
REPORT BY THE U.S.

General Accounting Office

With Better Management Information, IRS Could Further Improve Its Efforts Against Abusive Tax Shelters

Historically, abusive tax shelters have posed a tax administration problem for IRS. The large and ever-increasing number of abusive tax shelter returns, the inventiveness of promoters in devising new types of shelters, and the administrative burden created for IRS personnel by shelter examinations have strained IRS' resources. And, as IRS' backlog of tax shelter returns awaiting examination completion has continued to grow, many taxpayers have appealed the results of completed examinations, further straining IRS' resources.

IRS has responded by focusing top management attention on the problem and by taking new approaches. Recent administrative and legislative changes should help IRS to more efficiently and effectively administer the law involving tax shelters. GAO believes, however, that IRS would be able to make better decisions on the level of resources needed and how they should be targeted if it developed better management information than it now has on program operations and results. GAO makes several recommendations designed to help IRS further improve its efforts in this regard.



GAO/GGD-83-63
AUGUST 25, 1983

026510

Request for copies of GAO reports should be sent to:

**U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760**

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are \$3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are \$1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".



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

GENERAL GOVERNMENT
DIVISION

B-212165

The Honorable Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
Department of the Treasury

Dear Mr. Egger:

This report discusses the Internal Revenue Service's (IRS') efforts to address a major tax administration problem--abusive tax shelters. The report recognizes that IRS has given abusive tax shelters considerable management attention and has committed extensive resources to this problem area. It points out that IRS could further improve its program operations with better management information, particularly given the many recent substantive legislative and administrative actions.

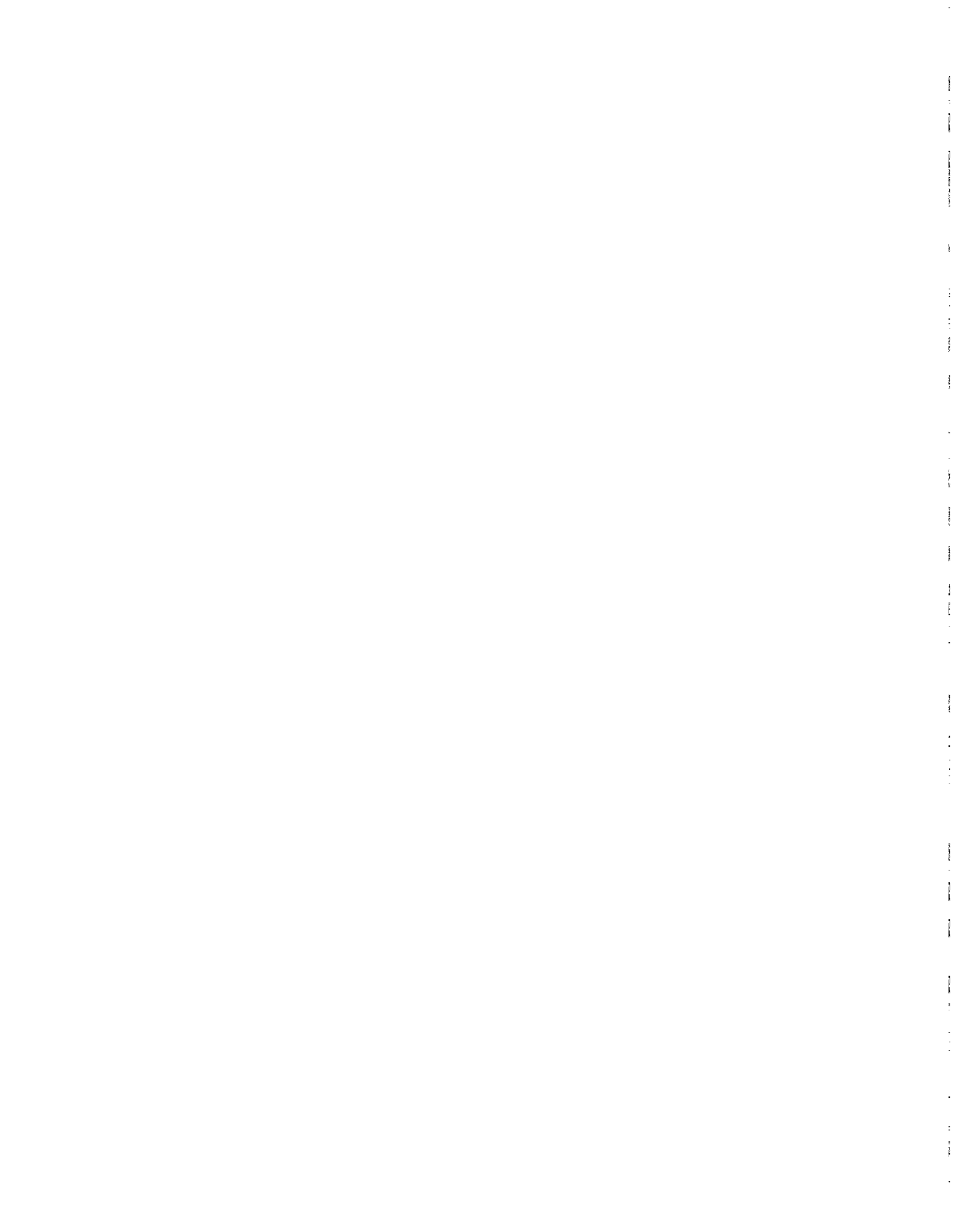
This report contains recommendations to you on page 27. As you know, 31 U.S.C. §720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

Copies of the report are being sent to the Chairman, Senate Finance Committee; the Chairman, House Committee on Ways and Means; the Chairman and the Vice Chairman, Joint Committee on Taxation; other interested congressional committees; the Director, Office of Management and Budget; the Secretary of the Treasury; and other interested parties.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director



D I G E S T

For many years abusive tax shelters have posed a tax administration problem for IRS. Some tax shelters involve legitimate methods or transactions through which taxpayers defer or reduce tax liability. Others, however, lack economic purpose other than the generation of tax benefits and constitute an abuse of the tax laws. The number and types of abusive tax shelters successfully marketed have steadily grown. IRS has responded by increasing its resource commitment to the area. As a result, IRS' total case inventory has increased. Also, many examined cases have been appealed, further straining IRS' resources.

IRS believes that the revenue lost to abusive tax shelters is substantial and that, if it does not take forceful action, taxpayer compliance may be adversely affected. Hence, over the years, IRS has focused top management attention on the area, made administrative modifications to its program, and obtained legislative relief. All too frequently, however, as soon as IRS surmounted one obstacle to efficient and effective administration, another arose.

Recent legislative and administrative changes should enable IRS to enhance its efforts against abusive tax shelters. As it does so, IRS would be able to make better decisions on the level of resources needed and how they should be targeted if it developed better management information on program operations and results.

At the request of the Joint Committee on Taxation, GAO reviewed IRS' activities in the tax shelter area. This report describes the actions IRS has taken and makes recommendations concerning types of management information that would help IRS in its future decisionmaking.

OBSTACLES IRS HAS FACED AND ACTIONS
IT HAS TAKEN IN ITS TAX SHELTER PROGRAM

In recent years the size and complexity of IRS' workload in the tax shelter area have strained its resources. In 1973, IRS classified abusive shelters into 2 types; by 1982 the number of types IRS identified as abusive had risen to 18. IRS' approach to examining shelter returns, known as the "must work" or "mandatory examination" approach, has required that virtually every shelter return identified as potentially abusive must be examined. Under this approach, IRS' case inventory had grown from 174,262 returns as of September 30, 1980, to 314,516 returns as of March 31, 1983. Examiner staff days devoted to the Tax Shelter Program have also increased, amounting to 2.5 percent of direct examination time in fiscal year 1979 and 8.9 percent of direct examination time in the first 6 months of fiscal year 1983. (See pp. 6 and 7.)

Examining abusive shelters often imposed a significant administrative burden on examiners, with adverse effects on their morale. This burden arose partly because an abusive shelter is often set up as a partnership with the promoter as the general partner and the investors as limited partners. Thus, examining such a shelter required the examiner to control several returns, often for different tax years and in different districts. From discussions with examiners in the two IRS districts that rank first and second in tax shelter inventory, GAO estimated that about 60 percent of examiner time was spent on such administrative tasks as tracking and controlling returns, with only 40 percent applied to such technical tasks as examining returns and developing examination issues. At its present pace of about 70,000 completed examinations annually, the March 31, 1983 Examination Division backlog of 314,516 tax shelter returns would take more than 4 years to process--even if no new cases were added to inventory. (See pp. 9 to 11 and 22 to 25.)

Another problem for IRS is that completing Examination Division action on tax shelter cases often does not end the impact of those cases on IRS resources. For the 18 months ending March 31, 1983, for example, 58 percent of completed tax shelter examinations were appealed, involving 90 percent of all potential revenue from these examinations. (See pp. 10 and 11.)

GAO notes that IRS has responded to these obstacles to efficient and effective tax administration by focusing top management attention on the area and by devising new approaches. In 1980 an IRS task force was formed to report directly to the Commissioner on problems in the Tax Shelter Program. The task force made 35 recommendations, many of which have been implemented. (See p. 8.) And, most recently, in August 1982, the Commissioner announced a new policy, the "out-of-pocket" expenses approach, which will allow IRS personnel, in certain pre-1981 cases, to offer a settlement in which the taxpayer can deduct the first year's investment in the shelter. This approach is designed to help IRS reduce the number of cases in its inventory. (See pp. 11 and 12.)

In addition to these administrative actions, IRS has repeatedly sought, and the Congress has provided, legislative relief. Most recently, the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 gave IRS several enforcement tools it can use against promoters of abusive shelters. Moreover, TEFRA simplifies administrative aspects of partnership examinations. (See pp. 8 and 9.)

IMPROVED MANAGEMENT INFORMATION
COULD HELP IRS EVALUATE EFFECTS
OF RECENT CHANGES

IRS now has new means with which to address problems that have troubled its strategic planning and operations. For example, the administrative burden on examiners should be

eased by TEFRA's partnership provisions and the case backlog may be reduced by the out-of-pocket expenses approach. Still, the demonstrated inventiveness of shelter promoters and the large number of taxpayers who have appealed completed examinations in the past suggest that optimism that the shelter problem is now becoming less severe should be moderated with caution.

In this regard, GAO believes that better management information would help IRS either make sure that legislative and administrative changes are producing the intended results or identify further changes that may be needed. Given this, GAO suggests that the following types of information, which should not be construed as all inclusive, would prove useful and contribute to more informed decisionmaking by IRS:

- A breakdown of the total case inventory in the Tax Shelter Program by tax year and shelter type. With such data IRS would be able to identify and analyze trends in the number of abusive tax shelter returns added each year. Such data could, for example, tell IRS whether a district with a large inventory of shelter returns is experiencing administrative bottlenecks which need to be addressed or is, in fact, experiencing an increase in identified tax shelter cases. (See pp. 16 to 18.)

- A breakdown of the inventory by number and characteristics of taxpayers (rather than by number of returns). Such data could indicate whether tax shelter abuse is widespread or limited to a relatively small number of taxpayers. IRS would also know whether the same or different taxpayers were frequently under examination. Such data on the size and composition of the universe of taxpayers involved in abusive shelters could be useful to IRS in targeting its resources. (See pp. 16 to 18.)

--More precise estimates of the tax revenue loss due to abusive shelters. IRS examination officials believe that the current estimate of a \$3.6 billion loss per year, projected by IRS planners, may be too high. If so, IRS may be overallocating its resources to tax shelters; conversely, if the estimate is too low, IRS may be underallocating. (See pp. 18 and 19.)

--Information on the results of the "must work" approach, which would tell IRS whether the must work approach continues to strain resources. This, in turn, would alert IRS to the possible need for a change in strategy, such as examining only selected, rather than all, suspect returns. (See pp. 20 to 22.)

--Information on the extent of administrative burden on examiners, which would tell IRS whether it should consider, among other things, using computer systems and centralized support staffs more extensively. (See pp. 22 to 25.)

RECOMMENDATIONS

GAO makes several recommendations designed to help IRS further improve its efforts against abusive tax shelters through better management information on the size of the tax shelter problem, the impact IRS is having on that problem, and the effects of recent legislative and administrative changes. (See pp. 27 and 28.)

AGENCY COMMENTS

IRS said that it agreed with the basic thrust of the report, that it has already taken some steps to improve its efficiency in responding to the problem of abusive tax shelters, and that it plans to act on all but one of GAO's proposed recommendations. The need for that recommendation, dealing with the Appeals, Counsel, and Examination Committees, was obviated by changes in functions and responsibilities that occurred after GAO completed its work. (See p. 28.)



C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Tax shelters--legitimate versus abusive	2
	IRS' innovative efforts against abusive tax shelters	6
	Case backlog: a problem yet to be resolved	9
	Objectives, scope, and methodology	12
2	IRS NEEDS TO IMPROVE ITS MANAGEMENT INFORMATION ON TAX SHELTERS	15
	IRS needs better data with which to validate its current strategy or devise a new one	15
	To assure itself that current problems in operations are being solved and new ones are not arising, IRS needs to carefully monitor the results of day-to-day operations	19
	Closer monitoring of out-of-pocket expenses approach is warranted	25
	Conclusions	26
	Recommendations to the Commissioner of Internal Revenue	27
	Agency comments and our evaluation	28
APPENDIX		
I	Tax shelter returns reported in program inventory	29
II	IRS' efforts to curtail tax shelter abuse	30
III	Tax Shelter Program accomplishments	34
IV	IRS tax shelter task force recommendations by program area	35
V	Calculation of potential benefit through freeing examiners of some administrative duties	36

VI	Letter dated June 23, 1983, from the Acting Commissioner of Internal Revenue
----	--

38

ABBREVIATIONS

ACE	Appeals, Counsel, Examination Committees
AIMS	Audit Information Management System
CID	Criminal Investigation Division
ERTA	Economic Recovery Tax Act of 1981
GAO	General Accounting Office
IRS	Internal Revenue Service
ITC	Investment Tax Credit
TCMP	Taxpayer Compliance Measurement Program
TEFRA	Tax Equity And Fiscal Responsibility Act of 1982

CHAPTER 1

INTRODUCTION

Our tax system's effectiveness depends in large measure on the taxpayers' belief that the tax burden is fairly distributed and that the Internal Revenue Service (IRS) will deal in a fair and timely manner with those who do not comply with the tax laws. If the taxpaying public perceives otherwise, the effectiveness of the tax system may diminish. Recently, there has been widespread publicity purporting that many citizens are abusing the system by "sheltering" their income from taxes; "beating the system" by using illegal tax protest schemes; not filing a return; or filing a return but underreporting their income. This report, requested by the Joint Committee on Taxation, deals with IRS' efforts to expeditiously and efficiently complete examinations of those tax shelters which IRS calls "abusive." We have previously reported and testified on such other major tax compliance problems as illegal tax protesters ^{1/} and persons who do not file tax returns. ^{2/}

For IRS officials, abusive tax shelters have been a major tax administration problem for several years. Officials have cited various statistics and projections from IRS' examination information system to describe the extensiveness of abusive tax shelters. For example, the Commissioner told the American Bar Association in August 1981:

"The proliferation of abusive tax shelters also is a tax administration problem of major proportions * * *. When I was sworn in as Commissioner, there were 217,000 returns [in IRS' examination inventory] identified as tax shelter returns." ^{3/}

In October 1981, the Commissioner said:

"* * * (A)t the end of July, this figure had increased to over 238,000 returns, representing \$2.6 billion in proposed additional tax and penalties * * *. Altogether we estimate that

^{1/} "Illegal Tax Protesters Threaten Tax System" (GGD-81-83, July 8, 1981).

^{2/} "Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them And Collect Their Taxes" (GGD-79-69, July 11, 1979).

^{3/} Roscoe L. Egger, Jr., Commissioner of Internal Revenue, Remarks before the Tax Section Meeting, American Bar Association, New Orleans, Louisiana, August 8, 1981, "IRS--The Present and the Future," IRS News Release--IR-81-93.

abusive shelters may well cost the U.S. Treasury as much as \$3.6 billion a year in lost tax revenue." 4/

And, in September 1982, the Commissioner stated that "there are almost 300,000 shelter returns under examination by the Service. Over 16,000 shelter cases are currently pending before the Tax Court, equal to roughly 30% of the total docket." 5/

As the Commissioner explained in October 1981, abusive tax shelters have a dual cost:

"Our concern with such schemes goes beyond the revenue lost to the government. And that's no small amount--\$3.6 billion a year, according to our estimates. Abusive tax shelters drain our country of a resource that's even more precious than that \$3.6 billion a year--respect for the American tax system." 6/

TAX SHELTERS--LEGITIMATE VERSUS ABUSIVE

The Congress has created provisions in the tax code that are intended to encourage certain economic and social goals through tax advantages. Such advantages are frequently described as "tax shelters."

The mechanics of how tax shelters work are fairly straightforward. Tax shelters can provide three major types of tax advantages: (1) deferring payment of taxes on current income; (2) converting taxable income from a higher to a lower tax rate; and/or (3) increasing deductions through the leveraging of invested funds.

In some tax shelters, promoters blend these advantages very creatively or interpret the law most favorably to their interest when applying it to the specific facts and circumstances of the particular tax shelter. Some such shelter promotions are viewed by IRS as abusive. However, it is difficult to specifically define abusive tax shelters because, as the Commissioner of Internal Revenue stated in September 1982, "any definition would be

4/ Egger, Remarks before the Heart of America Tax Institute, Kansas City, Missouri, October 6, 1981, "Defusing Abusive Tax Shelters," IRS News Release--IR-81-122.

5/ Egger, Testimony before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, September 28, 1982, p. 8.

6/ Egger, Remarks before the University of Chicago Law School, 34th Annual Federal Tax Conference, Chicago, Illinois, October 30, 1981, "New Directions in Tax Shelters," IRS News Release--IR-81-127.

unlikely to cover all of the possible permutations and contingencies which could be created by promoters of such shelters." ^{7/} And, as he indicated in August 1981, promoters are constantly devising new tax shelters:

"More and more shelter promoters are marketing shelters that involve essentially artificial transactions, inflated appraisals, unrealistic allocations and schemes generally lacking in economic reality." ^{8/}

The most explicit internal guidance IRS has provided to its staff to describe abusive tax shelters is in IRS' examination handbook. The handbook describes an abusive tax shelter as one "utilizing improper or extreme interpretations of the law or the facts to secure for investors substantial tax benefits which are clearly disproportionate to the economic reality of the transaction." The handbook gives this further guidance in identifying the characteristics of an abusive tax shelter:

"An abusive Tax Shelter is one that lacks economic reality or viability when viewed in its entirety. To prove lack of economic reality or viability, an in-depth financial analysis is required * * *. The key question is: 'Was the transaction entered into primarily for tax avoidance?' To help answer this question, the examiner must first gain an understanding of the transaction in its entirety."

In an October 1981 speech the Commissioner gave the following example of a tax shelter which IRS considers abusive:

"[A] taxpayer may buy \$10,000 worth of bibles 'wholesale' from a promoter. The taxpayer holds them for 1 year to qualify as an appreciated capital gain and then donates them to a religious group. Come tax time, the taxpayer deducts \$40,000 as the so-called fair-market value of this charitable donation." ^{9/}

The taxpayer supports the deduction through an appraisal provided by the promoter which shows the current fair market value of the Bibles to be \$40,000.

^{7/} Egger, September 1982 Testimony, p. 4.

^{8/} Egger, Remarks before the Tax Section Meeting, American Bar Association, New Orleans, Louisiana, August 8, 1981, "IRS--The Present and the Future," IRS News Release--IR-81-93.

^{9/} Egger, Remarks before the Heart of America Tax Institute, Kansas City, Missouri, October 6, 1981, "Defusing Abusive Tax Shelters," IRS News Release--IR-81-122.

A different type of scheme gives a taxpayer a way to claim a large write-off for a small investment. In the same October 1981 speech, the Commissioner described this type of scheme:

"In a loss partnership deal involving movie-making, a 30-person partnership is set up with each partner investing \$50,000 to purchase a film from an independent producer. The producer also is given a nonrecourse note for \$4.5 million. For tax purposes, the film is treated as worth \$6 million and assigned a useful life of three years, giving the partnership total tax write-offs of \$2 million the first year, or \$67,000 per partner--\$17,000 more than the cash investment." 10/

A third type of scheme involves investment tax credits. In his September 1982 testimony, the Commissioner gave an example of this type:

"The scheme operates in the following manner. An entity that purchases a master recording for \$100 sells it to a production company for \$2,500. The production company sells the master to a corporate promoter for \$250,000 (or 100 times their cost). The corporate promoter pays 1% cash (or \$2,500, which was the original cost to the production company) and executes a 12-year 'recourse' note. This leverage factor of 99 to 1 is the most flagrant discovered to date. The note payments prior to the 12th year are from the proceeds of master recording sales. At the end of the 12th year, when the note is due and payable, we assume the only corporate assets that will be available for the production company to proceed against will be its own original master recording, which results in the note being essentially nonrecourse.

"The corporate promoter leases the master for 7 years, on a nonexclusive lease, to investors who are individuals and partnerships for a \$16,000 lease expense. The corporate promoter elects to pass through to the investors the investment tax credit (ITC), which is based on the \$250,000 ostensibly paid by the promoter for the master.

10/Ibid.

"The scheme generates deductions and ITC which presumably flow to the investors, eliminating their current tax liability and creating unused ITC to carry back to prior years. The investors file form 1045 (tentative carryback allowance) carrying back the unused ITC to the 3 prior years and eliminating tax liability in those years. Under IRC [Internal Revenue Code] 6411, that money is required by statute to be refunded within 90 days. The promoter will lend investors the cash, at 20% interest, to invest in the scheme. Upon receipt of the quick refund, the investor pays off the loan from the promoter.

"This scheme was sold in 1979, 1980 and 1981 with the following estimated impact:

1979 promotion---over 700 investors with about \$10 million ITC carried back;

1980 promotion---nearly 1,700 investors with over \$17 million ITC carried back; and

1981 promotion---an estimated 2,800 investors with some \$30-35 million ITC carried back.

"The total impact of this scheme for 3 years is estimated to be about 5,200 investors, with some \$57 million to \$62 million ITC passed through to them". ^{11/}

IRS' overall category of abusive tax shelters also includes some shelter schemes that clearly involve fraudulent activity. For example, in one instance a promoter marketed real estate tax shelters but backdated documents and prepared false statements to cover the fact that the real estate was not actually acquired.

In response to the growth in the number and kinds of shelters in recent years, IRS' efforts to cope with them have increased in scope. In 1973, IRS' tax shelter examinations were limited to tax sheltering activities in oil and gas. In the next 2 years, real estate, farm operations and motion pictures were added. Since then, IRS has widened its program to cover additional activities in which it encountered substantial abuse. IRS presently records the results of its tax shelter examinations in 18 specific categories such as coal, leasing, mining, lithographs, and commodities. (See app. I for the complete list.) IRS records show that the inventory of tax shelter returns in IRS' Examination Division had grown to 314,516 returns as of March 31, 1983.

^{11/}Egger, September 1982 Testimony, pp. 6-7.

IRS' INNOVATIVE EFFORTS AGAINST ABUSIVE
TAX SHELTERS

In recent years IRS has given abusive tax shelters considerable management attention and committed extensive resources to this problem area. Many of IRS' approaches for combatting abusive shelters have been innovative. In what follows, we describe actions taken by IRS and the Congress in recent years, including steps IRS is taking to address the current problems.

Administrative efforts

IRS has made abusive tax shelters a priority tax compliance activity and deals with potentially abusive tax shelters under what is sometimes called the "must work" or "mandatory examination" approach. IRS uses a variety of techniques to identify potential abusive tax shelter returns. Once IRS identifies a tax shelter which appears to be abusive, the tax returns associated with that shelter are sent to the Examination Division in the appropriate IRS district office. There the examiner, with almost no exceptions, must start an examination.^{12/} The examiner develops IRS' position regarding the tax shelter's validity and identifies all the other participants in that tax shelter whose returns may have been filed in any IRS district. The examiner may refer the return to the Criminal Investigation Division, particularly if there is a possible fraud violation involving a large scheme. After the IRS position has been developed, the taxpayer is given an opportunity to agree or disagree with IRS' conclusions.

The taxpayer may appeal the Examination Division's conclusions either within IRS through its Appeals Division, or through the Federal court system, especially the Tax Court. If the taxpayer disagrees and chooses to appeal within IRS, a committee made up of representatives of the Appeals Division, Office of Chief Counsel, and Examination Division--the ACE Committee--decides whether the case should be (1) more fully developed by the Examination Division, (2) moved forward to the Appeals Division, or (3) designated to be litigated.

^{12/} Examination Division program guidelines for fiscal year 1983 provide that two categories of examination work are to have resources devoted to them before resources are applied to the category that includes abusive tax shelters. Thus, it is now possible that some IRS districts may not have sufficient resources to examine every abusive tax shelter. However, thus far in fiscal year 1983 resources have been sufficient in all but two districts to continue the must work approach. Even these two districts have been able to examine a significant number of abusive tax shelter returns.

IRS' approach thus involves extensive efforts and resource commitments not only by the IRS Examination Division but also by such others as the Criminal Investigation Division, the Appeals Division, and the Office of Chief Counsel. In this report, unless otherwise noted, when we refer to the Tax Shelter Program we refer to the Examination Division program for abusive shelters. (See app. II for further description of the roles played by these functions and others in IRS.)

As a result of the must work approach, IRS has examined a large number of returns and devoted increasing amounts of examiners' time to combatting abusive tax shelters. According to IRS' Examination Division information system, as of March 31, 1983, there were 314,516 returns reported in the program, compared to 284,828 on September 30, 1982; 248,828 on September 30, 1981; and 174,262 on September 30, 1980. In the first 6 months of fiscal year 1983, IRS completed examinations of 35,363 returns totalling \$558 million in additional tax and penalties. In fiscal year 1982, IRS completed examinations of 71,793 returns involving \$954 million in additional tax and penalties. IRS completed examinations of 49,474 returns in fiscal year 1981 involving \$593 million in additional assessed tax and penalties. IRS completed examinations of 17,444 returns in fiscal year 1980 involving \$164 million in additional assessed tax and penalties. (See apps. I and III for more detailed statistics on IRS' current examination inventory and completed examinations.)

Similarly, the direct examination time charged by examiners to the Tax Shelter Program has been significant in the last several years:

	<u>Direct Examination Time</u> <u>Staff Days Expended</u>		<u>Tax shelter</u> <u>time as per-</u> <u>cent of total</u>
	<u>Tax Shelter</u> <u>Program</u>	<u>All examination</u> <u>programs</u>	
FY79	48,234	1,907,466	2.5
FY80	113,488	1,893,943	6.0
FY81	167,349	1,774,304	9.4
FY82	193,866	2,445,222	7.9
FY83 (6 months)	105,527	1,180,620	8.9

Conducting examinations of abusive tax shelters identified by IRS processing techniques is only one way IRS is trying to curb them. IRS has increased the level of examination coverage of high income taxpayers who are more likely to use tax shelters. IRS has also sought to identify new tax shelter schemes through other means and has issued revenue rulings giving IRS' position on the tax effect of these schemes.

In November 1980, IRS' top management took a major initiative when the Commissioner established a national office task force to evaluate the Tax Shelter Program. As a result of its study, which involved visits to 5 district offices, the task force made 35 recommendations to the Commissioner. Many of these recommendations have since been implemented. (See app. IV for a summary of the recommendations.)

Actions taken included:

- Revising procedures and devising standards to process tax shelter examinations more expeditiously through the administrative process to appeals and to litigation.
- Updating various portions of the program guidelines in the Internal Revenue Manual in areas such as asset valuations, examination and coordination procedures, and management reports.
- Formulating an approach to relieve examiners of some administrative and clerical duties by forming centralized support units in districts with a large volume of tax shelter examinations.

Legislative initiatives

In addition to its administrative efforts, IRS has sought legislative tools to deal with abusive tax shelters. In response and on its own initiative, the Congress has passed several laws designed to eliminate certain tax abuses and/or impose tougher penalties. Specifically, longstanding congressional concern over tax shelter abuse culminated in the enactment of various provisions in the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981 (ERTA), and, most recently, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Among other reforms, the 1976 act was designed to limit leveraging of certain tax shelter benefits that occurred through the use of loans for which the taxpayer had no personal liability for repayment. The act introduced the "at risk" rule which limited deductibility of certain claimed losses that exceeded the total of the taxpayer's cash investment and the indebtedness for which the taxpayer was personally liable.

However, IRS found that one unfortunate result of the 1976 tax reform legislation was the proliferation of tax shelter areas of investments where the "at risk" rule did not apply. Reacting to this change, the Congress in the Revenue Act of 1978 placed additional constraints on potentially abusive tax shelters by expanding the "at risk" principle to cover most activities except real estate investments.

Tax shelter abuse continued to be a problem and the Congress again addressed the tax shelter area. In ERTA, the Congress strengthened the civil penalties that could be used against taxpayers who inflate the appraised value of an asset. Such penalties provide an added and important disincentive to overvaluing assets in tax shelters. In addition, the Congress reduced the tax advantages of using certain transactions ("tax straddles") in the commodities market. The Department of the Treasury had estimated that such straddles alone resulted in the loss of \$1.3 billion in tax revenue in 1981.

Most recently, in some provisions of TEFRA, the Congress has given IRS additional enforcement tools. TEFRA strengthened the existing penalties and added others for use against taxpayers who participate in abusive tax shelters, as well as added penalties which can be applied to promoters of such schemes. TEFRA provides that IRS can assess a penalty against a promoter of a tax shelter arrangement who makes a gross valuation overstatement, or who makes a statement which the person knows or has reason to know is false or fraudulent as to a material matter. Gross overstatement of valuation is defined as a value relating to a credit or deduction which is more than 200 percent of correct value. The new TEFRA penalty is substantial--the greater of \$1,000 or 10 percent of the gross income derived or to be derived by the promoter from the arrangement. In addition, TEFRA adds a penalty for substantial understatement of tax liability with special rules for cases involving tax shelters. Finally, TEFRA includes a potentially powerful enforcement tool--injunction. Under TEFRA, the Government can seek an injunction in a U.S. District Court to halt conduct subject to the promotion penalty.

TEFRA may also give IRS examiners some relief from the administrative burden which currently results from tax shelter examinations. Before TEFRA, IRS examiners had to proceed separately against each member of a partnership involved in a tax shelter scheme. Now, TEFRA permits a single-audit approach to partnerships. TEFRA's single-audit approach should streamline partnership examinations and litigation. Generally, partnership returns filed for periods beginning after September 9, 1982, will be covered by the TEFRA partnership provisions.

CASE BACKLOG: A PROBLEM YET TO BE RESOLVED

In addition to the administrative and legislative initiatives discussed above, IRS has taken steps to deal with another problem--the large case backlog in all phases of the Tax Shelter Program, from examination through appeals. The backlog in the appeals process has come into existence because many taxpayers have appealed completed examinations. For the 18-month period ending on March 31, 1983, taxpayers contested 58 percent of completed examinations, involving over 90 percent of all potential taxes assessed during that period in the Tax Shelter Program.

To reduce this backlog, the Commissioner has announced a new policy designed to settle pre-1981 tax year contested cases. Under this policy, called the "out-of-pocket" expenses approach, IRS personnel will be able to offer taxpayers a settlement in which they can deduct their investment in the first year of the shelter. In addition to the out-of-pocket expenses approach, IRS may target litigation on cases where a promoter or representative did not accept an out-of-pocket settlement. IRS believes this new approach will, over time, help reduce the existing Appeals Division and Tax Court backlog.

IRS has tried to settle tax shelter examinations but many taxpayers have disputed the results

IRS reported completing examinations of 71,793 tax shelter returns in fiscal year 1982. On September 30, 1982, however, 284,828 tax returns remained in the Tax Shelter Program. Similarly, in the first 6 months of fiscal year 1983, IRS completed 35,363 examinations but 314,516 returns were reported in the Tax Shelter Program at the end of that period.

Although examinations of 107,156 tax returns were completed over the 18-month period ending on March 31, 1983, the results of 58 percent of those examinations were contested by taxpayers through the appeals system. Furthermore, the contested examinations involved over 90 percent of all the potential taxes assessed from the Tax Shelter Program during that period.

	<u>Fiscal year 1982</u>		<u>First 6 months of fiscal year 1983</u>	
	<u>Tax returns</u>	<u>Proposed tax assessment (millions)</u>	<u>Tax returns</u>	<u>Proposed tax assessment (millions)</u>
Total examinations completed	71,793	\$954.2	35,363	\$558.1
Disposition of completed examinations:				
Taxpayer agreed	24,946	85.3	12,732	58.9
Taxpayer did not agree	41,906	868.9	20,293	499.2
Examinations with no tax adjustment	4,941	-	2,338	-

New "out-of-pocket" expenses approach

In August 1982, the Commissioner approved a new policy intended to reduce the existing case backlog: the out-of-pocket expenses approach. IRS personnel can use this in pre-1981 tax year cases. Essentially, taxpayers will be allowed to deduct their investment in the initial year of the shelter as settlement. Thus, as the Commissioner put it, taxpayers "will receive no artificial tax benefits from their participation in abusive tax shelters; rather, they will receive only a dollar deduction for each actual dollar invested." ^{13/} As a further incentive, IRS plans to focus on particular groups of cases for early litigation and will consider including cases where a promoter or representative declined an out-of-pocket expenses settlement.

- - - -

The problem of abusive tax shelters has over the years proven to be persistent and difficult for IRS to combat. Promoters have continued to devise and market new tax shelters; IRS now has a case backlog which could take more than 4 years to work through; a significant administrative burden has existed for IRS examiners working in the tax shelter area; and IRS' resource commitment to tax shelters has been made at the expense of other areas in IRS' enforcement program. As the present Commissioner put it in his September 1982 testimony, there has been "continual leapfrogging between the Service and the Congress on the one hand, and tax shelter promoters on the other. Each time the IRS or the Congress developed a method of slowing or halting some objectionable shelter practice, promoters and/or investors would find some way around it--essentially jumping over the roadblocks." ^{14/}

IRS now has new tools to deal with abusive tax shelters. The out-of-pocket expenses approach to settling old cases should help IRS with the backlog in the tax shelter area, which IRS will need to deal with before it can effectively use all of TEFRA's enforcement provisions. The injunction and penalty provisions of TEFRA give IRS enforcement tools which should help IRS promote a greater degree of compliance with the tax laws. In addition, the partnership provisions of TEFRA will streamline audits of tax shelter returns and should in the future reduce the administrative burden audits involving partnerships have created for IRS examiners.

The effectiveness of these new tools and IRS' success in implementing them will become apparent in the near future. It is important that IRS begin as soon as information is available

^{13/}Egger, September 1982 Testimony, p. 8.

^{14/}Egger, September 1982 Testimony, p. 6.

to scrutinize the effect of its new tools. To assure itself that its overall strategy is indeed an effective one, and to know whether modifications need to be made to day-to-day operations, IRS will need to look carefully at how the new legislation and the new procedures are impacting on existing problems in the Tax Shelter Program.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Joint Committee on Taxation asked us to review IRS' activities in the tax shelter area. We focused on two problem areas which we believed to be of particular importance:

- the quality and use of information IRS has on the nature and size of the abusive tax shelter problem, and
- the obstacles IRS has faced in quickly and efficiently completing examinations involving abusive tax shelters.

We did our work primarily at the IRS National Office and the Los Angeles and Manhattan District Offices. These two districts ranked first and second among all IRS districts in number of tax shelter examinations and, in combination, had about 30 percent of the reported national inventory of tax returns in the Tax Shelter Program as of June 1980. At the IRS National Office, we interviewed top level officials and representatives of the Examination Division, Appeals Division, Criminal Investigation Division, the Tax Shelter Working Group under the Associate Chief Counsel (Technical) and the Office of Chief Counsel. At the district level, we interviewed both district management officials and tax examiners. We also talked to IRS officials in the Western and North Atlantic regions in which the Los Angeles and Manhattan districts are located. In all, we talked with over 100 IRS employees.

We also (1) analyzed IRS policies, procedures, and related instructions pertaining to tax shelters; (2) examined IRS management reports, correspondence, Tax Shelter Program files, internal studies and program evaluations; (3) reviewed the legislative history of the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, and the Tax Equity and Fiscal Responsibility Act of 1982 pertaining to tax shelters; and (4) reviewed numerous articles in financial publications which described tax shelter techniques, offerings, and advantages.

We supplemented our research with a judgmentally selected sample of active IRS examinations of tax returns in the Tax Shelter Program. During the period July through September 1980,

we selected and reviewed 18 tax shelter "projects" in the Los Angeles District Office and 33 tax shelter "cases" in the Manhattan District Office. ^{15/} To obtain a mix, we based our selection on one or more of the following characteristics:

- Type of shelter, e.g., coal, commodities, movies, etc.
- Number of tax returns associated with the shelter.
- Size of the potential tax adjustment.
- Age of the shelter, in terms of the initial tax year being examined.

The projects and cases selected totalled about 8,000 tax returns with \$441 million in potential adjustments to the taxable income reported in Los Angeles and 2,000 returns involving \$166 million in potential adjustments in Manhattan. We believe that this selection provided a reasonable basis for identifying and verifying the major barriers to IRS efforts in dealing with abusive tax shelters.

We completed our initial interviews and data gathering by October 1980. In November 1980 the Commissioner established a Tax Shelter Task Force to review IRS' efforts and make recommendations to him for improvement. Shortly thereafter, we shared our interim observations with the chairman of the task force prior to task force visits to five representative IRS districts (Brooklyn, Chicago, Jacksonville and the two where we had done our initial work.) Subsequently, we limited the scope of our work as it became apparent that the conclusions and recommendations of the IRS task force paralleled ours.

In March 1981, the task force made its 35 recommendations to the Commissioner. (See app. IV for a more complete description of the task force's recommendations.) There was no substantive difference of opinion between us and the task force about the obstacles to IRS' Tax Shelter Program or about the need to make improvements. Also, IRS top management began immediately to take action on most of the recommendations. Accordingly, we decided to limit our effort to monitoring IRS' progress in implementing the task force's recommendations and to developing information on some points the task force did not fully pursue.

^{15/} Projects and cases are two ways IRS organizes its tax shelter examinations. Typically, projects involve more tax returns than cases because the various tax shelter schemes of a single, common promoter will be grouped together as one project for examination purposes.

Although we did limit the scope of our work, we decided to issue this report for several reasons. First, we wanted to document for the record IRS' innovative approach to the tax shelter problem. Second, we wanted to show that there is a need for IRS to develop better management information for evaluating its abusive tax shelter strategy and program implementation, especially in light of the new tools it has recently acquired. Finally, we believe that the Joint Committee on Taxation and other committees may find this report useful in the continuing process of legislative oversight of the Internal Revenue Service and its programs.

This audit was performed in accordance with generally accepted government auditing standards.

CHAPTER 2

IRS NEEDS TO IMPROVE ITS MANAGEMENT INFORMATION ON TAX SHELTERS

In recent years IRS has demonstrated the seriousness of its commitment to combatting abusive tax shelters. It has, for example, increased the level of resources applied to this problem, formed a task force to analyze the situation and taken action on the task force's recommendations, and sought legislative relief.

With IRS' adoption of the out-of-pocket expenses approach to settling old cases and the recent legislative relief provided by TEFRA, the outlook for achieving increased compliance with the tax shelter laws has improved. Yet it is too early to tell what the results will be. IRS will need to know these results quickly. It will need to assure itself that in the changed situation its strategy is an appropriate one and its day-to-day operations are working efficiently. If such is not the case, IRS will need to make appropriate modifications rapidly so that problems do not become as troublesome as they have proven in the past.

To make the best decisions possible, IRS will need better management information than it now has. Specifically, IRS will need better management information on two levels: (1) information for strategic planning as to how to best allocate its resources and (2) information on the efficiency of its day-to-day operations. In this chapter we suggest how obtaining certain types of management information could help IRS in its future planning and operations, and we describe some significant problems that exist in IRS' current management information.

IRS NEEDS BETTER DATA WITH WHICH TO VALIDATE ITS CURRENT STRATEGY OR DEVISE A NEW ONE

At present IRS does not have reliable information on the current size of the tax shelter abuse problem and thus does not have reliable information on the estimated revenue loss resulting from tax shelter abuse. Without such information, collected over time, IRS planners will be hampered in assessing current trends and predicting future ones. They will need such information in the future to make the best possible allocation of IRS' resources and to target those resources wisely.

While we are not attempting in this report to specify all types of management information which would be valuable to IRS planners, our work has suggested certain types of information, currently not available, which would help give IRS planners better estimates of the size of the tax shelter abuse problem as

a whole. At a minimum, better management information on the size and composition of the universe of taxpayers involved in abusive shelters, on the patterns of abuse by shelter category, and on the yearly estimated revenue loss would be of use to IRS planners in their future decisions. While it is not possible to accurately estimate the additional cost to IRS of the various kinds of improved management information we are suggesting, we believe that the data elements for most of it exist now in IRS' data bases. The elements need only be compiled and used in new ways.

IRS needs to collect and aggregate
data so it can better assess trends
in shelter abuse

At present the data from the examination information system are not aggregated to provide a useful measure of (1) the size and composition of the universe of taxpayers involved in abusive tax shelters, (2) the extent of abuse as a proportion of overall taxpayer activity, or (3) the patterns of abuse by specific shelter category. As a result, IRS can neither effectively measure current trends nor predict future ones.

IRS' Tax Shelter Program statistics represent a count of the inventory of tax returns on hand at the time the count was done. While this number is useful for purposes of knowing absolute workload on hand at that point in time, it is less useful for evaluating or devising a strategy for dealing with the overall problem. For example, the returns on hand may be from many taxpayers for one tax year and one taxpayer may have returns from several tax years included in the inventory. IRS thus does not know how the number of returns under examination is changing, tax year by tax year, nor does IRS know how many taxpayers repeatedly engage in abusive tax shelter activity.

To illustrate the difference between the number of tax returns and the number of taxpayers in the Tax Shelter Program, IRS did a special tabulation, at our request, of the reported abusive shelter tax returns in two district offices.

Profile Of The Tax Shelter Program Inventory
At Two District Offices
As Of April 30, 1981

<u>Tax year</u>	<u>Los Angeles District Office</u>		<u>Manhattan District Office</u>	
	<u>Number of returns for each tax year</u>	<u>Number of taxpayers grouped by earliest return in the program</u>	<u>Number of returns for each tax year</u>	<u>Number of taxpayers grouped by earliest return in the program</u>
1973 and Prior	633	397	4,800	2,315
1974	566	355	1,293	515
1975	1,408	977	2,286	1,364
1976	3,626	2,416	4,443	2,616
1977	5,460	3,009	3,642	2,486
1978	6,277	2,925	4,040	1,255
1979	4,227	1,510	1,548	490
1980	<u>5</u>	<u>1</u>	<u>18</u>	<u>12</u>
Total	<u>22,202</u>	<u>11,590</u>	<u>24,070</u>	<u>11,053</u>

This table shows that in these two districts the number of reported tax shelter returns in the Tax Shelter Program inventory was substantially more than the number of taxpayers in the inventory. For example, these two IRS districts reported 46,272 returns but only 22,643 taxpayers; that is, on average there were slightly more than two tax returns for each taxpayer. This statistic could mean that more than 1 year of a particular shelter was under examination or that the same taxpayer was involved in separate shelters in different years. Other data in the table above also raise questions about trends in abuse. For example, the year-by-year analysis indicated that the age of the tax returns in Manhattan's inventory was much greater than in Los Angeles' inventory. Also, the number of taxpayers added each year in both districts had declined since 1977. These statistics raise such questions as whether

--new abusive tax shelters are less prevalent, or

--new cases are being identified and placed in the program more slowly because of the sheer size of the current workload.

It is difficult to draw convincing conclusions from information developed for only one point in time, but more thorough analyses of trends could be made if such data were accurately collected and aggregated on a regular basis.

Analyses of trends could help IRS decide whether its allocation and program strategy decisions should be modified. For example, if an apparent decrease in the number of abusive tax shelter returns identified in a given year were traced back to an administrative bottleneck, IRS could devise appropriate administrative solutions. If an actual decrease were found over time, IRS could evaluate whether allocating more resources would likely accelerate the downward trend or whether the downward trend might well continue even if IRS used fewer resources.

Moreover, if IRS had data on the numbers of taxpayers involved in abusive tax shelters, aggregated by income class, IRS would know better how widespread the problem is; that is, whether and to what extent tax shelter abuse occurs primarily in certain income classes. Such information would be helpful to IRS in deciding what proportion of its resources should be allocated in the future to the tax shelter area and how those resources could most wisely be targeted.

In addition to needing routinely collected and aggregated information on the number of returns and taxpayers involved, IRS also needs to better aggregate information on patterns of abuse by shelter category. IRS' automated information system presently allows shelters to be categorized in 18 categories plus an "other" category (see app. I). However, the proportion of shelters categorized as "other" has been continuously high. Aware of this problem, IRS has been updating and correcting its program data since early fiscal year 1980. It has succeeded in reducing the percentage categorized as "other" from 38 percent in September 1980, to 23 percent in March 1983. This percentage seems to us, however, to still be too high to be useful in decisionmaking.

With a more accurate breakdown of patterns of abuse by shelter category and with this information collected over time, IRS would know whether specific areas of tax shelter abuse were proving more troublesome than others. If this were the case, IRS could then identify those specific areas of abuse and target its limited resources accordingly.

To allocate scarce resources, IRS needs the best information possible on estimated revenue loss

Responding to the need to try to describe the size of the abusive tax shelter problem, the Commissioner has estimated in a public statement that the annual revenue loss to the Treasury from abusive tax shelters is \$3.6 billion (see p. 2). This estimate, to our knowledge, is the only IRS public statement on total potential loss caused by abusive tax shelters. An estimate of this kind is a positive step in providing the Congress, IRS management, and the public a more complete description of the size of the abusive tax shelter problem.

The reliability of this estimate, however, is unclear. IRS planners developed the estimate by making certain assumptions and projecting data from IRS' Taxpayer Compliance Measurement Program (TCMP). IRS planners found, from a one-time special analysis of TCMP data, that only about one of every four abusive commodity straddle shelters would be identified by regular IRS return selection techniques. The planners then assumed that this ratio could be applied to all other types of abusive shelters such as those in movies, coal, or oil and gas. The revenue projection based on this assumption produced the \$3.6 billion estimate.

In contrast to IRS planners, some IRS examination officials believe that the revenue loss estimate is too high. The examination officials argue that commodity tax shelters may not be representative of tax shelters as a whole and that data on such shelters are not the best possible on which to base revenue loss estimates. They further point out that all returns are subjected to special computer programs which flag suspect returns. They therefore believe that, other than commodity straddles, most abusive tax shelters are being identified.

If the \$3.6 billion estimate is accurate, then IRS may not be spending enough resources to curb the abuse in tax shelters. However, if the estimate is dramatically overstated, then IRS may be devoting too many resources. But regardless, without the best information possible about the size and trends in abusive tax shelters, IRS' ability to allocate its resources to the problem wisely will be impaired.

TO ASSURE ITSELF THAT CURRENT PROBLEMS IN OPERATIONS
ARE BEING SOLVED AND NEW ONES ARE NOT ARISING, IRS
NEEDS TO CAREFULLY MONITOR THE RESULTS OF DAY-TO-DAY
OPERATIONS

Despite IRS' serious commitment to combatting tax shelter abuse, program operations have experienced significant problems. Case processing times have been long and the administrative burden on tax shelter examiners has been heavy, with adverse effects on examiner morale. At present, a 4-year backlog of returns remains to be processed.

To assure itself that solutions now being implemented are having their intended effect and that no new problems in day-to-day operations are arising in the post-TEFRA environment, IRS will need accurate, and appropriately aggregated, information on the results of its operations. At a minimum, IRS will need to closely monitor the effects of the must work approach and the amount of administrative burden on examiners. In what follows, we outline the history of past problems which have contributed to the backlog and suggest some types of information IRS will need to make decisions about its procedures.

Is the must work approach still viable?

Under the must work approach (see pp. 6 and 7) IRS, in effect, has directed its examiners to examine every abusive tax shelter they identify, regardless of

- the extent or seriousness of the abuse,
- the time remaining before the statute of limitations expires, or
- the potential effect on the examination plan.

Because of this saturation approach, the number of tax returns scheduled for examination for abusive tax shelter issues increased at an unexpectedly rapid rate. As a result, our work suggested that an unintended and unfortunate by-product of this policy has been to slow completion of examinations.

In addition, the must work approach has affected other IRS programs. One IRS regional official, in an April 1979 memorandum, described the operational effect of the must work approach as follows:

"While [overall] achievement of the [total] field examination work plan and planned rates are important objectives, priority assignment and examination of subject (tax shelter) cases are tantamount to 'must work' * * *. In summary, Abusive Shelter Cases (Class III) and Protester cases must receive priority over normal general program work."

And the then-Director of IRS' National Office Examination Division recognized as early as December 1980 that the must work approach posed a potentially serious dilemma for IRS. At that time, he told us that in the future IRS might not have adequate resources to continue to identify and examine all abusive shelters and still have a balanced examination program in all other areas.

The large and growing number of tax returns with abusive tax shelter issues made IRS' day-to-day operations more difficult. As more and more tax returns were identified, more strain was placed on those resources needed to complete these examinations, including examiners, engineers and appraisers, and others involved in deciding how to dispose of examinations. The inprocess inventory of tax returns grew as more tax shelters were found and few examinations were completed.

The IRS task force concluded that IRS should recognize that certain districts may not be able to examine all abusive shelters identified. However, the task force did not recommend that the must work approach be abandoned or substantially modified, and the approach currently remains in force.

The limitations of IRS' information system prevented us from making a thorough analysis of the effect of the must work approach on the number of returns in the Tax Shelter Program. Nevertheless, we believe one point is fairly clear: the approach contributed to conditions in which tax return examinations were not being completed expeditiously.

It is too soon to tell what the impact of TEFRA will be on case processing times. TEFRA's injunction and penalty provisions may increase compliance so that fewer cases will have to be added under the must work approach. The streamlining of partnership audits may resolve the problem of the large administrative burden on examiners, which has also been a contributing factor in lengthening processing times. IRS will need to know quickly if these changes are in fact having their intended effect; that is, in the future IRS will need better management information than it now has on numbers of cases entering the system by year and on case processing times to know whether the must work approach is causing problems and, if so, to what extent.

An implicit assumption of the must work approach seems to be that examining every abusive tax shelter is an effective deterrent to taxpayers' continued involvement in abusive shelters. But rigid adherence to this approach does not appear to fully consider the tradeoffs which are involved between identifying more, newer shelters and expeditiously completing those which have already been identified. The Commissioner as early as October 1981 perceived the importance of timely results from the Tax Shelter Program. He said:

"Obviously taxpayers also know that we can't litigate every tax shelter case * * *. Many of those 8,500 cases were docketed as far back as 1975. They bear no relationship to tax shelters being marketed today. If and when they're closed, the case precedents may not have much impact on shelter sales that are going on now." ^{1/}

^{1/} Egger, Remarks before University of Chicago Law School, 34th Annual Federal Tax Conference.

In the event that IRS' management information indicates that past problems stemming from the must work approach continue, IRS strategic planners should consider a change in strategy such as examining selected, rather than all, suspect returns.

Administrative burden on examiners has contributed to long processing times

The complex nature of tax shelter examinations has created a significant administrative burden on examiners. The following table shows the results of estimates made for us between June and September 1980 by 43 examiners in two district offices. The examiners estimated that, on average, they spent 63 percent of their direct examination time on administrative tasks.

	<u>Los Angeles</u>	<u>Manhattan</u>	<u>Total</u>
Administrative hours	13,560	2,265	15,825
Total hours charged to tax shelter examinations	22,029	3,156	25,185
Percent administrative time (administrative hours divided by total hours)	62	72	63

In addition, we identified a January 1980 Manhattan District Office study, which had not previously been forwarded to IRS headquarters, that analyzed 995 tax shelter examinations performed by 40 examiners and found that 62 percent of the examiners' time (18,809 hours out of 30,244) was spent performing administrative duties.

Management information of this type had not been available to IRS planners and some IRS officials were initially skeptical about the validity of these estimates. However, subsequent to our briefing of IRS officials, the IRS Tax Shelter Task Force found similar conditions when they visited five districts, including the two we reviewed. The examiners interviewed by the task force estimated that generally between 40 and 70 percent of the direct examination time charges on tax shelter examinations were for tasks considered administrative in nature.

The large paperwork burden typically created by processing a tax shelter examination has had several causes. In contrast to the examination of one taxpayer in a single IRS district, the examination of a tax shelter scheme typically involves a promoter and many taxpayers located in more than one IRS district. Furthermore, these examinations are often partnership

examinations because many tax shelter promotions are organized with the promoter as the general partner and the investors as limited partners. Rather than devoting most of their time to gathering the facts of the examination and developing IRS' position, examiners have spent much of their time identifying those taxpayers involved in the tax shelter, locating the appropriate tax returns, and keeping track of the returns of each partner. This last task has been important because the examiner needed to take action to protect the Government's interest when the statute of limitations was close to expiring. The statute was a factor in many tax shelter examinations because these examinations take a long time to complete. As a result, additional paperwork was needed to secure the consent of each participant to extend the examination period.

Many examiners told us that administrative tasks resulting from problems encountered during the examination specifically involved (1) identifying and securing tax returns and (2) controlling and coordinating intradistrict and interdistrict tax shelter examinations. To assist in controlling returns and managing paperwork, IRS developed various computer systems. These systems were to control partners' returns until tax adjustments, if any, resulted from the partnership examination. To ensure proper handling of returns, IRS established procedures for (1) requesting and initiating control of all returns related to a partnership examination, (2) notifying each district office of returns in that district that have been filed by investors in tax shelters that are under examination in another district, and (3) providing information on the location and status of returns during the course of the examination as well as notification of the results of the examination.

IRS has had several case control systems. One element of IRS' computerized Audit Information Management System (AIMS), the AIMS Control of Related Returns, has assisted in requisitioning and controlling partners' returns in partnership examinations whether in the district where the books and records of the partnership are located or in other districts where some partners' returns are maintained. In addition to AIMS, IRS developed the Related Returns Notification System to have the computer generate forms providing data regarding the initiation, status, and disposition of tax shelter examinations. This system could produce, where warranted by volume, reports by computer rather than manually. Several other systems exist which have been regionally, rather than nationally, developed and implemented. For example, the Combined Case Control System was designed to control large groups of interrelated or centrally controlled cases. This system, developed and used in the Western Region, provides certain additional capabilities to

other existing systems that control returns and produce reports, such as tracking the statutes of limitations of tax shelter returns. ^{2/}

As a part of its work, the IRS Tax Shelter Task Force looked at the case control systems described above. The task force concluded that the existing systems were "ineffective, redundant, and do not provide the proper information and control necessary for our field personnel to fulfill their mission." The task force recommended a series of procedural, technical and system improvements, some of which have been implemented while others are being studied further.

In the future, the partnership provisions of the Tax Equity and Fiscal Responsibility Act of 1982 should alleviate part of this administrative burden. These provisions will enable IRS to audit partners in a single proceeding against the partnership. Where such provisions are applicable, examiners will not have to track examinations of all the individual partners involved and the statutes of limitations which apply to them. A 1982 IRS analysis of the effect of this new law concluded that IRS could save approximately 1,000 examiner staff-years because IRS would no longer need to secure and control related returns in tax shelter examinations of partnerships. IRS estimated that these staff years, when applied to other returns in need of examination, would result in \$275 million in additional assessed tax per year. While we did not attempt to validate this figure, we agree that IRS' burden should be reduced. In hearings before the House Committee on Ways and Means leading up to the passage of TEFRA, we suggested that the proposed partnership provisions would greatly simplify IRS' task in administering the tax laws as they relate to partnerships, individuals, and other entities involved in partnerships and Subchapter S corporations.

IRS will need to know soon whether in fact the administrative burden is easing and, if so, whether the new levels of burden are acceptable. If IRS finds that they are not acceptable, IRS should take appropriate action. One action IRS might consider is using additional support staff more frequently to perform some administrative tasks commonly done by examiners. By so doing, the examiners' time now charged to these tasks could either be used to examine other abusive shelters or be used in other parts of IRS' examination program. Potential benefits of

^{2/} Subsequent to the completion of our audit work, IRS officials told us that the system was extended nationwide in October 1982.

this change would include: (1) increased revenue; (2) reduction in the amount of examiner time per tax shelter examination; and (3) improved examiner morale in the Tax Shelter Program.

According to the estimates we made when we did our work, the potential financial payoff of freeing examiners from a portion of the administrative tasks associated with tax shelter examinations could be substantial. In the pre-TEFRA environment we estimated that at least \$45 million in additional taxes and penalties could have been assessed annually by the five IRS District Offices (Brooklyn, Chicago, Jacksonville, Los Angeles and Manhattan) included in the IRS Tax Shelter Task Force study. Our estimate assumed a reduction from 60 to 20 percent of examiners' time devoted to administrative duties and further assumed that examiners would be freed to work on examinations other than tax shelter returns. IRS officials in the Los Angeles and Manhattan District Offices believed that a reduction of this size could be achieved by using additional support staff. (See app. V for details of our methodology and assumptions.)

While the potential increase in assessed tax and penalties is a strong incentive to reduce administrative burden, another effect would be improved examiner morale. Several examiners working on tax shelter examinations told us they had little enthusiasm for accepting additional tax shelter examinations. Sixty-seven percent of the 43 examiners we asked said that, if given a choice, either they would not choose another tax shelter examination under any circumstances, or they would only if certain conditions were met, such as relief from the administrative and clerical tasks associated with abusive tax shelter examinations. Similarly, the IRS task force reported that 62 percent of the examiners interviewed said they did not want to be assigned to another tax shelter examination after completing the tax shelter examination(s) to which they were presently assigned.

CLOSER MONITORING OF OUT-OF-POCKET EXPENSES APPROACH IS WARRANTED

Under IRS' recently adopted out-of-pocket expenses approach (see p. 11), IRS personnel will be able to offer taxpayers a new way to settle pre-1981 cases. The approach thus offers promise for reducing the backlog of old cases thereby relieving some of the burden on the Appeals Division and Chief Counsel.

However, it is too soon to tell if the approach will work as planned. IRS will need information on how many cases are being settled under the approach and how many taxpayers are refusing settlement. IRS will also need to know how litigation against promoters or representatives who refuse an out-of-pocket

settlement is proceeding. Since the history of tax shelters is one in which IRS has had to contend with rapid change, IRS will need information to assure itself that the out-of-pocket expenses approach is indeed proving effective in reducing the backlog and, if not, to decide how best to change the approach.

CONCLUSIONS

In the new post-TEFRA environment, IRS will need management information not currently available in order to make strategic and operational decisions on how to deal with tax shelter abuse. The need for such information is underscored by the history of IRS' past efforts against tax shelters. Despite innovative approaches and close attention by IRS top management, the number of abusive shelter returns continued to grow, and problems occurred in program operations. Now that IRS has acquired new enforcement tools and adopted the new out-of-pocket expenses approach to settling pre-1981 cases, operations may run more smoothly and the number of new returns identified may decline as compliance increases. IRS will need to monitor the results of recent changes to make sure they are having the intended effect and, if they are not, to decide quickly on new actions as appropriate.

IRS needs improved information on two levels--strategic and operational. On the strategic level, IRS will need to collect and appropriately aggregate better management information on the current size of the problem and the estimated revenue loss caused by tax shelter abuse. With such information, IRS' strategic planners will be in a better position to gauge current trends and predict future ones. They will then be able to make the best possible strategic decisions on how to allocate IRS' limited resources in the future.

On the operational level, IRS will need to monitor how well the must work approach, with its resulting demands on IRS' limited resources, is working in the new situation. IRS will also need to assure itself that the levels of administrative burden on tax shelter examiners are easing and that old cases are being settled as expected under the out-of-pocket expenses approach. With better management information on case processing times and program workload, IRS will be more able to assure itself that operations are running efficiently or, if they are not, take administrative action as needed. Better management information on operations will be important also for strategic planners: if past problems are not being solved or if new ones arise, IRS planners will need to consider making strategic changes, such as modifying the must work approach, or seeking further legislative relief.

RECOMMENDATIONS TO THE COMMISSIONER
OF INTERNAL REVENUE

We recommend that the Commissioner develop such management information as is appropriate and necessary to more accurately gauge the current size of the problem of abusive tax shelters and the impact IRS is having on noncompliance in this regard.

For example, reliable estimates of revenue loss, of the total universe of abusive shelters by type and of the total universe of taxpayers involved in them would help IRS know how big the problem is. The trends developed from this information could, over time, show the impact of IRS' efforts. Information could also be aggregated to show whether tax shelter abuse is widespread or whether a relatively small number of repeat offenders are involved, and whether IRS' use of TEFRA's penalty and injunction provisions is affecting noncompliance. With such information, IRS would be in a better position to validate its current strategy for combatting abusive tax shelters or devise new approaches.

We also recommend that the Commissioner develop such management information as is appropriate and necessary for determining whether TEFRA and administrative changes have eliminated the causes of past problems, such as the uncompleted examination case backlog and administrative burden on examiners, and for identifying as early as possible any other obstacles to effective and efficient program operations. If, in implementing this recommendation, IRS finds that the must work approach is still resulting in administrative difficulties, we further recommend that the Commissioner:

- reassess the goal of expeditiously examining every abusive shelter which is identified, in light of this goal's impact on IRS' examination plan,
- formulate, if this goal is found to be no longer attainable, criteria for deciding which abusive tax shelters are most in need of examination, and
- make more extensive use of centralized support staffs and computer, rather than manual, systems to further free examiners from clerical and administrative tasks.

In the long run, the out-of-pocket expenses approach should help IRS settle old cases and relieve the resulting burden on the Appeals Division and Office of Chief Counsel. TEFRA's partnership provisions should ease the administrative burden on examiners, thus improving their morale, and shorten case processing times. If so, IRS may not need to make further changes. To assure itself that this is indeed the case,

however, IRS will need to develop appropriate information. If past problems persist or new ones develop, appropriate management information can help IRS decide whether administrative modifications are needed or whether further legislative relief should be sought.

AGENCY COMMENTS AND OUR EVALUATION

In a letter dated June 23, 1983, the Acting Commissioner of Internal Revenue commented on a draft of this report. (See app. VI.) He said that IRS agreed with the basic thrust of the report and that it had already taken some steps to improve its efficiency in responding to the problem of abusive tax shelters.

He also said that IRS plans to act on all but one of our proposed recommendations. IRS did not agree with our proposal to develop a more systematic method for recording decisions of the Appeals, Counsel and Examination (ACE) committees in order to monitor their activities. These are committees in each district which decide the disposition of tax shelter cases after they have been reviewed by the Examination Division. IRS pointed out that it had recently narrowed the function and responsibilities of the ACE committees and that, for this reason, it believed that any management information from these committees would now have limited applicability. In view of this change in the role of the ACE committees, we have dropped that proposed recommendation from our report.

IRS also indicated that our report may overemphasize the issue of the reliability of IRS' \$3.6 billion estimate of the revenue loss attributable to tax shelters. Our purpose in discussing that estimate was to illustrate the need for better data to support more informed operational and strategic decisions. IRS' comments indicate that it recognizes this need and now plans, through two current Taxpayer Compliance Measurement Programs and other means, to obtain more specific information for use in making future estimates of the tax shelter revenue loss.

Tax Shelter Returns Reported In Program Inventory

<u>Shelter type</u>	<u>IRS shelter code number</u>	<u>9/30/80</u>	<u>9/30/81</u>	<u>9/30/82</u>	<u>3/31/83</u>
Oil and gas	101	14,894	20,488	19,683	20,559
Real estate	102	23,318	34,593	39,985	42,912
Farming	103	5,134	8,996	8,676	8,704
Movies	104	22,753	26,122	27,938	28,113
T.V. video tapes	105	2,031	3,342	4,846	5,889
Coal	106	13,861	20,834	26,152	26,780
Commodities	107	5,244	9,791	15,247	18,575
Master recordings	108	3,748	7,392	12,840	13,296
Leasing	109	4,000	6,753	11,902	17,452
Books	110	2,281	3,984	5,170	5,811
Cable T.V.	111	1,743	3,068	4,216	4,682
T-bills	112	-	5,284	12,441	15,977
(note a)					
Health care	-	1,394	-	-	-
(note a)					
Contributions	113	1,058	1,663	2,757	2,904
Foreign trusts	114	749	1,210	290	293
Mining	115	3,218	6,204	12,488	15,670
Patents	116	984	1,349	2,189	2,057
Lithographs	117	1,204	2,767	5,044	6,243
Research and development	118	842	1,940	4,687	6,890
Other (note b)	<u>015</u>	<u>65,806</u>	<u>83,048</u>	<u>68,277</u>	<u>71,709</u>
Total		<u>174,262</u>	<u>248,828</u>	<u>284,828</u>	<u>314,516</u>

a/Code 112 is assigned for T-bills. Health care rather than T-bills was reported in the 9/30/80 AIMS report.

b/Includes shelter types not listed above and returns which had not been coded to individual shelter types.

Source: IRS AIMS Table 40.5

IRS' Efforts To CurtailTax Shelter Abuse

This appendix describes in more detail IRS' organization to fight abusive tax shelters and IRS' continuing efforts to identify and examine abusive tax shelters.

IRS' organization

IRS' approach to abusive tax shelters, a serious tax compliance problem, consumes substantial resources throughout IRS' organization. The primary elements of the approach are: identifying and examining all abusive tax shelters; issuing guidance as quickly as possible in the form of revenue rulings about IRS' position on new shelter techniques; and resolving examinations of tax shelters as expeditiously as possible. IRS may also assist in developing needed legislation to curb certain abuses and in pursuing criminal investigation and prosecution in certain instances. The major organizational roles are outlined below. ^{1/}

Commissioner's office

The Office of the Commissioner provides the overall program policy direction, and the Commissioner serves as IRS' chief spokesman. In this capacity, the office has been active in several specific activities regarding tax shelters such as:

- Emphasizing through speeches the importance and priority of IRS' activities against abusive tax shelters.
- Approving initiatives designed to improve IRS' effectiveness.
- Suggesting legislative proposals to tighten the tax code, increase penalties, and improve IRS' efficiency in tax shelter examinations.

Examination Division

A policy directive on December 12, 1977, established the current organizational structure for examining and investigating tax shelter cases. This arrangement grew out of a national office coordinated program started in 1973 for examining potentially abusive schemes in the oil and gas industry. The coordinated program was envisioned to provide close cooperation and

^{1/} Some others within IRS play a less direct program role and, therefore, are not discussed in detail here. Some examples include: Assistant Commissioner (Planning, Finance and Research) and Internal Audit.

coordination among the examination, appeals, litigation, and rule making functions of the IRS. The program was expanded in the next 2 years to include real estate, farming operations and motion picture tax shelters. The program's objective was to examine cases, identify issues, develop IRS positions on tax shelters determined to be abusive, and identify cases for litigation. While the National Office maintained overall coordination, a field coordinator knowledgeable in the industry was selected for each shelter activity.

In 1977, the Commissioner concluded that the initial objective of IRS' efforts was achieved. The Tax Shelter Program was then incorporated into the regular returns examination program so that the audit efforts could be expanded.

The Assistant Commissioner, Examination, among his other duties, is responsible for the overall planning, coordinating, and monitoring of the Tax Shelter Program and for uniformity and nationwide coverage within the program. This includes developing guidelines and procedures, continuing liaison with other national office functions and providing assistance in establishing an effective training program.

In the Tax Shelter Program, examination tax shelter coordinators at each level--national, regional and district--serve as coordination links. A region may issue supplemental instructions to a National Office guideline or may be the impetus for some experimentation. The National Office may use a regional initiative as the basis for a National Office directive. For example, the Western and North Atlantic regions have been pioneers in enhancing computer programs to identify tax shelters and help manage the resulting paperwork. Each has also published pamphlets which describe various tax shelter schemes.

At the district level, the chief of the Examination Division is responsible for designing an action plan and appointing a district tax shelter coordinator who serves as the day-to-day focal point for the Tax Shelter Program. District group managers, the first line supervisors in the Examination Division, are responsible for specific duties in the district examination of tax shelter cases. These include duties such as:

- Coordinating with the tax shelter coordinator, district counsel and other districts in multi-district cases.
- Assigning returns for examination to examiners who can start, do, and conclude examinations expeditiously.
- Referring potential fraud cases to the Criminal Investigation Division (CID).
- Providing guidance so that cases proceed in a timely manner and are consistent with instructions from IRS' National Office, regional offices, and district offices.

Criminal Investigation Division

Another compliance organization, the Criminal Investigation Division, investigates suspected criminal tax violations. It selects and investigates fraud cases which involve large schemes or may have a high tax compliance effect (e.g., deterrence). For example, CID would investigate if the promoter of a tax shelter was suspected of fraud. Such tax evasion can occur when one or more of the following elements are part of a tax shelter scheme.

1. The asset upon which the scheme is based does not exist.
2. The asset exists, but its value is deliberately highly overstated based on false appraisals.
3. Documents such as the prospectus, deeds, contracts, and agreements are false or have been backdated.
4. The amount paid by the investor to the promoter is not spent for the purpose intended.

By IRS National Office directive, one of CID's top five priority programs is its program against abusive tax shelters. However, each region and district has flexibility to tailor its objectives to meet local needs. From October 1, 1978, through September 30, 1982, IRS reported that CID's investigations resulted in 48 convictions.

Appeals Division

The Appeals Division becomes involved in tax shelter cases if the taxpayer disagrees with the recommended tax adjustment of the Examination Division. Under procedures designed to expedite tax shelter cases, a committee of three--a representative from district counsel, one from appeals, and the district examination tax shelter coordinator--decides if the case should be further developed by Examination Division, settled by Appeals Division or expedited to litigation.

Associate Chief Counsel, Technical

A group of analysts under the Associate Chief Counsel, Technical, are assigned to develop revenue rulings. Such revenue rulings provide examiners with the "official Service position" that they must follow when examining new and novel tax shelter schemes. This group was established in January 1980 to strengthen IRS' overall attack on abusive tax shelters by quickly identifying instances where a revenue ruling was needed and by quickly publicizing a position. By identifying and ruling on new tax shelter issues, IRS hoped also to alert taxpayers

about IRS' position, thereby providing an additional deterrent to participating in abusive tax shelters.

Identifying and examining more
potentially abusive tax shelters

IRS has been improving its system of selecting tax returns in order to identify more abusive tax shelters. Since a partnership loss "flows through" to an individual tax return, tax shelters were often marketed by limited partnerships. However, IRS largely ignored the partnership return as a possible starting point for conducting its examinations. IRS relied instead on the returns of the individual partners to indicate which partnership entities should be examined. But IRS found this "back door" approach to be ineffective and untimely for dealing with the proliferation of complex tax shelter partnerships. In 1978, IRS expanded this to a "front door" approach by selecting partnership returns for audit and then tracking the returns of the individual partners.

In response to "at risk" reform, more tax shelters began to be found on other tax reporting forms. Thus, IRS developed additional methods to identify abusive schemes reported on other tax forms such as Schedule C--Profit or (Loss) From Business or Profession.

Largely because of the use of tax shelters, IRS also changed the way it groups tax returns by income class. For 25 years, returns were grouped by classes based on adjusted gross income. The net effect of IRS' approach to allocating examination resources among these classes is generally the higher the income class, the greater the chance of being audited. But artificial deductions--largely abusive tax shelters--caused many returns of taxpayers with high incomes and complicated financial and tax affairs to be classified in low adjusted gross income classes with a correspondingly lower probability of being audited. To correct this problem, IRS has started to categorize returns based on total positive income--the sum of all positive income items appearing on a return without subtracting losses. IRS believes this latter approach is a more accurate measure of the taxpayers' tax activities and results in more examination resources being devoted to higher income taxpayers. For example, a taxpayer with \$200,000 in salary and \$180,000 in income adjustments will no longer be in the same group with a taxpayer earning \$25,000 with \$5,000 in income adjustments.

Tax Shelter Program Accomplishments

Shelter type	Fiscal year 1981			Fiscal year 1982			First 6 months of fiscal year 1983		
	Number of returns	Assessment (\$000)		Number of returns	Assessment (\$000)		Number of returns	Assessment (\$000)	
		Taxpayer agreed	Taxpayer did not agree		Taxpayer agreed	Taxpayer did not agree		Taxpayer agreed	Taxpayer did not agree
Oil and gas	5,561	\$ 3,130	\$ 16,853	5,838	\$4,266	\$28,823	1,766	\$1,803	\$11,294
Real estate	8,486	4,532	34,549	10,914	8,993	61,642	4,849	5,881	30,643
Farming	2,634	2,555	23,951	4,667	4,417	29,005	1,957	1,451	14,240
Movies	9,376	3,337	131,956	9,418	6,392	110,588	3,521	4,739	39,298
T.V. video tapes	662	581	8,310	1,525	1,514	13,400	758	1,260	7,961
Coal	2,762	1,797	66,664	5,536	8,804	135,881	2,958	5,433	48,541
Commodities	2,324	1,703	37,166	3,716	4,240	85,801	1,686	3,815	57,477
Master recordings	1,305	943	25,349	4,310	5,005	46,864	3,790	4,503	28,538
Leasing	1,363	992	11,865	2,508	3,114	31,881	1,600	2,363	20,028
Books	729	188	11,412	1,252	2,465	25,618	813	1,646	13,939
Cable T.V.	198	120	8,835	805	894	17,339	520	380	7,898
T-bills	390	974	7,620	1,903	6,169	61,878	1,925	6,635	50,382
Contributions	604	370	7,584	750	866	8,349	493	902	3,722
Foreign trusts	294	100	16,631	165	198	6,855	49	108	891
Mining	762	884	9,839	3,595	10,335	54,231	2,013	7,403	29,743
Patents	200	102	1,191	701	514	9,615	226	284	3,254
Lithographs	250	79	4,909	893	2,355	18,478	861	2,060	24,398
Research and development	459	166	25,567	835	1,375	16,589	385	371	31,756
Other (note a)	<u>11,115</u>	<u>8,338</u>	<u>112,347</u>	<u>12,462</u>	<u>13,358</u>	<u>106,060</u>	<u>5,193</u>	<u>7,858</u>	<u>75,177</u>
Total (note b)	<u>49,474</u>	<u>\$30,893</u>	<u>\$562,597</u>	<u>71,793</u>	<u>\$85,277</u>	<u>\$868,898</u>	<u>35,363</u>	<u>\$58,895</u>	<u>\$499,181</u>

a/Includes shelter types not listed and returns which had not yet been recoded to individual shelter types.

b/Detail may not add to the total due to rounding.

SOURCE: IRS AIMS Table 40.6

IRS Tax Shelter Task ForceRecommendations By Program Area

The IRS Tax Shelter Task Force, which is cited throughout this report, was formed in November 1980 and issued its final report to IRS top management in March 1981. The task force made 35 recommendations designed to improve IRS' performance in completing examinations of tax returns involving abusive tax shelters. Recommendations were made in the following areas:

<u>Program area</u>	<u>Number of recommendations</u>
1. Tax shelter statistics	2
2. Volume of tax shelter returns-started and unstarted	6
3. AIMS procedures, administrative time, and clerical staffing	5
4. Use of computers	2
5. Maintaining tax return files pending completion of related examinations	3
6. Revisions to procedures for expediting tax returns to counsel and appeals	6
7. Engineering	4
8. Identifying tax shelter returns	3
9. Taxpayer/representative procrastination	1
10. Morale of employees	2
11. Miscellaneous areas	<u>1</u>
	<u>35</u>

Calculation Of Potential Benefit
Through Freeing Examiners Of
Some Administrative Duties

	<u>Col. 1</u>	<u>Col. 2</u>	<u>Col. 3</u>	<u>Col. 4</u>	<u>Col. 5</u>	<u>Col. 6</u>
IRS District Office	Total FY 80 applied staff hours for tax shelter examinations (note a)	Reduction in examiner administrative tasks (60% to 20%) (Col. 1 x 40%)	FY80 examination results of individual returns other than tax shelter returns Average hours Tax and Penal- per return ties per return (note b) (notes b and c)		Production gains from reduction in examiners' administrative tasks ----- Additional returns examined (Col.2 divided by Col.3)	Additional tax and penalties (note c) (Col.4 x Col.5) (millions)
Brooklyn	42,648	17,059	17.7	\$5,130	964	\$ 4.94
Chicago	38,952	15,581	15.2	3,645	1,025	3.73
Jacksonville	86,936	34,774	16.3	6,989	2,133	14.90
Los Angeles	109,376	43,750	14.5	4,751	3,017	14.33
Manhattan	82,440	32,976	24.9	6,284	<u>1,324</u>	<u>8.32</u>
Total					<u>8,463</u>	<u>\$46.22</u>

a/SOURCE: Audit Technical Time Reports (ATTR), - Z-25 Tables - "Tax Shelter Applied Time Analysis." For the purpose of the GAO analysis, the Z-25 data was converted from staff days to staff hours.

b/SOURCE: AIMS, Table 70.0 - "Source of Returns."

c/Dollar amounts reported represent assessments, not collections.

Methodology and Assumptions Used to
Calculate the Potential Effect of
Freeing Examiners of Some Administrative Duties

The estimate of additional tax and penalties which could be assessed is based on reducing from 60 percent to 20 percent the proportion of the examiner's administrative time charged to direct examination time of abusive tax shelters (see col. 6 on previous page for calculation of additional tax and penalties). For example, if an examiner charged 100 hours to tax shelter examinations, the portion attributable to administrative tasks would be reduced from the current estimate of 60 hours to 20 hours. IRS officials in the Los Angeles and Manhattan district offices believed that a reduction to 20 percent is reasonable and achievable if certain actions were taken, such as establishing centralized administrative support groups to perform these tasks.

Also, we used the following assumptions to estimate the additional tax and penalties:

1. Administrative time charges averaged 60 percent of all tax shelter direct examination time in the two districts we reviewed and the three additional districts included in the IRS task force study. The actual rates ranged from 40 to 70 percent.
2. The additional time made available through reducing examiners' administrative tasks would be used to examine more individual returns that are not tax shelter returns. Using individual returns from all sources except tax shelters in our projections yields results which are more conservative and more reliable.
3. Clerical staff can perform administrative duties in the same amount of time that examiners currently are doing them.

To arrive at the net benefit from this change, the estimate of the potential increase in tax assessment and penalties was reduced by about \$800,000, the estimated cost of clerical staff to perform those administrative tasks which examiners are performing. This salary estimate is the sum of the reduction of examiners' hours spent on administrative tasks for the five districts, multiplied by \$5.52, the hourly rate of a GS-4, step 1, administrative/clerical specialist at the time of our calculations. The costs of related fringe benefits are not included in the calculation.

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

JUN 23 1983

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "With Better Management Information IES Could Further Improve Its Efforts Against Abusive Tax Shelters."

We agree with the basic thrust of the report and have already taken steps that will improve the Service's efficiency in responding to the problem of abusive tax shelters. Our specific comments on the report recommendations are enclosed.

We would like to clarify one aspect of the report text regarding the \$3.6 billion estimate of tax shelter revenue loss projection from the Service's Taxpayer Compliance Measurement Program (TCMP). Even though the report states that the reliability of the estimate is unclear, it appears to attribute more to the figure than was intended when it was originally submitted on July 1, 1981. At that time, it was pointed out that the estimate was rough and subject to a great deal of uncertainty because the data in the shelter area was limited. In connection with future estimates of the tax shelter revenue loss, there are plans to obtain more specific tax shelter and shelter related information in two current TCMP surveys on partnership returns and individual returns. In addition, information will be obtained about "at risk" activity under section 465 of the Code.

With kind regards,

Sincerely,



Acting Commissioner

Enclosure
Comments on report recommendations

IRS COMMENTS ON RECOMMENDATIONS CONTAINED IN
DRAFT REPORT ENTITLED "WITH BETTER MANAGEMENT INFORMATION
IRS COULD FURTHER IMPROVE ITS EFFORTS AGAINST ABUSIVE TAX SHELTERS"

Recommendation: The Commissioner develop such management information as is appropriate and necessary to more accurately gauge the current size of abusive tax shelters and the impact IRS is having on noncompliance in this regard.

Response: We concur and will study the need for additional management information in this area.

Recommendation: The Commissioner develop such management information as is appropriate and necessary for determining whether TEFRA and administrative changes have eliminated the causes of past problems, such as the uncompleted audit case backlog and administrative burden on examiners, and for identifying as early as possible any other obstacles to efficient and effective program operations.

Response: It is still too early to tell with any certainty if the relevant TEFRA provisions are working as intended. Once we have more operational experience with TEFRA overall, we will be in a better position to examine the adequacy of these provisions. We agree that such management information is necessary, and plan to develop such information as is appropriate and feasible.

Recommendation: The Commissioner:

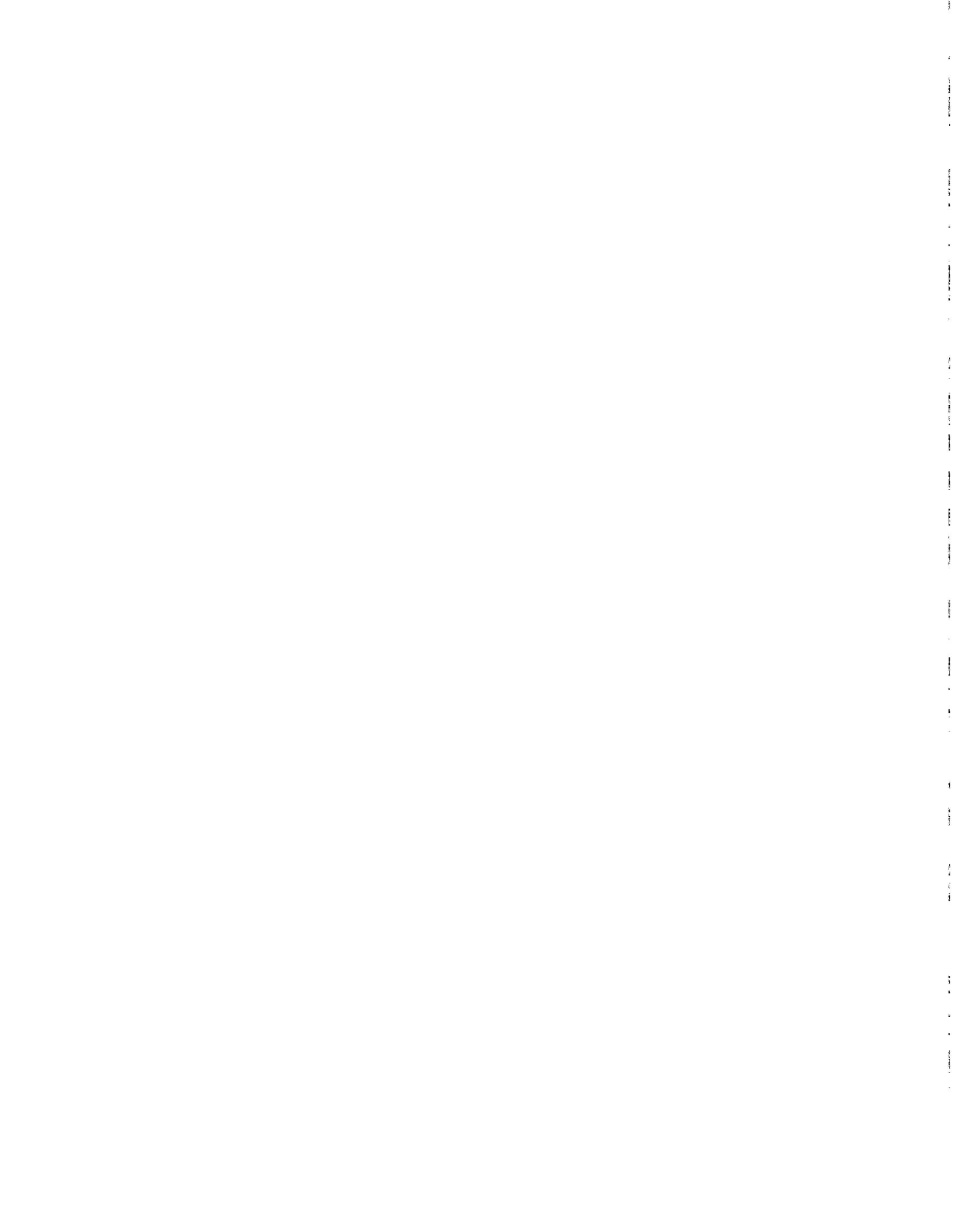
- reassess the goal of expeditiously examining every abusive shelter which is identified, in light of the goal's impact on IRS' examination plan,
- formulate, if this goal is found to be no longer attainable, criteria for deciding which abusive tax shelters are most in need of examination, and
- make more extensive use of centralized support staffs and computer, rather than manual, systems to further free examiners from clerical and administrative tasks.

Response: We concur and are in the process of implementing this recommendation. In Fiscal Year 1984, the Examination Program Guidelines will require that resources be devoted to stopping shelters in mid-stream by utilizing the injunctive and promoter penalty provisions under TEFRA. Criteria are being established to determine not only those shelters most in need of examination but also those appropriate for the injunctive and promoter penalty provisions. The implementation of the partnership provisions of TEFRA will make more extensive use of centralized support staffs and computers at the service centers which will reduce administrative duties in the districts.

- 2 -

Recommendation: The Commissioner develop a more systematic method for recording decisions of the ACE committees in order to monitor their activities.

Response: We do not feel that this is appropriate because in August 1982, the definition of litigating vehicle was redefined based on our experience in the area. This redefinition resulted in the narrowing of the function and responsibility of the ACE committees. Thus, any management information from these committees would have very limited current applicability.



AN EQUAL OPPORTUNITY EMPLOYER

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

**OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, \$300**

**POSTAGE AND FEES PAID
U. S. GENERAL ACCOUNTING OFFICE**



THIRD CLASS