in the development of DIF formulas for returns showing assets in excess of $1 million. Examination Division officials believe, however, that DIF formulas will be feasible only for returns showing assets of up to $5 million, which will still leave a significant number of non-DIF-scored returns.

The question then is whether IRS should revise its policy on automatics. The answer requires a decision as to whether the benefits to be derived from inventory controls are more important than those derived from classifying virtually every return that is not DIF scored. This is a decision that properly rests with IRS. As we see it, the benefits are significant both ways. Inventory controls give management a way to alleviate the problems associated with mass surveys and unratable ordering. On the other hand, IRS' goal of auditing those returns most in need of audit is best served by a system that requires every return's audit potential be evaluated each year.

Any expansion of DIF to higher-asset corporate returns as a result of the current TCMP cycle will also improve equity by making the selection process less subjective. TCMP and DIF are the least subjective of all selection methods--TCMP returns are selected randomly; DIF returns are initially selected through computerized mathematical formulas.

Other returns are selected much more subjectively in that they involve judgmental decisions by classifiers. In this regard, a classifier could abuse the process by selecting a return for audit not because of an objective determination that the return warranted audit but because he recognized the corporation and thought it should be audited. The classification process includes two important features, however, that control abuse--the classifier is someone other than the person who will be examining the return and his decision is subject to concurrence by the examiner's group manager and the examiner.

Still other returns (multiyear and related pickups) are selected directly by examiners. As such, the controls just discussed with respect to classifier-selected returns are missing. IRS does provide one control--a requirement that an examiner's request for a return be approved by his group manager--but that control seems inadequate. An examiner is not required to fully explain in writing why he wants the return, what he found in auditing the original return that aroused his interest in the requested return, and how significant the issues are that he wants to pursue. Without such information, IRS has little assurance that the examiner has a valid basis for his request.

We do not want to curtail an examiner's ability to <u>inspect</u> a taxpayer's prior or subsequent year's returns during an audit. IRS now allows, and in fact encourages, its examiners to do that as a normal routine and we are suggesting nothing to change that routine. Our concern rests at the point when an examiner decides to go beyond inspection and wants to <u>audit</u> the prior or subsequent year's return or a related return. Management control at that point is essential if IRS is to assure itself that the examiner's intentions are valid and if IRS wants to effectively control its inventories.

The greater the extent to which examiners bring returns into the audit stream from their end of the line, the less inventory control can be exercised at the front end of the line by the Returns Program Manager. Management has to have some way, then, of controlling examiner-initiated audits. We do not see how it can do that without requiring examiners to justify their requests for returns.

IRS' management information system could also be upgraded as it relates to the corporate selection process. Because a DIF-selected return has a greater aura of objectivity and equity due to the use of mathematical formulas and because IRS takes pride in commenting on the large percent of returns selected through DIF, management should revise its information system to accurately reflect the number of DIF-selected returns by accounting for such returns separately from automatics. In conjunction with this revision, IRS should avoid using terms such as "computer identified" to categorize automatics because, in reality, the computer has no role in their selection for audit. Such categorization tends to understate the subjectivity of the process by which automatics are actually selected.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that IRS

--further revise its filing procedures to require that low-asset, non-DIF-scored returns be filed separately and be assigned for audit like other non-DIF-scored corporate returns;

--require examiners, when requesting returns, to adequately explain in writing why they need the returns so that the requests can be properly evaluated;

--revise its management information system by separating DIF-identified returns from automatics and by avoiding terminology that attributes selection of automatics to the computer; and

--reconsider its criteria for designating a corporate return as an automatic and its requirement that all automatics be classified each year.

IRS COMMENTS AND OUR EVALUATION

In its response to our recommendations, IRS agreed to further revise its filing procedures and said it would revise its management information system to properly distinguish between DIF-identified returns and automatics.

IRS said also that it would reconsider the criteria for corporate automatics and the requirement that all automatics be classified each year. IRS expressed tentative plans to divide corporate automatics into two categories--those returns showing assets of $50 million or more and those showing assets of less than $50 million--and said it would consider whether returns in the second category could be classified every other year instead of annually. Such a move would enhance IRS' efforts to better control inventories. We would suggest, however, that IRS consider also the feasibility of redefining its criteria to minimize the total number of automatics.

IRS strongly objected to our recommendation that examiners be required, when requesting returns, to explain in writing why they need those returns. IRS said that

--the codes used by examiners were sufficient for a supervisor or reviewer to determine why the return was being requested;

--it had completed a comprehensive review of all its codes 2 years ago, in response to a similar recommendation in our report on IRS' selection of individual income tax returns for audit, and had made appropriate changes to those codes; and

--any questions regarding the need for securing a return would be discussed before the requisition was approved since each requisition had to be approved by the examiner's group manager.

We disagree with IRS. Examiners have broad authority to request and audit whatever returns they deem necessary to determine a taxpayer's correct tax liability. We are concerned whether IRS has enough control over that process to adequately protect against examiners requesting returns simply to harass taxpayers. Although we are not aware of any harassment, the potential is there and IRS has inadequate controls to protect against it.

The comprehensive review IRS completed 2 years ago did not result in "appropriate changes" to its codes. The codes for multiyear audits and related pickups still are not sufficiently descriptive. A multiyear audit code tells management that a return is being requested for audit because it is a prior or subsequent year's return. A related pickup code tells management only that the requested return is somehow related to another return. The codes do not tell management specifically why the examiner thinks the return warrants audit.

The codes, in fact, are even less descriptive than they were before. For example, IRS had one code that examiners were to use when requesting a related return filed by a subsidiary corporation, another code for requesting related returns filed by brother-sister corporations, and another code for requesting related returns filed by corporate officers. Now IRS has one code that it uses for requesting all related returns.

We recognize that an examiner's request is subject to supervisory inquiry but such inquiry is not mandatory and, therefore, cannot be assured in all cases. More importantly, the results of any such inquiry will usually not be documented. The absence of a written explanation also impedes any postaudit review, such as that done by IRS' regional offices, because those reviewers generally rely on case files rather than discussions with examiners.

IRS should also be concerned with its ability to respond to taxpayer complaints of harassment. Without any written explanation in the audit case file as to why the examiner requested the return for audit, IRS has little assurance that the examiner had a valid basis for his request. As such IRS might be hard pressed to respond to charges of harassment.

In summation, a written explanation would require the examiner to spell out his purpose in requesting the return which, in turn, might deter him from making unjustified requests and would provide an audit trail for future review.

CHAPTER 4

IMPROVING THE MANUAL CLASSIFICATION PROCESS

COULD HELP IRS GET MORE FROM ITS AUDIT PROGRAM

A major aspect of the corporate selection system is the manual classification process whereby experienced revenue agents screen returns to evaluate their audit potential. IRS emphasizes the importance of uniform and equitable treatment of taxpayers during this process, and its procedures call for classifiers to "scrutinize" corporate returns so as to identify and select those with the highest audit potential. In reality, IRS has inadequate assurance that the manual classification process is identifying the best corporate returns for audit or that the most productive issues are being addressed during the audits. This situation could be improved if IRS (1) provided the guidance necessary to make the classification process less subjective and (2) revised its procedures to enable classifiers to screen returns in more detail.

IRS' MANUAL CLASSIFICATION PROCESS COULD BE MORE EFFECTIVE

The purpose of the manual classification process is to get into the audit stream those returns most in need of audit. What little data IRS has that can be used to evaluate that process indicates that it has not been very effective in achieving its purpose in the corporate area.

The Director of IRS' Examination Division told us that no-change rates, which indicate the extent to which audits have resulted in no change in tax liability, are key indicators of classifier effectiveness in identifying returns warranting audit. While noting that other factors, like poor quality examinations, could cause no-change audits, the Director acknowledged that classifier ineffectiveness was a major contributor.

Because classifiers play an important part in selecting DIF-scored and automatic returns for audit, we reviewed the no-change rates for audits of such returns during the last 3 years and found that a third of the returns identified by classifiers as having good audit potential had proved unproductive.

Fiscal year	Number of returns audited	Number of no-change audits	Percent no change
1976	87,899	30,309	34.5
1977	89,470	29,946	33.5
1978	74,102	22,520	30.4
Total	251,471	82,775	32.9

Although some IRS personnel feel that a 30-percent no-change rate is not unacceptable and does not really indicate classifier ineffectiveness, we feel otherwise. To better illustrate our concern, consider the following. IRS' projections of its most recent TCMP data indicate that if all filed corporate returns showing assets of less than $100,000 were audited, about 30 percent would result in a change to the taxpayer's reported tax liability. Using the number of returns filed during calendar year 1977, 30 percent would equal about 270,000 audits. During fiscal year 1978, however, IRS audited only about 36,000 returns showing assets of less than $100,000. Even though the number of filed returns that would have resulted in productive audits (270,000) was 7-1/2 times the number of returns IRS actually audited (36,000), IRS still ended up with a third of its audits being unproductive.

Until now we have been discussing no-change rates which relate to audited returns. Many returns, however, never get audited even though they were selected for audit by classifiers. IRS refers to such returns as "surveyed returns." Its procedures provide that (1) a group manager can survey--or reject--a return, before assigning it to an examiner, if he determines that the return does not warrant audit or that the return exceeds workload capacity and (2) an examiner can survey a return if he determines, after considering the return but before contacting the taxpayer, that an audit would result in no material change in tax liability. 1/

Information on returns surveyed by group managers and examiners because of low audit potential could be used to assess classifier effectiveness. IRS has not been able to do that, however, because its management information system

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1/This discussion does not include the many returns surveyed by Returns Program Managers. Surveys at that level would be based on excess inventory considerations rather than low audit potential and thus are more pertinent to chapter 3, where we discussed mass surveys resulting from ineffective inventory controls.

does not provide separate data on the number of returns surveyed because of excess inventory and the number surveyed because of low audit potential.

Group managers and examiners have surveyed a large number of returns in the past. If a significant number of those returns were surveyed because of low audit potential, IRS would have further evidence of classifier ineffectiveness. For example, statistics for DIF-scored returns filed in 1975 and 1976 (unreliable data precluded us from using more recent years) showed that of 121,627 DIF-scored corporate returns selected for audit by classifiers, 47,805 (or 39 percent) were surveyed by group managers and examiners. The statistics are even more interesting when carried a step further. Of the selected returns that were eventually audited, 26,693 resulted in no change in tax liability. Thus, in total, of 121,627 returns selected by classifiers as warranting audit, 74,498 (or 61 percent) either were surveyed by group managers and examiners or were audited unproductively.

As we said before, neither we nor IRS know how many of the 47,805 surveyed returns were surveyed because of low audit potential as opposed to excess inventory. It is important to note, however, that about half (23,195) were surveyed by examiners and that IRS procedures say nothing about examiners surveying returns because of excess inventory; the procedures refer only to low audit potential as a basis for examiner survey.

IRS NEEDS TO DO MORE TO MAKE THE CLASSIFICATION PROCESS LESS SUBJECTIVE

One reason why the manual classification process has not been very effective is that classifiers receive insufficient guidance to assist them in making selection decisions. Although subjectivity is unavoidable when asking classifiers to evaluate audit potential, the classification process is more subjective than one would reasonably expect. IRS could eliminate some of this subjectivity by providing better classification guidelines and training and by improving its review and feedback procedures.

Classifiers' opinions on audit potential differ significantly

IRS officials told us they select their most experienced revenue agents to classify corporate returns. These agents are generally considered the best at identifying audit issues and returns in need of audit.

To help assess how well classifiers perform, we conducted several reclassification tests. Classifiers at all but one location visited 1/ were asked to screen a sample of returns chosen from those awaiting classification at that location. The results were recorded in such a way that the returns could be put back into the inventory of returns awaiting classification without anyone knowing they had already been screened. The returns were then allowed to flow through the classification process a second time for screening by a different classifier at the same location. This second screening was considered the official classification for purposes of further IRS processing.

In comparing the results of the first and second screenings, we found that classifiers differed significantly in their opinions on whether returns should be audited.

1/The Philadelphia service center had only one classifier on duty at the time of our visit, so we did not conduct a reclassification test there. The Chief of the service center's Classification Branch performed his own test, however. According to a June 1978 memorandum, each of 125 high-asset corporate returns was screened by 2 classifiers. In 86 cases the classifiers made the same decisions to accept or select the return, and in 39 cases their decisions differed--a disagreement rate of 31 percent.

	Number of returns classified (note a)	Number of returns classified differently (note b)	Percent classified differently
Service centers:			
Brookhaven	100	19	19
Fresno	50	19	38
Ogden	100	44	44
	250	82	33
Districts:			
Baltimore	100	37	37
Manhattan	100	42	42
Newark	100	35	35
Phoenix	49	23	47
Reno	15	6	40
San Francisco	107	42	39
	471	185	39
Total	721	267	37

a/Generally, we tried to get about 100 returns reclassified at each location. Neither Phoenix nor Reno had that many returns awaiting classification, so we adjusted the size of our test accordingly. At Fresno, we limited our test to 50 returns to avoid unnecessary work disruptions.

b/We categorized a return as having been classified differently if the two classifiers disagreed about whether the return should be audited.

The 37 percent rate of disagreement is even more interesting in light of the following aspects of our tests which would tend to keep the rate from being even higher.

--Classifiers performing the second screening at one service center knew how the returns had been classified originally because IRS had not removed green flagsheets indicating selected returns.

--The test at another service center inadvertently included some returns IRS automatically selects for audit.

--The returns classified at the district level had already been scored for audit potential by the computer. Because classifiers saw only those returns with the highest scores, there should have been little disagreement as to audit potential.

Some IRS personnel told us that the disagreement rates shown in our tests indicated a need to improve the classification process. According to the Examination Branch Chief at one service center, for example, IRS cannot be assured the best returns are being selected for audit unless these rates are decreased. A regional analyst responsible for monitoring classification activities in one region and a district Returns Program Manager in another region said that an acceptable rate was about half that indicated by our tests.

Of the 47 IRS managers and classifiers we interviewed, 32 agreed the classification process was arbitrary.

--One classifier told us he based some of his decisions to select returns on "intuition," rather than specific audit issues.

--Another classifier said he considered such things as neatness and legibility in deciding whether to select a return for audit.

--A third classifier, upon reexamining a return he had previously selected for audit, could find nothing wrong with it and could not say why he had identified the issue cited on the classification checksheet. He said also that he had selected another return because he felt something was wrong, so he chose a couple of issues just to get the return into the audit stream.

Why classifiers disagree on audit potential

Some differences of opinion are inevitable when the human element is involved in assessing audit potential. Our review indicated, however, that many differences between classifiers were not inevitable. Classifiers differed in their (1) procedures for screening returns, (2) views on the productivity of audit issues, (3) standards of materiality, and (4) opinions about their role in screening DIF returns. Some classifiers also felt they did not have enough time to adequately assess a return's audit potential, and others expressed unfamiliarity with certain types of returns they classified.

Different screening procedures

Much of the information on a typical corporate return comes from two sources: the balance sheet and the income statement. 1/ Most classifiers emphasized the information from only one of those sources during the classification process, although guidelines provided by some districts specifically asked that equal attention be given to both.

We asked 43 classifiers if they devoted more attention to information from either source while screening corporate returns. Sixteen said they usually emphasized income-related information; 13 said they focused on balance sheet information; 11 said they treated both sources equally; and 3 said that their emphasis changed according to the size of the corporation.

Classifiers cited various reasons for emphasizing one information source over another, such as

--information on income was directly related to tax liability,

--income-related information preceded balance sheet information on the return, or

--the balance sheet provided more productive issues.

Some classifiers acknowledged that their emphasis on specific parts of a return might have caused them to overlook potential audit issues and accept potentially productive returns during our reclassification tests.

--One classifier told us he did not pay much attention to balance sheet issues. He said this was probably why he had accepted a return which another classifier had indicated contained two balance sheet issues with good audit potential. When we brought the results of the other screening to his attention, the classifier who had originally accepted the return agreed that it should have been selected for audit.

1/A balance sheet is a financial statement summarizing the assets, liabilities, and net worth of a particular individual or business at a given date. An income statement summarizes the transactions of a business during a specified period (usually a year), showing the net profit or loss.

--Another classifier said that he had missed two balance sheet issues identified by the other classifier because he performed a very limited analysis of balance sheet information.

--A third classifier said he may have overlooked an issue identified during the other screening because it was contained on a supporting schedule in the back of the return. He explained that he had probably spent too much time reviewing income-related line items and had to rush through the rest of the return. After seeing this omission when he reviewed the return a second time, he agreed that the return should have been selected for audit.

Views on the productivity of audit issues vary

The frequency with which classifiers disagree on a return's audit potential may be due to the fact that they also disagree on the audit potential of specific issues.

Of the 267 returns classified differently during our reclassification tests, 124 had 3 or more issues identified as having audit potential by the classifiers who selected the returns. In one district, for example, 42 returns were selected for audit by 1 classifier and rejected by another. Thirty-two of these returns had 3 issues identified by the classifier who selected the return, and 22 had 5 or more issues.

The frequency with which one classifier can identify several audit issues on a return while another sees nothing on the same return demonstrates that classifiers differ sharply in either their ability to recognize audit issues or their perceptions of whether those issues are worth auditing. In that regard, we asked classifiers what audit issues they considered the most productive and the least productive on low-asset corporate returns. Classifiers often had opposite views on the same issue, with the views on some issues, such as depreciation and retained earnings, split almost equally between productive and unproductive.

Issue	Productive	Unproductive
Retained earnings	15	17
Officers compensation	16	20
Shareholder loans	20	5
Repairs	21	8
Depreciation	18	15

Even classifiers in the same district disagreed about productivity. In one district, for example, two classifiers cited repairs as a productive issue while two others included repairs in their lists of unproductive issues.

We observed other indications that classifiers might be having problems identifying productive issues.

--IRS compiles statistics by line item for the detailed audits done under TCMP. These statistics indicate that a net operating loss is one of the most productive issues on low-asset corporate returns. None of the classifiers interviewed, however, cited net operating loss as a productive issue, and some even told us that the presence of a large net operating loss was the main reason they accepted the return as filed.

--During our reclassification tests, several classifiers repeatedly cited the same issues in explaining their decisions to select returns for audit. Classifiers told us that they tended to favor certain issues and areas of the return based on their previous audit experience.

Materiality standards differ

IRS does not provide instructions or guidelines on how much tax change potential must be present to warrant a corporate return's selection for audit. However, 21 of 40 classifiers we asked said that they had a minimum dollar tax change potential in mind that must be met before they selected a corporate return for audit. They indicated that the amount often varied depending on such factors as the corporate asset size, amount of tax paid, and geographic location.

--One classifier said he varied his minimum requirement from $1,000 for a corporate return showing assets of less than $50,000 to $3,000 for a corporate return showing assets of $1 million to $5 million.

--Another classifier said he would not select a corporate return with a $1,000 potential tax change if the amount of tax paid was $250,000, but he would select the same return if the amount of tax paid were only $10,000.

--A classifier said he had a minimum tax change requirement of $500 for a return of a corporation located within the boundaries of a small rural post of duty, whereas his minimum requirement was $1,000 for a similar return filed by a corporation located in a larger urban post of duty.

--Another classifier said returns from more distant locations required higher audit potential because of the travel time required.

Materiality standards may differ depending on the classifier's grade level. IRS generally requires that grade 12 revenue agents classify high-asset corporate returns and that grade 11 or 12 agents classify low-asset returns. This is consistent with the procedures IRS generally follows in assigning returns for audit--low-asset returns to lower-graded agents, high-asset returns to higher-graded agents.

In one district, a grade 12 revenue agent was accepting a large percentage of the returns he classified. According to the Returns Program Manager, the classifier was essentially getting rid of returns because they seemed to lack sufficient potential to justify a senior agent's time. The Returns Program Manager noted, however, that these returns had issues with good potential for the lower-graded agents who normally audited them. For example, from one group of returns normally examined by GS-9 revenue agents, the classifier selected only 38 percent for audit, whereas the Returns Program Manager, upon reclassifying the same returns, selected 92 percent.

A grade 12 revenue agent from another IRS district agreed that senior agents tended to accept low-asset returns because the issues and amounts involved seemed immaterial when compared with returns they normally audited. He explained that when he classified low-asset returns, he had to change his frame of reference to that of a lower-graded agent to avoid accepting all the returns.

Using senior agents to classify returns normally audited by lower-graded agents has certain advantages in that the classification process and the examiner can benefit from the senior agent's experience. Better standards of materiality, however, would help protect against higher-graded agents accepting returns merely because their audit potential seems low in relation to the audit potential of returns they normally audit.

Differing opinions on classifier's role in screening DIF returns

Our reclassification tests showed that the overall rate of disagreement among district classifiers was higher than the rate among service center classifiers. (See p. 52.) This is particularly interesting considering that the returns classified at the districts had already been scored as to their audit potential by the computer (DIF) and in light of IRS' views on the classifier's role in screening high DIF-scored returns.

When DIF was first implemented, classifiers screened high DIF-scored returns and selected those that, in their judgment, warranted audit. In commenting on our November 1976 report on how IRS selects individual income tax returns for audit, however, IRS said that it

> "* * * plans to revise its instructions for screening high-scored DIF returns so that the number of returns that are accepted as filed will be reduced. In general, under this revision, high-score returns would be selected for audit unless sufficient data has been submitted as a part of the return to support questionable items."

The Examination Divison Director told us in January 1979 that IRS' comments on our prior report still represented the procedures he would expect classifiers of DIF returns to follow. In other words, a classifier should not be accepting a high DIF-scored return simply because it generally appears to have no audit potential. About 60 percent of the district classifiers interviewed, however, had attitudes directly opposite the Director's--they generally accepted the return as filed, unless they could identify potential audit issues.

The Internal Revenue Manual provides that classifiers be instructed in the fundamentals of the DIF system and the significance of DIF scores before they start classifying returns. IRS statistics show, on the average, that the higher a return's DIF score, the greater its audit potential. Nevertheless, about two-thirds of the 19 district classifiers we asked said they paid no attention to the DIF score. One classifier told us he felt lower DIF scores had a greater potential for tax change than high DIF scores. He stated that in his audit experience high DIF-scored returns generally had supporting schedules, whereas low DIF-scored returns did not. This classifier told us he went so far as to select returns with lower rather than higher DIF scores when he lacked other indicators of audit potential.

<u>Not enough time spent classifying each return</u>

IRS does not have quotas on the number of corporate returns classifiers should be screening each day, although some field offices have indicated what productivity they expect. One district's guidelines, for example, pointed out that:

> "Classifiers should be able to screen a minimum of 100 returns per day and greater numbers are possible, depending on the type of return being screened. Think of it this way: at 100 returns per day, you have over four minutes per return to make a selection. This is a lot of time if you remember that the classification process is designed to identify questionable returns, not to research issues or insure adjustments."

On the basis of a number of calculations at the locations visited, we estimate that classifiers generally screen about 100 returns a day, although a couple of classifiers told us their output was about twice that much. Averaging 100 returns a day, a classifier spends less than 5 minutes on each return. During this time, he must familiarize himself with the nature of the industry engaged in by the taxpayer; review many complex pages of narrative and numerical data; and compare information on individual line items, sections, pages, and supporting schedules with related data elsewhere on the return.

One Returns Program Manager told us, for example, that to properly evaluate the one amount shown on the return for repairs, a classifier should relate it to the corporation's name and geographic location; the nature of the corporation's business; the amount reported for cost of goods sold; and the amount, type, and age of the corporation's equipment. This information is located on several different pages of the return.

Some classifiers told us that while they did not have formal quotas, emphasis on classifying as many returns as possible often did not allow them enough time to adequately assess a return's audit potential. One classifier told us, for example, that he did not have enough time to use even the limited classification guidelines provided. Another said he had insufficient time to look up information, even to the extent of researching the industry code listed on the return to determine what type of business the corporation was engaged in.

Classifiers also cited time restrictions as a reason they had differed in selection decisions during our reclassification tests. One classifier said he had probably accepted a return as filed because he had missed an issue due to the time pressure of classifying as many returns as possible. Another told us he was going through the return too fast to adequately evaluate the potential of an issue he had missed. He attributed this to the informal goal of 100 returns classifiers were expected to screen each day in his district.

Lack of familiarity with certain types of returns

Fifteen classifiers told us they often felt unqualified to classify certain returns they are required to screen because they had had little or no experience auditing them. For example, one classifier said that revenue agents in the northern industrialized part of his district were not familiar with many returns from the more rural southern part, such as those involving the farming industry. As a result, revenue agents from the northern part who must classify farm returns have a difficult time doing so.

Similarly, a service center classifier said he had been requested to classify about 200 personal holding company returns. He told us he had no idea what would be considered good audit potential for such returns because he had never examined one. In fact, the audit issues on these returns usually revolve around the amount of undistributed personal holding company income subject to a special 70-percent tax imposed in addition to the regular corporate taxes.

Classifiers need better guidance

IRS uses several vehicles to help classifiers decide which returns warrant audit--national reference materials, local guidelines, and orientation sessions. However, national reference materials are too general to be of much use to classifiers; the nature and extent of local guidance varies;

and orientation sessions tend to focus on procedural rather than technical matters. As a result, classifiers often have to rely on subjective judgment in determining whether a return should be audited.

Current guidance is insufficient or ineffective

IRS districts and service centers maintain reference libraries which are available to classifiers. These libraries contain national guidance, such as

--income and expense statistics by industry and asset level;

--Internal Revenue regulations;

--announcements of Internal Revenue rulings and procedures;

--official texts of Federal court decisions and landmark State court decisions that deal with Federal taxation;

--texts of U.S. Tax Court decisions; and

--audit technique handbooks, which contain information to help examiners recognize and develop issues such as (1) various industry ratios, (2) discussions on various industry issues, like mineral interests for oil and gas concerns, and (3) techniques for determining the productivity of specific issues, like the accumulated earnings tax.

Fifteen of 34 classifiers we asked told us that without any guidance they had screened corporate returns involving industries or issues they knew little about. Several classifiers noted that libraries were of little value because of the time needed for research and the fact that reference materials were not helpful in identifying problem areas by industry or issue. According to the Returns Program Manager in one district, reference materials are too general to be of much use to classifiers. Another Returns Program Manager told us that reference materials were too difficult and time consuming for classifiers to use.

Because national guidance is geared toward information that applies throughout the country, each district office must give classifiers guidance that is more attuned to local economic conditions and compliance problems.

The 4 service centers visited classify returns (basically those that are not DIF scored) for 24 districts. Depending on the district, local guidance provided the service center classifiers varied from none to very specific.

--Some districts provided no guidance to the classifiers at the service centers.

--Some districts provided only general guidance, such as select "* * * those returns which could result in a substantial tax change."

--Some districts provided detailed lists of numerous issues they felt were either productive or unproductive and included additional information on compliance problems in their areas.

When local guidelines were provided, they were not always current.

Year most recent guidelines provided	Number of districts	Percent
1978	13	54
1977	3	13
1976 or earlier	2	8
No guidelines provided	6	25
Total	24	100

Two classifiers at one service center said the guidelines provided by some districts were so out of date that they were of little use.

Another vehicle through which IRS provides guidance is the orientation session. We attended those sessions at three locations. The orientation was geared to procedural matters, such as how and where to stamp a return as selected or accepted, how to safeguard stamps, and how to fill out reports on the number of returns classified, rather than technical matters, such as how to identify productive returns or what issues have good audit potential.

How IRS can improve its guidance

About 70 percent of the classifiers and 50 percent of the IRS managers we talked to believed better guidelines would help make the classification process more uniform and equitable. A regional classification analyst, for example, said such data would increase classification uniformity because screeners would more often base their decisions on available information rather than intuition. Classifiers told us that guidelines should be structured by industry and asset size and include information on

--common ratios, such as gross profit and bad debt percentages;

--local economic conditions, such as industries expecting to have unusually high or low gross profit margins because of local business fluctuations; and

--local compliance information, such as issues found to be productive in a certain area but not normally considered to have good audit potential.

Most classifiers we talked to believed the information needed to generate such guidelines was generally available and need only be condensed into one source.

The framework for better guidance already exists in the form of local guidelines that some districts provide classifiers. Information could be required in detail of each district, updated annually, consolidated, supplemented with national office data, and presented to classifiers in a uniform format. Such an exchange could insure that classifiers receive timely notification of pertinent data generated in other areas of the country. It would also help classifiers quickly gain an understanding of local conditions when they must screen returns from other districts.

In supplementing district input to the guidelines, IRS could draw on the data now in its reference libraries. It could also draw on other sources, like TCMP, issue tracking, and industry specialists.

Some IRS officials cited TCMP as a good source of information on productive and nonproductive audit issues. TCMP provides information on return line items that seem to cause taxpayers the most problems. For example, TCMP audits of corporate returns processed in 1973 show that many taxpayers had a problem in correctly reporting depreciation. That line item was changed in about 22 percent of all TCMP corporate audits.

IRS' issue-tracking study (see p. 23) is also gathering information on productive audit areas. If successful, this project will generate data on what issues can be expected to yield the most in terms of tax adjustments per examination hour spent.

Still another source of information for classifier guidelines are the pools of industry specialists IRS is establishing throughout the country. One function of these pools is to keep abreast of issues and compliance problems in their industries. The knowledge generated by these pools could be incorporated into guidelines. Classifiers felt such data could help them assess the audit potential of certain types of corporate returns with which they might not be familiar.

As for the orientation sessions, a national office official responsible for the classification program acknowledged that the instructions classifiers now get are often too procedurally oriented and indicated that IRS hoped to improve the situation in conjunction with its shift to centralized classification. A more technically-focused orientation session could alleviate problems we identified by familiarizing classifiers with classification policies, the significance of DIF scores, the proper approach to classifying a return, the role of materiality in the decision to select or reject a return for audit, and issues unique to different types of returns.

A Returns Program Manager in one district suggested using a video tape presentation to provide this information to classifiers. He noted that the tape could go through the classification of various types of corporate returns, showing examples of line items classifiers should pay attention to.

IRS needs to better review classifiers' work and provide more effective performance feedback

In addition to improving the front end of the classification process through better guidelines and training, IRS needs to tighten its controls over the end product through a more aggressive quality review program. IRS procedures require that classifiers be evaluated on the basis of how well they select returns most in need of audit and identify the most productive issues on returns they select. Because the national office did not provide many specifics on how to conduct these evaluations, however, most locations visited were doing little to monitor classifiers' work and classifiers were getting almost no performance feedback. IRS has recently revised its quality review requirements, but many of the details are still left to local management.

Except for one, the service centers visited were doing little in the way of reviewing their classification activities--either looking at only a few returns or only superficially examining the technical adequacy of classifiers' decisions.

--One service center pulled a sample of about 10 selected and 10 accepted returns weekly. During the first 6 months of 1978, 203 selected and 210 accepted returns were reviewed but not one error was found.

--Another service center sampled 10 percent of all accepted returns but had not reversed a classification decision since August 1977. Service center officials agreed that quality review was limited and were attempting to establish a more formal system.

--The quality review staff at a third service center used a sample size that varied with the volume of returns classified. During the first 6 months of 1978, it reviewed 543 returns and identified only 4 errors, an error rate of 0.7 percent. Furthermore, all four errors involved procedural matters.

--The fourth service center sampled about 10 percent of all returns classified. In contrast to the other service centers, quality review appeared to be more than just a rubber stamp operation. During the first 6 months of 1978, the service center reviewed 1,088 returns and found 46 errors, an error rate of 4.2 percent. In addition, 29 of these errors concerned technical decisions on tax issues which affect a return's audit potential and thus the overall decision on whether it should be selected.

District Returns Program Managers told us they informally checked the work of their classifiers. In most cases, documentation did not exist to show how closely the classifiers' work had been screened or to serve as a basis for feedback. When monitoring results were available, they indicated cursory reviews with little effort directed at challenging classifiers' decisions on audit potential. For example:

--One Returns Program Manager said he reviewed returns periodically. He had no set timeframes or sample sizes and kept no record of the results.

--Records in another district indicated that during the 6 months ended June 30, 1978, the Returns Program Manager had reviewed only 42 returns and found none in error. Although he identified nine questionable classification decisions, he made no attempt to change them or discuss them with the responsible classifiers.

--The Returns Program Manager in a third district had no set review timeframes. She reviewed about 30 classified returns during the 6 months ended November 30, 1978, and had no record of any errors being noted.

Because little effort has gone into reviewing classified returns, IRS has had no means of adequately evaluating a classifier's performance and providing feedback. Evaluations have usually been irregular and lacked specific information that could help classifiers improve performance.

--Of the four service centers visited, two provided no feedback because they had not questioned any classification decisions. The other two evaluated their classifiers, but those evaluations were not informative, tending to include the same general remarks, such as "he does a good job."

--Of the six districts visited, five described the frequency with which they made performance evaluations as "it varies" or "occasionally." These evaluations were often not discussed with the classifiers and tended to contain little informative data. We found no evidence that the sixth district had prepared any performance evaluations.

IRS recently revised its procedures to require a more thorough quality review of the manual classification process. A December 1978 revision to the Internal Revenue Manual required districts and service centers to perform and document

--an evaluation of classifiers, including the identification of additional training needs;

--a review of classified returns, both those selected for audit and those accepted as filed;

--a review of completed audits to test the effectiveness of classification procedures; and

--a review of returns surveyed from the examination stream after being selected by the classifier "to monitor the volume of surveys and to compare the quality of returns entering and leaving the Examination stream."

IRS managers interviewed believed that such reviews would be helpful in assessing a classifier's performance and providing feedback. These new procedures provide no assurance, however, that the revised system will provide adequate or uniform quality review because many decisions which affect the review effort will still be left to local management. This could result in continued quality review variations of the kind we observed at the locations visited.

The following chart summarizes the decisions that are either specified or left to local management for the four reviews required by the new procedures.

Type of review	Frequency	Sample size	Feedback mechanism
Evaluate classifier	Not specified (note a)	Not specified (note b)	Discussion
Classified returns	Monthly	Not specified (note c)	Not specified (note d)
Completed audits	Quarterly	Not specified	Not specified (note d)
Surveyed returns	Not applicable (note e)	5 percent	Not specified (note d)

a/Each classifier must be evaluated, but the frequency is not specified.

b/A "sufficient number" of returns are to be reviewed.

c/A "representative sample" of returns are to be reviewed.

d/The procedures require documentation of review results but say nothing about using that documentation as a feedback mechanism for classifiers.

e/Five-percent sample size would cover frequency requirement.

As the chart shows, these new procedures will still leave IRS with no uniformity on major decisions involving how these reviews will be carried out. Also no mechanism has been established to consolidate and distribute most of the information obtained in these reviews to provide classifiers additional guidance and feedback.

Finally, any IRS attempt to assess the productivity of audit issues identified by classifiers may be hampered by the fact that the checksheets on which classifiers document the identified issues are not always retained. We sampled 186 returns which had been audited, closed out, and returned to the service centers. Despite a requirement that checksheets be retained as a part of the audit case files, about half the returns had no checksheets.

IRS NEEDS TO ALLOW FOR MORE DETAILED CLASSIFICATION

Besides helping classifiers identify returns and issues for audit, IRS needs to better insure that examiners receive full benefit from the classification process. IRS procedures now restrict classifiers from thoroughly screening a corporate income tax return, noting all the issues they feel warrant audit, and explaining those issues in adequate detail. Allowing a more detailed classification would help insure that examiners (1) received the best returns for audit and (2) understood what the classifiers had seen that had caused them to select the returns.

Classifiers are not required to identify all audit issues

IRS procedures require classifiers to stop screening a corporate return once they have decided to select it for audit and to note on the checksheet only the audit issues identified up to that point. Analysis of the returns used in our reclassification tests indicates that classifiers identify about two to three audit issues for each return selected.

Location	Number of returns selected for audit (note a)	Number of issues identified on selected returns	Average
Service centers:			
Brookhaven	41	76	1.8
Fresno	59	136	2.3
Ogden	82	316	3.8
	182	528	2.9
Districts:			
Baltimore	137	187	1.4
Manhattan	74	285	3.8
Newark	127	268	2.1
Phoenix	45	154	3.4
Reno	22	29	1.3
San Francisco	142	366	2.6
	547	1,289	2.4
Total	729	1,817	2.5

a/Each return was classified twice. If it was selected for audit both times, we counted it twice in computing the number of returns selected and averaging the number of issues identified.

The averages varied greatly among individual classifiers. For example, the initial screening of 100 returns at one service center resulted in 61 decisions to select and 280 issues identified--an average of 4.6 issues on each selected return. The second screening of these same returns by different classifiers at the same location, however, resulted in 21 selection decisions and 36 identified issues--an average of only 1.7 issues on each selected return. Similar examples were noted at the districts. At one district, the number of average issues identified per return on the first screening was 5.4 versus 2.8 on the second.

One reason for these differences is that several classifiers told us they usually performed a more thorough screening than IRS procedures required. They felt this was necessary to adequately assess the overall audit potential of the return. One classifier said that identifying only one or two audit issues and then stopping made it nearly impossible to assess a return's potential. Another noted that this procedure allowed classifiers to assess the potential only of certain issues, not the entire return.

In addition to providing a better assessment of the return's overall potential, most of the 55 managers, classifiers, and examiners interviewed believed that having classifiers note all audit issues on a return would help the examiner perform a more effective audit by helping to insure productive issues were not overlooked. The Examination Division's official position is that a more detailed classification would be time consuming and duplicative because after a return is selected for audit and assigned to an examiner, the examiner conducts a preaudit analysis which enables him to identify all productive audit issues. As one district put it in its classification guidelines:

> "Indicate the 1 to 3 issues which caused you to select the return for audit * * *. Remember that the examiner will make a thorough precontact analysis of the return so that you do not need to make a complete time-consuming issue-by-issue analysis of the return once you have determined the return should be audited."

We tested the Examination Division's position by following up on 12 returns selected for audit both times during our reclassification tests. 1/ Because only one of the two classifications was official, the revenue agents, in preparing their preaudit analyses, were aware only of the issues identified by one of the classifiers. We discussed the issues identified by the examiners during their preaudit analyses, compared them with the issues cited in the unofficial classifications, and found 18 instances on 10 of the 12 returns when the examiners had failed to consider issues cited by the unofficial classifier. For example:

1/We had to limit our test to 12 returns because (1) our test procedure restricted us to returns that had been selected for audit by 2 classifiers and (2) most of the reclassified returns had not advanced far enough in the audit stream by the time we had completed our fieldwork to facilitate followup.

--One examiner acknowledged that he should have picked up two issues identified by the unofficial classifier--a large repairs deduction and a questionable investment tax credit. As a result of our discussion, the agent planned to examine those issues.

--Another examiner said he had done only a limited analysis of retained earnings. As a result, he missed an issue cited by the unofficial classifier. The issue involved the corporation's accumulation of about $300,000 in excess retained earnings, with a potential additional tax liability of about $100,000.

Internal audit reports on the detailed examinations performed under TCMP tend to support the indications of our limited test. TCMP audits are done by IRS' best examiners and involve a line-by-line examination of the entire return, which is more thorough and time consuming than normal IRS audits. Still, IRS internal auditors found that examiners had failed to adequately comment on potentially good audit issues in 20 percent of the TCMP corporate audits that internal audit reviewed in 10 district offices.

Classifiers are not required to explain the issues identified

Classifiers record the audit issues they identify on a checksheet, either by marking a box next to the issue or writing in the issue on a blank line. Because each region develops its own checksheets, the formats vary. (See app. V for checksheets used by two regions.)

The checksheets generally list various line items on the return and are often used to classify different types of returns. One region's checksheet, for example, is used to classify individual, fiduciary, partnership, and corporate returns. Despite their differing formats, each checksheet contains a section where classifiers can add narrative comments to explain an issue they have identified.

Narrative comments are often needed when the issues checked by the classifier are subject to misinterpretation by the examiner. Classifiers gave us several examples of how an issue could be misinterpreted if it is not adequately explained.

--<u>Depreciation</u>. The classifier may be questioning the asset life, whereas the agent may consider only the mathematical computation.

--<u>Gross profit percentage</u>. The classifier may think gross sales are understated, while the examiner may consider only the cost of goods sold.

--<u>Repairs</u>. The classifier may think some repair costs have been included in the cost of goods sold, while the revenue agent may check only the line item deduction for repairs and consider it reasonable.

About 75 percent of the classifiers we talked to agreed that additional narrative comments would aid examiners. A review of the checksheets used in our reclassification test, however, indicated many classifiers had not provided narrative comments. Analysis of the checksheets used in our tests at 2 districts, for example, revealed only 3 explanations on 137 checksheets containing 242 issues. We cannot explain why so many classifiers acknowledge the need for narrative comments while so few actually provide them.

Some districts that we did not visit but whose returns were being classified at service centers that we did visit recognized the value of narrative comments and asked their classifiers to explain, when appropriate, why an issue was identified as having audit potential. One district, in making this request, said simply "Don't leave the examining officer guessing!" We do not know if the checksheets for those districts were any more informative than the ones for the districts covered by our review.

Examiners who subsequently had to audit some of the returns selected for audit during our reclassification tests cited several examples of classifiers identifying issues without explaining why they felt the issues warranted audit.

--One examiner told us a $12,000 repairs deduction on a return listing close to $2 million in equipment lacked potential, and the classifier should have explained why he had identified it.

--Another examiner noted that an issue listed as a travel and entertainment deduction lacked potential because as an expense it was immaterial.

--A third examiner said he could not determine what the issue--related lease company--pertained to. He said he did not see any affiliated corporate relationship on the return and the classifier should have provided a more definitive explanation.

Even when the need for narrative comments seemed obvious, they were not always provided. We noted some checksheets, for example, that identified the audit issue as "other" without any further explanation of what the classifier had in mind.

The Classification Branch Chief at one service center felt that requiring classifiers to provide narrative comments would increase the quality of the classification process because classifiers would have to give some thought to why an issue was identified, rather than merely checking a box. In this regard, our discussions with classifiers on why they had selected returns in our reclassification tests elicited an admission by one classifier that it was not apparent even to him why he had identified a particular issue.

CONCLUSIONS

The manual classification process is a key aspect of the system by which corporate returns are selected for audit because the classifier screens returns and selects those with the best audit potential. Despite its importance, IRS has no real way to assess how well the process is functioning. IRS' management information system is not generating the type of data that might help with such an assessment, such as data on the number of returns selected for audit by classifiers but subsequently surveyed by examiners and group managers because of low audit potential. Information we accumulated during our assessment of the manual classification process, however, has led us to conclude that the process has not effectively achieved its objective in the corporate area and that IRS, at the very least, has little assurance that the best corporate returns are being audited or that the most productive issues are being addressed during the audits.

One problem with the process is its overly subjective nature--so subjective that we found two classifiers disagreeing about 37 percent of the time on whether a corporate return should be selected for audit, even when it had already been identified by the computer as having good audit potential. Disagreements occurred because classifiers often

--concentrated on screening only certain parts of the return, ignoring other potentially productive areas;

--had opposite opinions on the productivity of certain issues;

--used different materiality standards, which varied according to the corporation's size, the amount of taxes it paid, its geographic location, or the grade of the classifier;

--were unaware of IRS' policy on how DIF-scored returns should be screened or disregarded the significance of DIF scores as indicators of audit potential;

--felt they lacked sufficient time to properly screen returns; and

--were unfamiliar with certain returns they were required to screen, because they had had little or no audit experience with them.

Some differences of opinion are inevitable when classifiers must use their professional judgment. Although we recognize the value of an experienced revenue agent's judgment, the important decisions made during the classification process should be based on more substantive criteria--a view shared by most classifiers we talked to. Many factors that contribute to differing classification decisions could be alleviated if IRS provided better guidelines, more technically focused training, and more effective performance feedback. Without improved guidance, we fail to see how this vital cog in IRS' selection system can function effectively.

With better guidelines, classifiers could base their decisions more on information than intuition. Guidelines could be condensed into one handbook and include information structured by industry and asset size on common ratios, the relative productivity of audit issues, local compliance problems, and local economic conditions. This information is already generally available from various sources, including audit technique handbooks, TCMP, and IRS' issue tracking study. What IRS has to do is make the information more accessible to classifiers.

IRS should also look closely at the classification checksheet as a vehicle for helping classifiers. Instead of using checksheets that do little more than list the line items on the corporate return, IRS should develop checksheets that are tailored to specific industries or types of returns, such as those filed by homeowners associations, and that direct the classifier's attention to specific audit issues related to those industries or returns.

Also, in lieu of having each region develop its own checksheets, IRS should develop checksheets for use everywhere. This would better insure classification uniformity and would provide a uniform basis for any attempt by IRS to assess the classification process.

The classification process would be further enhanced if IRS gave its classifiers orientation sessions that went beyond mere procedural requirements. IRS should use those sessions to (1) remind classifiers how to screen a return so that potentially productive areas are not neglected and (2) provide information on any problems or issues unique to certain types of returns or industries that classifiers may not be aware of. Information should also be provided on the different roles a classifier must assume when screening DIF-scored versus non-DIF-scored returns.

Classifiers could also do a better job if they were provided feedback on whether they had selected returns most in need of audit and had identified the most productive issues on those returns. Because field offices have directed little effort toward reviewing classifiers' decisions, IRS has had no way of adequately assessing classifier performance and providing feedback.

IRS has recently revised its quality control procedures as they relate to classification. Those procedures now require field offices, among other things, to review a sample of audited returns and returns surveyed from the audit stream after being selected by the classifier--both important sources of feedback on the ultimate productivity of the returns a classifier selects and the issues he identifies. These new procedures, however, still do not adequately specify how often reviews should be made, how many returns should be reviewed, or what type of feedback classifiers should receive. Until such details are incorporated into the procedures, IRS will have little assurance that the reviews are being carried out consistently and uniformly or that the information obtained is being used to help classifiers do a better job.

The second problem with the manual classification process is that classifiers do not identify all significant audit issues on the returns they select for audit and do not adequately explain the issues they do identify. We find it inconceivable that IRS would assign its most experienced revenue agents to screen corporate returns for the expressed intent of selecting the best for audit and then restrict them from doing just that by telling them, in effect, to not screen the entire return or identify all significant issues. Screening just part of a return, in our opinion, does not enable classifiers to adequately assess audit potential so as to provide examiners with the best returns.

Along these same lines, we noted in chapter 3 that a ranking system, in concept, would provide IRS with a much sounder method of assuring that the best returns are assigned for audit first. Any attempt by IRS to rank non-DIF-scored returns according to their audit potential, however, will prove unworkable without a more detailed classification process. Only if a classifier screens the entire return and notes all identified issues on the classification checksheet can the person who ranks returns have a sufficient basis for accomplishing that task.

We also wonder how much more IRS could get out of its classification process, in terms of better audits, if classifiers spent more time screening returns, identifying issues, and explaining the issues identified. The answer may lie in the phrase "if classifiers spent more time." Management argues that having classifiers identify all potential audit issues on a corporate return would be time consuming and duplicative because an examiner reviews the return completely during his preaudit analysis.

Management may be having second thoughts, however. At a meeting of regional commissioners in 1978, IRS' Assistant Commissioner for Compliance acknowledged that the classification process may have to be reassessed when he asked:

> "Considering the complexity of today's tax laws, should we divert more resources to Classification and require comprehensive issue identification by classifiers?"

We would answer "yes." As we see it, the only other choice is for IRS to do away with the classification process and have returns go directly to examiners. The examiners can then decide which returns warrant audit and which do not. We find that choice unacceptable because it deprives the selection process of a valuable control against abuse--the fact that the person selecting a return for audit is someone other than the person who will be auditing it.

We view the manual classification process as one of the most important aspects of IRS' corporate audit program because it determines which of the many returns filed are going to be audited. The amount of Federal revenue generated through the program is directly affected, then, by the success of the process in identifying the best returns for audit. Considering that, we feel that any concerns about spending too much time during classification are misplaced.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that IRS

--revise its management information system to generate data, such as the number of returns surveyed because of low audit potential, that would help management assess the effectiveness of its manual classification process;

--issue detailed guidelines to help classifiers select corporate returns for audit, including information on common ratios, the relative productivity of audit issues, compliance problems, and local economic conditions;

--establish more specific measures of materiality to help classifiers evaluate audit potential;

--clarify its procedures for classifying DIF-scored returns to better insure that classifiers understand the national office's views on what their role should be in classifying such returns as opposed to non-DIF-scored returns;

--revise its orientation sessions to insure classifiers are adequately instructed on such things as how to screen a corporate return;

--advise classifiers, during orientation, that they should disqualify themselves from classifying types of returns with which they are unfamiliar;

--revise its classification review procedures to provide more uniformity and detail in the data gathered and give classifiers better feedback on performance;

--develop classification checksheets for use by all districts rather than allowing each region to develop its own;

--to the extent practicable, develop checksheets that are tailored to the type of corporate return or industry involved and that direct the classifier's attention to specific issues associated with that return;

--revise its procedures to require that classifiers scrutinize the entire return and note any and all significant audit issues;

--require classifiers to explain the issues they have identified to avoid misinterpretation by examiners; and

--assess the feasibility of a ranking system for use in filing and assigning non-DIF-scored returns after revising the classification process in line with our other recommendations.

IRS COMMENTS AND OUR EVALUATION

IRS concurred with each of our recommendations. But certain of its comments warrant further discussion.

IRS said it would revise its management information system to show the number of returns surveyed by disposal code. Unless it also redefines those disposal codes, however, IRS still will not have the information it needs on the number of returns surveyed because of low audit potential. IRS now has one disposal code to indicate returns surveyed by group managers before assignment to examiners and another code to indicate returns surveyed by examiners. The problem is that IRS has no way of knowing how many of those surveyed returns are due to low audit potential instead of excess inventory. Unless IRS establishes specific codes for group managers and examiners to use when surveying returns for low audit potential, its information on surveyed returns will still not be useful in assessing classifier effectiveness.

While agreeing with our recommendation that it revise its classification review procedures, IRS disagreed with our assertion that it had established no mechanism for using the information obtained during those reviews to provide classifiers additional guidance and feedback. It noted, for example, that the procedures require a sample review of completed audits "* * * to further identify problem areas which will be related to classifiers/screeners." In fact, the procedures say only that the purpose of such reviews is to identify problems; the procedures say nothing about providing this information to classifiers. IRS noted also that Returns Program Managers are required to notify management of any problems identified during their reviews of surveyed returns. But the statement in our report is directed at providing feedback to classifiers not feedback to management.

IRS took issue with our finding that classifiers were getting almost no performance feedback and referred to the recently revised classification review procedures as support for its position. Our finding, however, was based on a review of actual classifier evaluations, as discussed on page 66, which occurred before the new procedures were issued.

IRS said it agreed with the concept of a uniform checksheet for corporate returns to be used nationwide that will more specifically identify issues and that it was committed to develop such checksheets under centralized classification. IRS said also that the number of diverse industries would make tailored checksheets for each industry impractical. We agree that a tailored checksheet for <u>each</u> industry might be impractical, but we still believe tailored checksheets can and should be developed for certain of the larger industries and/or those industries that involve unusual audit issues.

IRS was silent on our recommendation that it require classifiers to explain the issues they have identified except to say that it would attempt, in designing a standardized checksheet, to make it possible for the classifier to more specifically identify the issue in question. While we support IRS' attempt to design its checksheets that way, we do not believe it can succeed to the point of eliminating the need for any written explanations by classifiers. To do so would require very detailed, lengthy checksheets. We therefore reiterate our recommendation that IRS require classifiers to explain identified issues--especially when the issue is one that has not been specifically defined on the preprinted checksheet.

IRS agreed that examiners may need help identifying issues but noted the problem cannot be solved by having classifiers--who are examiners themselves--spend more time classifying returns. IRS said what it needed to do is improve the technical ability of all examiners. IRS is correct in noting that the information in this report indicates a need to improve the technical ability of all examiners and that the problem cannot be solved by having classifiers spend more time classifying returns. But if IRS is saying that it stands to gain little by having classifiers spend more time, we would disagree.

If a classifier is charged with the responsibility of selecting the best returns for audit, he needs to review the entire return to properly assess its audit potential. Such a review would certainly require more time because our field work indicated that classifiers are not now being so thorough. In turn, we fail to see how an audit would not be enhanced by such a thorough classification--provided the classifier recorded all the significant issues identified during his review. Even if IRS improves the ability of its examiners to identify issues, it will never reach the point where every examiner can identify every issue. Thus, IRS will always stand to benefit from having two persons (the classifier and auditor) identify issues instead of just the auditor.

Along those lines, IRS agreed that it should revise its procedures to require that classifiers scrutinize the entire return and note all significant audit issues--but only for certain non-DIF returns (those showing assets of between $1 million and $50 million). IRS said it planned to eliminate the use of classification checksheets for DIF corporate returns and non-DIF corporate returns with assets of $50 million or more which, in effect, would preclude classifiers from noting any issues on those returns. IRS considers this elimination consistent with the concept that a classifier's role in looking at such returns is to eliminate those not in need of audit--as opposed to the classifier's role in looking at other corporate returns which is to select those most in need of audit. IRS also sees the elimination of checksheets as being responsive to our recommendation that it clarify the classifier's role in screening DIF returns.

We have several concerns with IRS' plans in this regard. It is unclear, for example, what IRS intends to do about non-DIF corporate returns showing assets of less than $1 million. Much more important, however, is our general disagreement with IRS' intent to curtail its use of classification checksheets.

We do not agree that IRS has to do away with classification checksheets to reinforce its distinction between a classifier's role in screening DIF returns and his role in screening non-DIF returns. We are not convinced that classifiers will understand the distinction even if checksheets are eliminated. In our opinion, IRS could best clarify the different roles of a classifier by clearly explaining and contrasting those roles in a written document. Nothing we have seen, including IRS' recently revised manual section on classification, has done that.

The classification checksheet is too important to eliminate, even for DIF returns. For a classifier to properly identify a DIF return as not warranting audit, he has to review the entire return. It would be a waste of time and talent for the classifier not to note on a checksheet the significant audit issues he identified during his review. With a checksheet, the examiner can benefit from the classifier's review and management can assess the classifier's work, especially his ability to identify issues. IRS could add to the checksheet a box that the classifier can check if he sees no audit issues but still has to select the return for audit because it is a DIF return or a return showing assets of $50 million or more. That box would serve to remind the classifier of his role in screening such returns.

CHAPTER 5

SCOPE OF REVIEW

We examined IRS' policies, procedures, and practices for developing examination plans and for selecting corporate income tax returns for audit. We interviewed national, regional, district, and service center personnel responsible for the matters under review, including

--Returns Program Managers, who develop and administer return selection programs at the district level;

--Classification Branch chiefs, who are responsible for return selection programs at the service centers; and

--classifiers, who screen tax returns at the district or service center in order to assess audit potential and select the best returns for audit.

To help evaluate the classification process and determine the extent to which classifiers agreed in assessing audit potential, we had 721 corporate income tax returns classified twice and compared the decisions. We also reviewed internal audit reports and used the data in those reports to supplement our data where appropriate.

We did our work at IRS' national office in Washington, D.C.; its New York, Philadelphia, and San Francisco regional offices; its Brookhaven, Fresno, Ogden, and Philadelphia service centers; and its Baltimore, Manhattan, Newark, Phoenix, Reno, and San Francisco district offices. The six district offices serve Maryland and the District of Columbia; the boroughs of the Bronx, Manhattan, and Staten Island in New York City and Westchester County in New York State; New Jersey; Arizona; Nevada; and the northern half of California. Together the six districts accounted for 17 percent of the 2 million corporate tax returns filed and 18 percent of the 150,000 corporate audits done in fiscal year 1978.

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

MAY 17 1979

Mr. Allen R. Voss
Director, General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Voss:

We appreciate the opportunity to review your draft report entitled, "IRS Can Improve Its Process for Deciding How Many and Which Corporate Returns Will Be Audited." As you suggested, representatives of your office and our Examination Division met on April 12, 1979, to discuss and resolve technical problems in the draft report.

The readers of your report will recognize that this is a sequel to two of your prior reports entitled, "How the Internal Revenue Service Selects Individual Income Tax Returns for Audit" and "Audit of Individual Income Tax Returns by the Internal Revenue Service." The current draft report on corporate returns indicates a number of areas where improvements in the process can be made. In most instances, we are in agreement with your recommendations. Our comments regarding specific recommendations are enclosed with explanations in those situations where some disagreement exists. Our comments are referenced to the applicable page number in the draft report. [See GAO note.]

With kind regards,

Sincerely,

Enclosures

GAO note: We changed the page references in IRS' comments to correspond to pages in the final report.

Department of the Treasury Internal Revenue Service

Page 26, Recommendation 1

We recommend that IRS define a quality audit and then conduct a controlled study to determine how long it takes to do a quality audit in each corporate asset class.

Comments

Define Quality Audit

Although quality audit is defined in our Manual, we will attempt to develop a more comprehensive definition.

Conduct A Controlled Study

We will attempt to develop a study to determine as much as possible about the relationship between the amount of time spent on audits and their quality.

Page 26, Recommendation 2

We recommend the IRS assess the adequacy of its planning process as it relates to miscellaneous returns by generating necessary evaluative data such as the number of miscellaneous returns audited and the productivity of those audits.

Comments

We concur.

Page 26, Recommendation 3

We recommend that IRS modify its planning process so as to limit changes from year to year, especially in audit classes with low turnover rates, and time major policy changes to minimize their impact.

Comments

We concur. Starting with the development of our FY 1980 plan, we will limit changes from year to year and, unless faced with overriding considerations, time major policy changes so that field offices can adjust their activities in furtherance of the plan.

Page 26 , Recommendation 4

We recommend that IRS consider expanding its ongoing efforts directed at using factors in addition to gross assets to categorize corporate returns, tracking corporate audit results by issue and industry, and identifying factors affecting voluntary compliance to take advantage of their broader planning implications. IRS should consider expanding the latter effort to the corporate area only after it has had an opportunity to assess its success in the individual income tax area.

Comments

1. Factors in addition to gross assets to categorize corporate returns.

We concur. We plan to undertake a class redefinition study at the completion of our current corporate TCMP survey. A similar study concerning individual returns resulted in a regrouping of such returns under Total Positive Income (TPI) classes rather than the present AGI classes.

In a redefinition study, all reported characteristics on a return are evaluated for their potential as returns' classes identifiers. Primary concerns in classing returns are:

i) returns must be assigned to a particular class when they are filed rather than after they are classified or examined. This requirement is paramount for planning since the distribution of return filings by class has to be estimated in advance if planning is to be of any use.

ii) classing has to be based on a single, rather consistent characteristic on a return. To minimize the uncertainties of planning, the same corporations cannot be allowed to continually shift from one class

Page 26 , Recommendation 4
Page 22, Paragraph 3 and 4 - Cont.

to another. This would be the case if classes were defined by such characteristics as gross sales or profits which are very susceptible to economic conditions. Other possible class designation, such as by industry, presents difficulties in corporations which belong to more than one industry grouping.

iii) the effectiveness of DIF formulas must be maximized. The ultimate efficiency for DIF is when each return is a class unto itself, but operating constraints limit the number of classes which can be efficiently planned and managed. Therefore, classes have to be defined as broadly as DIF formulas development will permit.

2. Tracking corporate audit results by issue and industry.

Although tracking corporate audit results by issue and industry would enable us to make more effective use of our resources, our computer capacity forces us to limit this effort to our largest corporate returns; i.e., the large case regional program and the Coordinated Examination Program (CEP). When additional computer capacity becomes available, we do plan to expand such tracking.

3. Identifying factors affecting voluntary compliance to take advantage of their broader planning implications.

We will consider this when our study on individual returns is completed and we have assessed the results.

Page 45, Recommendation 1

We recommend that IRS further revise its filing procedures to require that low asset nonDIF scored returns be filed separately and be assigned for audit like other nonDIF scored corporate returns.

Comments

We concur.

Page 45, Recommendation 2

We recommend that IRS require examiners, when requesting returns, to adequately explain, in writing, why they need the returns so that the requests can be adequately evaluated.

Comments

We do not agree with this recommendation. Existing procedures in the Internal Revenue Manual require examiners requesting a taxpayer's return and/or any files associated with that return to use a standardized form for submitting the requisition. A source code number which identifies the reason for the request must be entered on the form by the requestor. In the instances cited, related pick-ups and multiyear audits, the system codes are sufficient for a supervisor or reviewer to determine why the return is being requested. In addition, since all requisitions must be approved by the examiner's immediate group manager, any questions regarding the need for securing a return would be discussed before the requisition is approved.

Based on the same recommendation in the GAO report entitled, "How the Internal Revenue Service Selects Individual Income Tax Returns for Audit" (GGD-76-55, November 5, 1976), we made a comprehensive review of all our source codes to ensure that they were properly defined. The comprehensive review was completed in March 1977 and appropriate changes were made.

Page 45, Recommendation 3

We recommend that IRS revise its management information system by separating DIF identified returns from automatics and by avoiding terminology that attributes selection of automatics to the computer.

Comments

We concur. The Task Force implementing TPI classes for individual returns plans to identify automatic individual returns with a separate source code. Further, it has recommended the application of this concept to all automatic returns. This will enable us to revise the management information system and generate separate tables for automatic and DIF corporate returns, eliminating any terminology inconsistencies. Incidentally, automatic corporate returns are not designated as being selected by the computer in the IRM Chapter concerning Classification (IRM 4100). The only type of corporate returns identified as being computer selected in IRM 4100 are DIF returns.

Page 45, Recommendation 4

We recommend that IRS reconsider its criteria for designating a corporate return as an automatic and its requirement that all automatics be classified each year.

Comments

We concur with the concept of this recommendation. We will reconsider the criteria for corporate automatic returns and the requirement that all automatics be classified each year. Tentatively, we plan to divide the corporate automatic returns into two categories. The first category, returns with assets of $50 million and over, will be selected for examination like DIF returns; that is, they will be automatically selected for examination unless the classifier, in screening, eliminates a return as not warranting examination. The second category, those with assets below $50 million, will be classified, and classifiers will be required to identify the "most significant issues." We will also consider whether these returns can be classified so that each return will be classified every other year instead of every year. In addition, to the extent that DIF formulas can be developed for certain classes of automatic returns, we will delete these from the automatic category.

Page 76, Paragraph 3

We also wonder how much more IRS could get out of its classification process, in terms of better audits, if classifiers spent more time classifying returns, identifying issues, and explaining the issues identified. The answer may be in the phrase "if classifiers spent more time." The question of time keeps coming up when talking to classifiers, and management itself raises the issue of time when it argues that having classifiers identify all potential audit issues on a corporate return would be time consuming and duplicative because an examiner will be reviewing the return completely during his pre-audit analysis. Such an argument assumes that examiners don't need help identifying issues -- an assumption that is unsupported by any data we have seen.

Comments

We agree that examiners may need help identifying issues, but the problem cannot be solved by requiring classifiers to spend more time classifying returns. What we need to do is to improve the technical ability of all examiners. In consideration of this objective, we plan to increase our already high investment in training. Specific needs are being determined by Continuing Education and Quality Control Task Forces. (See also comments for Recommendations 8, 9, and 10, Page 78.)

APPENDIX I

Page 77, Recommendation 1

We recommend that IRS revise its management information system to generate data, such as the number of returns surveyed because of low audit potential, that would help management assess the effectiveness of its manual classification process.

Comments

We concur and will revise AIMS Table 1.2 so that it will show the number of returns surveyed by disposal code by examinaton class.

Page 77, Recommendations 2 and 3

We recommend that IRS:

issue detailed guidelines to assist classifiers in selecting corporate returns for audit including information on common ratios, the relative productivity of audit issues, compliance problems, and local economic conditions, and

establish more specific measures of materiality to assist classifiers in evaluating audit potential.

Comments

We concur. We will develop and issue instructions containing specific categories of information and measures of materiality to assist in the classification/screening of returns including corporate returns. This information will be required to be included in all orientation sessions. Additionally, field offices will be asked to add to the instructions any information regarding local conditions.

Page 77, Recommendations 4 and 5

We recommend that IRS:

clarify its procedures for classifying DIF scored returns to better insure that classifiers understand the National Office's views on what their role should be in classifying such returns as opposed to nonDIF scored returns, and

revise its orientation sessions to insure classifiers are adequately instructed on such things as how to screen a corporate return.

Comments

We concur. Revised IRM 4137.1 was issued in December 1978 to explain the classifier's role in screening DIF returns. It states that these returns are screened only "to eliminate those returns not warranting examination." Moreover, we will revise our procedures to eliminate the use of classification checksheets on individual and corporate DIF returns assigned to Revenue Agents. This will further distinguish the classifier's role between DIF and nonDIF returns, and be consistent with the fact that DIF returns are selected by the computer and manually screened only to eliminate those that are not in need of examination. (See comments for Recommendation 10, Page 78.)

APPENDIX I

Page 77, Recommendation 6

We recommend that IRS advise classifiers, during their orientation, that they should disqualify themselves from classifying returns with which they are unfamiliar.

Comments

We concur and will revise our procedures to make this point clear.

Page 78, Recommendation 7

We recommend that IRS revise its classification review procedures to provide more uniformity and detail in the data gathered and give classifiers better feedback on job performance.

Comments

We concur. We will revise our classification procedures to state how often the work of classifiers/screeners should be reviewed and sample size of the review. We will also develop a standard format for the form of documentation required for the review of accepted/selected returns. In addition, we will prescribe the sample size that is required for the review of completed audits. These changes should provide more uniformity and detail in the data gathered and give classifiers better feedback on job performance.

We do not agree with several statements in the report concerning classification reviews. Our comments below are categorized by type of review as shown in the table on Page 67.

Evaluate Classifiers:

We do not concur with the comment that "classifiers were getting almost no performance feedback." (Pg. 64) As noted by GAO, the quality review currently performed must be documented on Form 5126 and discussed with the classifier/screener. Further, a copy of the evaluation is forwarded to the appropriate group manager.

Classified Returns:

We do not concur with the statement that there is no feedback mechanism to "provide classifiers additional guidance and feedback." (Pg. 68) IRM 4165.3 states the RPM

Page 78, Recommendation 7 - Cont.

Comments

or Chief, Classification Branch, after conducting this review, may identify a "need for changes in instructions to classifiers/screeners." Hence, the information derived from this review is fed back to the classifier/screener.

Completed Audits:

We do not concur with the statement that the form of documentation is "not specified." (Pg. 67) IRM 4165.41 states that the items to be included in this review are shown in Exhibit 4100-15, which lists thirteen items that will be part of the documentation. [See GAO note.]

We do not concur with the statement that there is no feedback mechanism to "provide classifier's additional guidance and feedback." (Pg. 68) The review itself is a feedback mechanism to the RPM (Chief, Classification Branch) since the results are used by the people who perform the review. IRM 4165.41 states the purpose of the review will "test the effectivness of the classification procedures and to further identify problem areas" which will be related to classifiers/screeners.

Surveyed Returns:

We do not concur with the statement that the form of [See GAO note.] documentation is "not specified" and that there is no feedback to classifiers/screeners. IRM 4165.42 states Exhibit 4100-15 will be the basis for the review

GAO note: These comments about the form of documentation are no longer pertinent because they relate to a matter that has been dropped from the final report.

Page 78, Recommendation 7 - Cont.

Comments - Survey Cases

documentation. Further, this Manual section states the RPM (Chief, Classification Branch) will "notify appropriate management officials" of any problems identified by the review.

In conclusion, we have continually emphasized the importance of quality reviews in Classification in our visitation program to all regions. Further, the revision of review procedures based on problems identified in the field is an ongoing process.

Page 78, Recommendation 8, 9, and 11

We recommend that IRS:

develop national classification checksheets for use by all districts rather than allowing each region to develop its own checksheets,

to the extent practicable, develop classification checksheets that are tailored to the type of corporate return or industry involved and that direct the classifiers' attention to specific issues associated with that return,

require classifiers to explain the issues they have identified to avoid misinterpretation by examiners.

Comments

We concur with the concept of a uniform checksheet for corporate returns to be used nationwide that will more specifically identify issues. In fact, we are committed under centralized classification to develop such checksheets for each type of tax return. While we agree with the concept of a uniform checksheet for corporate returns, the number of diverse industries would make tailored checksheets for each industry impractical. In designing a standardized checksheet, however, we will attempt to make it possible to more specifically identify the issues(s) in question. For example, if the issue selected is depreciation, the classifier/screener will have to indicate whether the questionable area is basis, useful life, or some other factor.

Page 78, Recommendation 10

We recommend that IRS revise its procedures to require that classifiers scrutinize the entire return and note any and all significant audit issues.

Comments

We concur for certain nonDIF corporate returns (assets of $1 million up to $50 million).

We plan to eliminate the use of any classification checksheets for nonDIF corporate returns with assets of $50 million and over and DIF corporate and individual returns assigned to Revenue Agents. This is consistent with the concept that either DIF has selected the returns or because of size (assets of $50 million and over) the returns are automatically selected. In both instances, these returns are looked at only to eliminate those that are not in need of examination. (See also comments for Recommendation 4, Page 45 and Recommendations 4 and 5, Page 77.)

Page 78, Recommendation 12

We recommend that IRS assess the feasibility of a ranking system for use in filing and assigning nonDIF-scored returns after revising the classification process in line with our other recommendations.

Comments

We concur.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1978 or other taxable year beginning ...., 1978, ending ...., 19....

1978

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See Page 8 of Instructions)

Use IRS label. Otherwise please print or type.

Name
Number and street
City or town, State, and ZIP code

D Employer identification number (see instruction W)
E Date incorporated
F Enter total assets (see instruction X)
$

Gross Income

1 Gross receipts or gross sales........ Less: Returns and allowances........	1	
2 Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)	2	
3 Gross profit	3	
4 Dividends (Schedule C)	4	
5 Interest on obligations of the United States and U.S. instrumentalities	5	
6 Other interest	6	
7 Gross rents	7	
8 Gross royalties	8	
9 (a) Capital gain net income (attach separate Schedule D)	9(a)	
(b) Net gain or (loss) from Form 4797, line 11, Part II (attach Form 4797)	9(b)	
10 Other income (see instructions—attach schedule)	10	
11 TOTAL income—Add lines 3 through 10	11	

Deductions

12 Compensation of officers (Schedule E)	12	
13 (a) Salaries and wages........ 13(b) Less new jobs credit........ Balance ▶	13(c)	
14 Repairs (see instructions)	14	
15 Bad debts (Schedule F if reserve method is used)	15	
16 Rents	16	
17 Taxes	17	
18 Interest	18	
19 Contributions (not over 5% of line 30 adjusted per instructions—attach schedule)	19	
20 Amortization (attach schedule)	20	
21 Depreciation from Form 4562 (attach Form 4562) ...., less depreciation claimed in Schedule A and elsewhere on return ...., Balance ▶	21	
22 Depletion	22	
23 Advertising	23	
24 Pension, profit-sharing, etc. plans (see instructions) (enter number of plans ▶ ....)	24	
25 Employee benefit programs (see instructions)	25	
26 Other deductions (attach schedule)	26	
27 TOTAL deductions—Add lines 12 through 26	27	
28 Taxable income before net operating loss deduction and special deductions (subtract line 27 from line 11)	28	
29 Less: (a) Net operating loss deduction (see instructions—attach schedule) 29(a) .... (b) Special deductions (Schedule I) 29(b)	29	
30 Taxable income (subtract line 29 from line 28)	30	

Tax

31 TOTAL TAX (Schedule J)	31	
32 Credits: (a) Overpayment from 1977 allowed as a credit		
(b) 1978 estimated tax payments		
(c) Less refund of 1978 estimated tax applied for on Form 4466 ( )		
(d) Tax deposited: Form 7004 .... Form 7005 (attach)........ Total ▶		
(e) Credit from regulated investment companies (attach Form 2439)		
(f) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)	32	
33 TAX DUE (subtract line 32 from line 31). See instruction G for depositary method of payment. (Check ▶ ☐ if Form 2220 is attached. See page 3 of instructions.) ▶ $........	33	
34 OVERPAYMENT (subtract line 31 from line 32)	34	
35 Enter amount of line 34 you want: Credited to 1979 estimated tax ▶ Refunded ▶	35	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer Date ▶ Title

Paid Preparer's Information

Preparer's signature ▶ | Preparer's social security no. | Check if self-employed ▶ ☐

Firm's name (or yours, if self-employed), address and ZIP code ▶ | E.I. No. ▶ | Date ▶

Form 1120 (1978) Page 2

Schedule A Cost of Goods Sold (See instruction 2)

1 Inventory at beginning of year	
2 Merchandise bought for manufacture or sale	
3 Salaries and wages	
4 Other costs (attach schedule)	
5 Total	
6 Less: Inventory at end of year	
7 Cost of goods sold—Enter here and on line 2, page 1	

8 (a) Check valuation method(s) used for total closing inventory:
☐ Cost ☐ Lower of cost or market ☐ Other (if "other," attach explanation)

(b) Check if this is the first year LIFO inventory method was adopted and used. (If checked, attach Form 970.) ☐

(c) If the LIFO inventory method was used for this taxable year, enter percentage (or amounts) of closing inventory computed under LIFO

(d) Is the corporation engaged in manufacturing activities? ☐ Yes ☐ No

If "Yes," are inventories valued under Regulations section 1.471–11 (full absorption accounting method)? ☐ Yes ☐ No

(e) Was there any substantial change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No

If "Yes," attach explanation.

Schedule C Dividends (See instruction 4)

1 Domestic corporations subject to 85% deduction	
2 Certain preferred stock of public utilities	
3 Foreign corporations subject to 85% deduction	
4 Dividends from wholly-owned foreign subsidiaries subject to 100% deduction (section 245(b))	
5 Other dividends from foreign corporations	
6 Includable income from controlled foreign corporations under subpart F (attach Forms 3646)	
7 Foreign dividend gross-up (section 78)	
8 Qualifying dividends received from affiliated groups and subject to the 100% deduction (section 243(a)(3))	
9 Taxable dividends from a DISC or former DISC not included in line 1 (section 246(d))	
10 Other dividends	
11 Total—Enter here and on line 4, page 1	

Schedule E Compensation of Officers (See instruction 12)

1. Name of officer	2. Social security number	3. Time devoted to business	Percent of corporation stock owned: 4. Common	5. Preferred	6. Amount of compensation	7. Expense account allowances
Total compensation of officers—Enter here and on line 12, page 1						

Schedule F Bad Debts—Reserve Method (See instruction 15)

1. Year	2. Trade notes and accounts receivable outstanding at end of year	3. Sales on account	Amount added to reserve: 4. Current year's provision	5. Recoveries	6. Amount charged against reserve	7. Reserve for bad debts at end of year
1973						
1974						
1975						
1976						
1977						
1978						

Schedule I Special Deductions

1 (a) 85% of Schedule C, line 1	
(b) 60.208% of Schedule C, line 2	
(c) 85% of Schedule C, line 3	
(d) 100% of Schedule C, line 4	
2 Total—See instructions for limitation	
3 100% of Schedule C, line 8	
4 Dividends paid on certain preferred stock of public utilities (see instructions)	
5 Western Hemisphere trade corporations (see instructions)	
6 Total special deductions—Add lines 2 through 5. Enter here and on line 29(b), page 1	

Form 1120 (1978) **Schedule J** **Tax Computation** Page 3

(Fiscal year corporations, omit lines 1 through 8 and enter on line 9, the amount from Form 1120–FY (1978–79), line 5, Part III)

1 Taxable income (line 30, page 1)	
2 Enter line 1 or $25,000, whichever is less. (Members of a controlled group enter one-half of surtax allocation, see instructions)	
3 Subtract line 2 from line 1	
4 Enter line 3 or $25,000, whichever is less. (Members of a controlled group enter one-half of surtax allocation, see instructions)	
5 Subtract line 4 from line 3	
6 20% of line 2	
7 22% of line 4	
8 48% of line 5	
9 Income tax (Sum of lines 6, 7 and 8 or alternative tax from separate Schedule D, whichever is less)	
10 (a) Foreign tax credit (attach Form 1118)	
(b) Investment credit (attach Form 3468)	
(c) Work incentive (WIN) credit (attach Form 4874)	
(d) New jobs credit (attach Form 5884)	
11 Total of lines 10(a), (b), (c), and (d)	
12 Subtract line 11 from line 9	
13 Personal holding company tax (attach Schedule PH (Form 1120))	
14 Tax from recomputing a prior year investment credit (attach Form 4255)	
15 Tax from recomputing a prior year WIN credit (see instructions—attach computation)	
16 Minimum tax on tax preference items (see instructions—attach Form 4626)	
17 Total tax—Add lines 12 through 16. Enter here and on line 31, page 1	

Schedule K **Record of Federal Tax Deposits Tax Class Number 503**
(List deposits in order of date made—See instruction G)

Date of deposit	Amount	Date of deposit	Amount	Date of deposit	Amount

	Yes	No
G (1) Did you claim a deduction for expenses connected with:		
(a) Entertainment facility (boat, resort, ranch, etc.)?		
(b) Living accommodations (except for employees on business)?		
(c) Employee's families at conventions or meetings?		
If "Yes," were any of these conventions or meetings outside the United States or its possessions?		
(d) Employee or family vacations not reported on Form W-2?		
(2) Enter total amount claimed on Form 1120 for entertainment, entertainment facilities, gifts, travel, and conventions of the type for which substantiation is required under section 274(d). (See instruction Y.) ▶		
H (1) Did you at the end of the taxable year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).)		
If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; (c) taxable income or (loss) (e.g., if a Form 1120: from Form 1120, line 28, page 1) of such corporation for the taxable year ending with or within your taxable year; (d) highest amount owed by you to such corporation during the year; and (e) highest amount owed to you by such corporation during the year.		
(2) Did any individual, partnership, corporation, estate or trust at the end of the taxable year own, directly or indirectly, 50% or more of your voting stock? (For rules of attribution, see section 267(c).) If "Yes," complete (a) through (e)		
(a) Attach a schedule showing name, address, and identifying number; (b) Enter percentage owned ▶		
(c) Was the owner of such voting stock a person other than a U.S. person? (See instruction S.)		
If "Yes," enter owner's country ▶		
(d) Enter highest amount owed by you to such owner during the year ▶		
(e) Enter highest amount owed to you by such owner during the year ▶		
(Note: For purposes of H(1) and H(2), "highest amount owed" includes loans and accounts receivable/payable.)		
I Did you ever declare a stock dividend?		
J Taxable income or (loss) from Form 1120, line 28, page 1, for your taxable year beginning in: 1975 ...., 1976 ...., 1977		
K Were you a member of a controlled group subject to the provisions of section 1561? If "Yes," check the type of relationship. (1) ☐ parent-subsidiary (2) ☐ brother-sister (3) ☐ combination of (1) and (2) (See section 1563.)		
L Refer to page 8 of instructions and state the principal: Business activity .... Product or service		
M Did you file all required Forms 1087, 1096 and 1099?		
N Were you a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 3646 for each such corporation		
O Did you, at any time during the taxable year, have an interest in or signature or other authority over a bank, securities or other financial account in a foreign country (see instruction V)?		
P Were you the grantor of, or transferor to, a foreign trust during any taxable year, which foreign trust was in being during the current taxable year, whether or not you have any beneficial interest in such trust? If "Yes," you may be required to file Forms 3520, 3520-A, or 926		
Q During this taxable year, did you pay dividends (other than stock dividends and distributions in exchange for stock) in excess of your current and accumulated earnings and profits? (See sections 301 and 316.)		
If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliation Schedule, for each subsidiary.		

Form 1120 (1978) Page 4

Schedule L Balance Sheets

	Beginning of taxable year		End of taxable year	
ASSETS	(A) Amount	(B) Total	(C) Amount	(D) Total
1 Cash				
2 Trade notes and accounts receivable				
(a) Less allowance for bad debts				
3 Inventories				
4 Gov't obligations: (a) U.S. and instrumentalities				
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other fixed depreciable assets				
(a) Less accumulated depreciation				
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)				
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable				
16 Mtges., notes, bonds payable in less than 1 yr.				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more				
20 Other liabilities (attach schedule)				
21 Capital stock: (a) Preferred stock				
(b) Common stock				
22 Paid-in or capital surplus				
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated				
25 Less cost of treasury stock		( )		( )
26 Total liabilities and stockholders' equity				

Schedule M-1 Reconciliation of Income Per Books With Income Per Return

1 Net income per books		7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax		(a) Tax-exempt interest $	
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)			
5 Expenses recorded on books this year not deducted in this return (itemize)		8 Deductions in this tax return not charged against book income this year (itemize)	
(a) Depreciation . . . . $		(a) Depreciation . . $	
(b) Depletion . . . . . $		(b) Depletion . . $	
		9 Total of lines 7 and 8	
6 Total of lines 1 through 5		10 Income (line 28, page 1)—line 6 less 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings Per Books (line 24 above)

1 Balance at beginning of year		5 Distributions: (a) Cash	
2 Net income per books		(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
		7 Total of lines 5 and 6	
4 Total of lines 1, 2, and 3		8 Balance at end of year (line 4 less 7)	

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EVALUATION OF DIF'S EFFECTIVENESS

To assess DIF's effectiveness in the corporate area, we examined IRS' procedures in conducting two tests involving relationships in which DIF would be expected to prove superior if it were meeting its objectives. We also independently evaluated DIF's effectiveness through a correlation analysis of DIF scores with no-change rates.

DIF COMPARED WITH RANDOM AND PERFECT SELECTION

Using data from its TCMP audits of corporate returns filed in 1973, IRS compared DIF results with those of random and perfect selection. A DIF score computed for each return audited under TCMP was the basis for ranking the returns. Once the ranking was completed by asset class, the average tax change per return, at a predetermined level of audit coverage, was computed. This average tax change represented the results that would have been obtained if the returns had been selected for audit entirely on the basis of their DIF scores.

These results were compared, assuming the same level of audit coverage, with (1) the average tax change for all TCMP returns in each class--this represents random selection--and (2) the average tax change for the TCMP returns ranked by amount of tax change--this represents perfect selection.

Assets of at least	but less than	Percent of audit coverage (note a)	Average tax change per return		
			DIF	Random selection	Perfect selection
$1	$50,000	1.4	$1,920	$ 246	$ 8,390
$50,000	$100,000	3.3	1,997	456	8,215
$100,000	$250,000	3.1	4,084	827	15,048
$250,000	$500,000	6.4	4,918	1,356	14,237
$500,000	$1,000,000	8.2	7,356	2,423	20,979

a/This is the approximate percentage of returns by class that IRS audits in a fiscal year as a result of DIF selection.

This test shows DIF vastly superior to random selection. The comparison with perfect selection, however, clearly indicates room for improvement. It should be noted that IRS does not select returns for audit purely on the basis of DIF scores, as was done in this test. Manual screening has always been an integral part of IRS' selection process.

1977 DIF FORMULAS COMPARED WITH PREVIOUS FORMULAS

The DIF formulas used to score corporate returns filed before 1977 were based on 1969 TCMP data. Newer DIF formulas were developed on the basis of the 1973 TCMP.

To determine whether the new formulas were as effective as the old, IRS had a group of returns scored and ranked by both sets of formulas. Then, given a specific level of audit coverage, the results of the two rankings were compared.

		Old formulas		New formulas	
Assets of at least	but less than	Average tax change per return	Percent no change	Average tax change per return	Percent no change
$1	$50,000	$ 763	51.3	$1,920	34.5
$50,000	$100,000	1,479	42.0	1,997	26.9
$100,000	$250,000	3,215	34.9	4,084	26.1
$250,000	$500,000	3,144	26.0	4,918	26.8
$500,000	$1,000,000	7,021	33.3	7,356	21.0

In terms of both average tax change and percent no change, the new DIF formulas proved much more productive.

CORRELATION ANALYSIS OF DIF SCORES WITH NO-CHANGE RATES

The foregoing comparisons were made by IRS. We also independently analyzed IRS' audit results to try to determine, through techniques of statistical inference, whether DIF was effective.

IRS gave us the audit results for all corporate returns selected under the DIF system during tax year 1974. We determined the degree of relationship between DIF scores and no-change rates by making a correlation analysis. Such an analysis provides an index (correlation coefficient), or measure, of the degree of relationship between two variables--in this case DIF scores and no-change rates. The expected relationship was as follows--because the purpose of DIF is to measure the likelihood of a tax change after audit, a measurable relationship should exist between high DIF scores and low no-change rates and low DIF scores and high no-change rates. To measure this relationship, we ranked both the DIF scores and the no-change rates, the highest DIF score was ranked first and the lowest no-change rate was ranked first. The results are shown below.

Assets of at least	but less than	Correlation coefficient	Interpretation of coefficient (note a)
$1	$50,000	0.53	Moderate correlation
$50,000	$100,000	0.73	High correlation
$100,000	$250,000	0.88	High correlation
$250,000	$500,000	0.83	High correlation
$500,000	$1,000,000	0.64	Moderate correlation

a/The following interpretation was used to evaluate the degree of correlation.

Less than 0.20--slight correlation; almost negligible relationship.

0.20 to 0.39--low correlation; definite but small relationship.

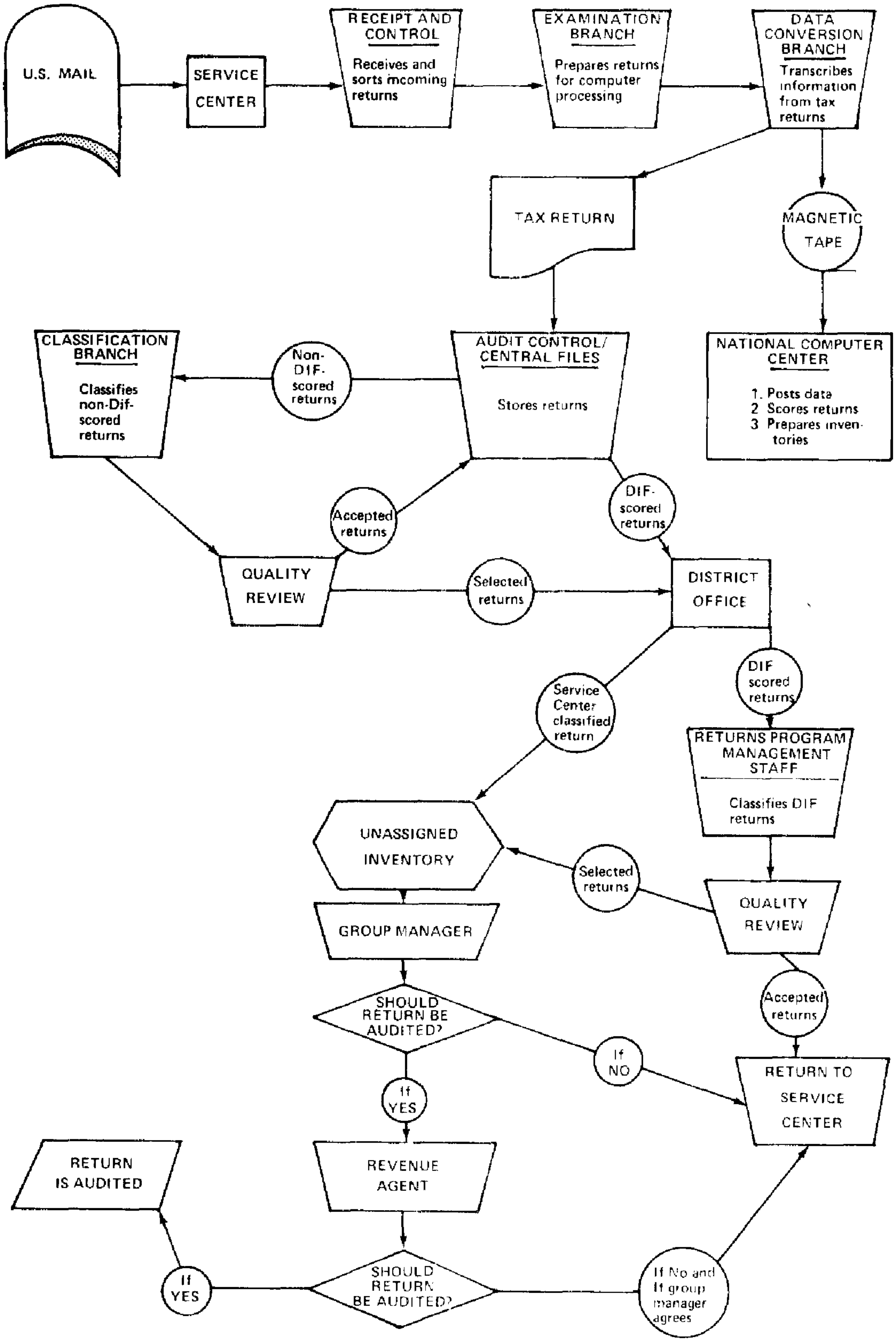
0.40 to 0.69--moderate correlation; substantial relationship.

0.70 to 0.90--high correlation; marked relationship.

Greater than 0.90--very high correlation; very dependable relationship.

Of the five formulas, three exhibited a high correlation and two a moderate correlation. This indicates that the higher the DIF score on a return, the more likely that an audit of that return will result in a tax change. We believe that this analysis provides one of the more convincing arguments for DIF effectiveness.

HOW CORPORATE RETURNS ARE SELECTED FOR AUDIT



APPENDIX V

CLASSIFICATION CHECK LIST

Classifier: | Date:

☐ 1120 ☐ 1120S ☐ 1065

Year ______ Activity Code ______

Selected	Assets	Changed	Reasons
☐	Accounts Receivable . . .	☐	. . . .
☐	Inventories	☐	. . . .
☐	Loans to Shareholders . . .	☐	. . . .
☐	Depreciable Assets	☐	. . . .
☐	Deferred Income	☐	. . . .
☐	Other	☐	. . . .
☐	. . . .	☐	. . . .
	Liabilities		
☐	Accounts Payable	☐	. . . .
☐	Loans from Shareholders .	☐	. . . .
☐	Other	☐	. . . .
☐	. . . .	☐	. . . .
	Shareholder Equity		
☐	Paid In or Capital Surplus.	☐	. . . .
☐	Retained Earnings	☐	. . . .
☐	Other	☐	. . . .
☐	. . . .	☐	. . . .
	Schedule M		
☐	. . . .	☐	. . . .
☐	. . . .	☐	. . . .
	Schedule K		
☐	. . . .	☐	. . . .
☐	. . . .	☐	. . . .

Selected	Income	Changed	Reasons
☐	Gross or Net out of Line . .	☐	. . . .
☐	Capital Transactions	☐	. . . .
☐	Cost of Goods	☐	. . . .
☐	Other	☐	. . . .
☐	. . . .	☐	. . . .
☐	. . . .	☐	. . . .
	Deductions and Credits		
☐	Compensation of Officers .	☐	. . . .
☐	Repairs	☐	. . . .
☐	Bad Debts	☐	. . . .
☐	Rent	☐	. . . .
☐	Depreciation	☐	. . . .
☐	Travel and Entertainment .	☐	. . . .
☐	Other	☐	. . . .
☐	. . . .	☐	. . . .
☐	. . . .	☐	. . . .
	General		
☐	Minimum Tax	☐	. . . .
☐	Investment Credit	☐	. . . .
☐	N.O.L.	☐	. . . .
☐	Basis (1120S) (1065)	☐	. . . .
☐	Other	☐	. . . .
☐	. . . .	☐	. . . .

Remarks: ____________________

Form **MAR–260-C** (9-77)

Department of the Treasury–Internal Revenue Service

CLASSIFICATION CHECK SHEET

BUSINESS RETURNS

☐ 1040 ☐ 1041 ☐ 1120 ☐ 1065 ☐ OTHER *(Specify)*

SELECTED	INCOME	CHANGED
☐	Automatic	☐
☐	Capital Transactions	☐
☐	Cost of Sales - Inventories	☐
☐	Dealers Reserve	☐
☐	Deferred Income	☐
☐	Distribution - Partnership Income	☐
☐	Excluded or Exempt Income	☐
☐	Gross Profit Percentage	☐
☐	Installment Sales	☐
☐	Rental Income	☐
☐	Royalties	☐
☐	*(Other)*....................	☐
	GENERAL	
☐	Accounting Method	☐
☐	Balance Sheet Item	☐
☐	Corporate Liquidation	☐
☐	Estimated Tax Penalty	☐
☐	Exempt Organization	☐
☐	Improper Accumulation of Surplus	☐
☐	Multiple or Collapsible Corporation	☐
☐	Reorganization - Merger	☐
☐	Section 1361 Organization	☐
☐	Section 1372 Organization	☐
☐	Surplus or Networth Adjustment	☐
☐	Unrelated Business Income	☐
☐	Investment Credit	☐
☐	*(Other)*	

SELECTED	EXPENSES AND DEDUCTIONS	CHANGED
☐	Advertising	☐
☐	Alimony	☐
☐	Amortization	☐
☐	Bad Debts	☐
☐	Casualty Loss	☐
☐	Contributions	☐
☐	Depletion	☐
☐	Depreciation	☐
☐	Exemptions	☐
☐	Interest	☐
☐	Medical	☐
☐	Net Operating Loss	☐
☐	Officers Salaries	☐
☐	Other Salaries and Wages	☐
☐	Outside Salesman	☐
☐	Pension or Profit Sharing	☐
☐	Repairs	☐
☐	Taxes	☐
☐	Travel and Entertainment	☐
☐	*(Other)*....................	☐

REMARKS

CLASSIFIER	DATE	
		☐ ENGINEERING - VALUATION ☐ SECURITIES

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE *(See reverse)* **ROWR** FORM **179** (REV. 12-64)

(268050)

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