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IRS' Efforts to Ensure Corporate
Tax Compliance

Statement of
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Before the
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Committee on Governmental Affairs
U.S. Senate



IRS' EFFORTS TO ENSURE
CORPORATE TAX COMPLIANCE

SUMMARY OF STATEMENT BY
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The Nation's tax gap--the difference between the amount of income tax owed for one tax year and paid voluntarily--is over \$100 billion and growing rapidly. The Internal Revenue Service (IRS) has estimated this income tax gap to be \$85 billion for 1987 and projected that it would reach \$114 billion by 1992. This tax gap is over one-third of the deficit that the administration projects for 1992. IRS estimates it will ultimately collect about one-quarter of each year's tax gap. IRS estimates that corporations account for \$31 billion of the \$114 billion gap.

The corporate tax gap has grown 3 times faster than the gap for individuals, and new evidence suggests that the gap for small corporations may be even greater than the estimates suggest. New IRS audit results show that 2.3 million small corporations (about 80 percent of all corporations) voluntarily paid 61 percent of the tax they owed in 1987. For 1980, just 7 years earlier, IRS audit results showed this voluntary compliance to be 81 percent. This dramatic drop in compliance contrasts sharply with much higher compliance levels for individual taxpayers during this period--about 82 percent.

GAO is reviewing corporate tax compliance and IRS' program to audit the largest corporations in the country. It appears that IRS may be losing its ability to promote voluntary compliance among the largest corporations because of various IRS management problems that have persisted since the late 1970s. For example, IRS does not know how much of the additional taxes it recommends from an audit are ultimately billed to the corporation after the appeals process. Also, IRS training for revenue agents has not kept pace with changes in the economy and in laws that are very difficult to administer (e.g., transfer pricing and intangible assets). GAO believes these problems partially explain why IRS estimates that large corporations appeal 80 percent of the taxes IRS recommends and that corporations win 75 percent of the appealed amounts.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to testify on corporate tax compliance and the Internal Revenue Service's (IRS) program to audit the largest corporations in the country--the Coordinated Examination Program. We are reviewing this program, and our testimony today will discuss our initial observations, setting the stage for our continuing work.

Our major points are: (1) the Nation's tax gap--the difference between the amount of income tax owed for a year and voluntarily paid--is over \$100 billion and growing; (2) the corporate tax gap has grown much faster than the individual gap, and new IRS evidence suggests that the gap for small corporations may be greater than estimated; and (3) IRS may be losing its ability to promote voluntary compliance among the largest corporations because of IRS management problems that have persisted since the late 1970s in an era of complex and changing tax laws.

THE NATION'S TAX GAP

IRS estimated that individuals and corporations failed to voluntarily pay about \$85 billion in 1987 income taxes and that this amount will grow to almost \$114 billion in 1992.¹ This "tax

¹These amounts exclude the remittance tax gap, which covers tax liabilities that taxpayers report but do not voluntarily pay in full, and which IRS estimated will be \$13.3 billion in 1992.

gap" is over one-third of the deficit that the administration projects for 1992.² Another tax gap as large or larger will be created in 1993 if voluntary taxpayer compliance does not improve. IRS estimates it will ultimately collect about one-quarter of each year's tax gap.

The projected 1992 tax gap is broken down into \$83 billion owed by individual taxpayers--a category that includes sole proprietors, partners, and self-employed people--and \$31 billion owed by corporations (see chart 1).

The individual tax gap includes people who fail to file a tax return or who file a return but do not report all income or claim too many deductions. IRS attributes almost all of the \$31 billion corporate tax gap to small and large corporations. IRS defines large corporations as those with assets of \$10 million or more; they account for \$24 billion, or 76 percent of the corporate tax gap. Small corporations--those with assets below \$10 million--make up \$7 billion, or 23 percent. The remaining \$0.4 billion (1 percent) is attributed to fiduciaries and other entities.

²In addition, taxpayers owed IRS about \$100 billion in accounts receivable as of February 1991. IRS had billed taxpayers for these taxes, penalties, and interest but the bills had not been paid. These amounts covered numerous tax years and included unpaid income, excise, and employment taxes. This \$100 billion would include IRS' remittance tax gap.

IRS bases its tax gap estimates on a variety of data, assumptions and techniques. Some may quibble over their accuracy and the way they are developed. We believe the estimates are valuable, not as precise measures, but as indicators of trends in the health of our Nation's voluntary tax system. Those trends show a disturbing drop in voluntary compliance by corporations.

CORPORATE TAX GAP GROWING OVER 3 TIMES
FASTER THAN THE TAX GAP FOR INDIVIDUALS

Over the period 1982 to 1992, the corporate tax gap will have grown over 3 times faster than the individual tax gap (chart 2). For corporations, the estimate grew nearly 200 percent--from \$11 billion to \$31 billion. For individuals, the tax gap estimate grew 60 percent--from \$52 billion to \$83 billion. This change in the make-up of the tax gap was largely due to the expected shift in overall tax liabilities following the 1986 Tax Reform Act. The portion of corporate income subject to tax was expected to grow while individual taxes were expected to fall. The estimated tax gap for corporations is likely to grow even higher when IRS updates it to reflect the most recent audit results.

New IRS Audit Results Show Dramatic
Decline in Small Corporation Compliance

New IRS audit results show that 2.3 million small corporations (about 80 percent of all corporations) voluntarily paid only an estimated 61 percent of the tax they owed in 1987. For 1980, just 7 years earlier, IRS' audit results showed that small corporations paid 81 percent of the taxes owed.³ If this dramatic drop in compliance for small corporations is accurate, it contrasts sharply with the stable voluntary compliance by individual taxpayers during this period--about 82 percent. It also suggests that small corporations did not pay their fair share of taxes in 1987 compared to other taxpayers. IRS does not know if compliance has improved since 1987 because these results are the latest available.

IRS estimates voluntary compliance for small corporations by auditing every line on a random sample of their tax returns. IRS recently summarized the results of the 19,000 1987 tax returns it audited to compute the 61 percent compliance rate. The summary shows estimates for the universe of small corporations.

³An analysis of IRS' audits of 1980 returns showed two-thirds of all small corporations failed to report part of their income. IRS has not done a similar analysis for audits of 1987 returns to determine what portion did not report all income.

- About half of the noncompliance was due to unreported income (\$15.4 billion) and half was due to overstated deductions (\$14.9 billion). The comparable figures for 1980 returns were about \$5 billion and \$6 billion, respectively.

- Small corporations in the Western part of the United States had the lowest compliance level in the Nation. They paid less than half of their 1987 income taxes (46 percent)--33 percentage points lower than IRS found in 1980. Small corporations in the Midwest had the highest compliance in 1987, paying 73 percent of their taxes.

- The underpayment of taxes exceeded \$6 billion and penalties would total \$1.7 billion, including \$873 million for substantially understating the tax liability, \$445 million for negligence, and \$225 million for fraud.

- In addition to the corporate tax gap, the officers and shareholders of small corporations failed to report \$10.6 billion in income on their individual income tax returns. This income was in the form of interest-free loans, personal use of corporate automobiles, personal travel, and other such constructive dividends.

Because the decreased compliance data are considered preliminary, IRS has not yet revised upward the \$7 billion tax gap estimate in

1992 for small corporations. Regardless of the size of the revised tax gap, corporations that do not voluntarily pay their taxes diminish the public's respect for our voluntary tax system. Moreover, it is unfair to other taxpayers who then bear a larger share of the tax burden.

While the reasons for this unprecedented decline in compliance between 1980 and 1987 are not known, several things are known about this time period.

-- There were major changes to the tax laws. The 1987 returns were the first ones that corporations had to file after the tax law was changed so substantially in 1986 to increase corporate tax liabilities. Corporate officials may not have fully understood how to apply the new tax law, resulting in higher noncompliance.

-- IRS and corporations did not (and still do not) receive information returns (e.g., Form 1099) for payments to corporations. IRS data show that when individual taxpayers know that IRS is aware of payments they received, they are more likely to report the income on their tax returns. IRS estimates that small corporations did not report about \$15 billion in total income for 1987. Of this amount, about \$2 billion was not reported for just five types of income--rent, capital gains, interest payments, royalties, and

dividends. These types of income could be included in an information returns program.

-- IRS' audit coverage for small corporations declined. From 1980 to 1987, it declined from 6.1 percent to 1.1 percent.⁴ IRS officials attributed this decreased audit coverage to shifts in resources from corporations to tax shelters.

We are concerned that the budget proposed for IRS in 1992 will do little to regain the level of audit coverage in 1980. Although the budget proposes about a 1-percent increase in examination staff years, total revenue agent staffing will still fall short of the numbers on board in 1988. While our tax system relies on taxpayers to voluntarily assess their tax liability and file returns on time, the threat of an IRS audit is a key component to maintaining voluntary compliance. When audit coverage declines to where small corporations are encouraged to play the "audit lottery," IRS may find itself incapable of reducing the growth in the tax gap created by the absence of a credible audit threat.

Mr. Chairman, even though compliance among small corporations appears to have dropped dramatically, large corporations account for most of the corporate tax gap. The third major area of our

⁴The audit coverage increased to 2.1 percent in 1990. Does not include audits of corporations without balance sheets.

testimony addresses IRS' management of its program for auditing the largest corporations--the Coordinated Examination Program.

IRS' MANAGEMENT OF THE COORDINATED EXAMINATION PROGRAM

In 1966, IRS began the Coordinated Examination Program to audit the Nation's largest and most complex corporations. The program covers about 1,500 corporations with assets usually greater than \$250 million.

This program was established because of the growth that took place in the size of corporations during the 1950s and 1960s and because of the realization that IRS' traditional "one case, one agent" approach no longer resulted in effective tax audits of large businesses. The Coordinated Examination Program relies on a team approach often involving several IRS districts and specialists, such as engineers and computer analysts.

CEP-recommended taxes account for a growing portion of all IRS-recommended taxes--from 43 percent in 1987 to 59 percent in 1990. (see chart 3.) CEP-recommended taxes have increased from about \$7 billion in 1987 to about \$11 billion in 1990--about a 57-percent increase.

IRS believes this program is the most productive examination program because it generates over half of the taxes that IRS

recommends from all examinations. But neither we nor IRS know how much of this recommended tax gets assessed and collected.

Nearly \$6 Of Every \$10 In Recommended
Taxes Apparently Are Never Billed

After an IRS audit team "recommends" that a corporation pay more taxes, the corporation may appeal the team's recommendation. In a 1989 study, IRS estimated that large corporations were appealing 80 percent of taxes recommended and winning 75 percent of the appealed amounts. In other words, IRS is apparently losing almost \$6 of every \$10 in recommended taxes and only assessing \$4 after the appeals process. IRS' estimate was not derived from actual case results, and no trend data is available to determine whether this "assessment rate" has increased or decreased.

IRS officials consider the assessment rate too low. If IRS' estimate is correct, we also believe the assessment rate is too low. We do not know at this point all the factors to blame for the "low assessment rate." Our work to date indicates a high level of frustration among IRS revenue agents who perceive that Appeals is "giving away" CEP-recommended taxes. Conversely, taxpayers and appeals officers told us that revenue agents do not adequately support their recommended tax adjustments. Appeals officers also said they try to settle as many cases as possible

to keep "too many" from going to court. In some cases we reviewed, appeals officers supported the revenue agents' position, but settled for a much lower amount to close the case. Revenue agents told us that when IRS does not take cases to court, taxpayers appeal more and more of the CEP-recommended taxes, particularly when they think a better bargain can be reached in appeals.

Whether taxpayers are being subjected to unwarranted examination recommendations or just benefiting from a lenient appeals function, they are appealing taxes "more and more". As of January 1988, \$25 billion was in dispute from taxpayers who were each appealing \$1 million or more. By January 1991, this amount had grown to \$36 billion--a 44 percent increase. Although precise data are not available, IRS officials said they believe most of these appealed amounts are from CEP. We are not sure where this trend may go. But growing workloads will undoubtedly make the job of the appeals officer even more difficult.

IRS has recently made several administrative changes to CEP that officials hope will improve its effectiveness. For example, IRS has created a new position--Executive Director of CEP--to provide overall direction to the program. Also, IRS' attorneys are getting involved early in the examination to help educate the audit team on the information needed to resolve issues that the team may raise during the examination.

Because our study of CEP is in its early stages, it is too soon for us to assess whether IRS' recent changes will improve the program as well as the assessment rate. However, we have reason not to be optimistic. IRS' recent studies and our interviews of IRS officials show the same problems exist today that were reported over 13 years ago.⁵ Chart 4 shows some of the most persistent management problems.

No Reliable Data on CEP-Recommended
Taxes That Are Ultimately Collected

What we find most intolerable is IRS' continuing inability-- nearly 25 years after CEP was created--to say what it ultimately receives in revenues as a result of CEP. As early as 1977, Congress heard testimony that IRS did not have the basic data necessary to manage the program effectively and determine whether CEP was promoting voluntary compliance. IRS did not have a system to identify (1) the amounts of CEP-recommended taxes that were appealed, assessed, and ultimately collected; and (2) which tax issues generated the most disputes with corporations and the most difficulties in sustaining them through Appeals.

⁵Hearings before the House Ways and Means Committee, Subcommittee on Oversight, September 1977, Serial 95-43.

Today, little has changed despite Congress' recommendation in 1978 that IRS develop such a system. IRS has once again begun a pilot system that might provide the necessary data, but it will be at least 5 years before useful data start to become available, and trend data will take even longer. As a result, most of the measures we will give you today are estimates that IRS made on the basis of limited data and the judgment of knowledgeable staff. Until reliable data become available, we must settle for a much less satisfactory measure of CEP's success--recommended taxes.

IRS Training Has Not Kept Pace

With Changing Tax Laws

In 1977, Congress heard testimony that many IRS field personnel were not receiving adequate training to effectively audit the sophisticated large taxpayers in CEP. For example, a former IRS District Director with 28 years' experience testified in 1977 that, in his opinion, CEP consisted of superficial examinations made by inexperienced, unsophisticated, untrained personnel.

Since then, the Internal Revenue Code has changed more than 100 times and has doubled in size. IRS revenue agents told us they have a hard time keeping up with constantly changing tax law. A senior IRS official said continuous changes to the law may be a greater problem than the complexity of its various provisions.

On the basis of our recent visits to three IRS district offices and our reviews of IRS studies, it appears that IRS' training has not kept pace with the changes to the law. Revenue agents we interviewed have not seen improvements in training they say they need to recommend taxes that can be sustained in appeals. The story we heard from one revenue agent illustrates the problem.

We interviewed the agent shortly after he had completed his first CEP examination in the insurance industry in several years. He said that he did not understand many of the complex laws passed in recent years that applied to the industry. As a result, he proposed an incorrect adjustment to the taxpayer's return. The taxpayer proceeded to explain the law to him and helped him to calculate the "correct" tax liability.

This agent was not alone. We have heard consistent complaints about training and IRS' own studies over the years have reached similar conclusions.

Inadequate training and guidance in how to administer certain sections of the Code may also lead to a low assessment rate. For example, Congress passed a law in 1981 authorizing a tax credit for research and experimentation expenses that IRS officials we interviewed say would take a scientist to administer. In their opinion, IRS has not written comprehensive guidelines that

revenue agents and taxpayers can follow. Because of the lack of clear guidance and training on what constitutes "research", an Examination official said revenue agents are having a very difficult time challenging corporations who are throwing the "kitchen sink" into their definition of "research".

Moreover, IRS training may not have kept pace with the changing domestic and global economy. The explosion in corporate mergers and acquisitions in the mid-1980s has led to numerous disputes between IRS and corporations that attempt to write off the costs of intangible assets included in the purchase price. The growing amount of assets and receipts of foreign-controlled corporations with United States subsidiaries has led to an increase in disputes with taxpayers over the cost of goods sold in the U. S., which is used to calculate taxable income. IRS had previously found this problem primarily among domestic companies that exported goods.

Behind the Times

In 1977, IRS was 3 to 5 years behind in auditing tax returns from large corporations. This delay made it difficult for the corporations to find the data that IRS requested and required IRS agents to figure out what the tax laws were when the tax return was filed. Today, IRS is auditing returns filed in the mid-

1980s, and corporations and revenue agents continue to complain.

Chart 4 also shows many other management problems that have persisted since 1977. IRS' studies show, for example, that (1) IRS districts that support another district's examination still do lower quality audits and are late completing them; (2) audits still are poorly planned, resulting in inefficient use of staff; and (3) CEP specialists, such as engineers and computer analysts, are still poorly used.

We have appended a case study to illustrate some of these problems and show how we calculated the assessment rate for an examination of a large corporation's tax return. The case study also demonstrates a few of the tools Congress has authorized to provide IRS more leverage in the audit process.

Tools That Benefit IRS

As we continue our work, we will be reviewing how well various tools are working. For example, corporations are subject to a penalty and must pay interest on any taxes still owed if they underpay their taxes by 10 percent (at least \$10,000). In addition, if a corporation does not provide requested information, IRS may issue a summons to obtain it. Our initial work raises questions about how effective these tools are.

A corporation can avoid the underpayment penalty by disclosing controversial tax positions it has taken. From the corporation perspective, this disclosure provides all the information IRS needs to identify audit issues. From the revenue agent perspective, this disclosure may be too vague to identify audit issues and yet global enough to preclude a penalty.

IRS does not have information on how often it encounters problems obtaining information. Revenue agents told us they often have trouble getting information but are reluctant to use a summons because it creates an adversarial relationship with the corporation. The corporation may believe that IRS' information requests are ambiguous, too encompassing, or seek information that is so old it is not easily obtained. Agents also said the summons process takes time to be enforced.

Corporations in CEP can pay substantial amounts of interest on additional taxes that result from an audit. Thus, they theoretically have an incentive to settle issues early to save interest costs. (The incentive is lessened to the extent that corporations believe they will win on appeal and avoid interest costs altogether.) Unlike individuals, corporations may deduct interest payments on their tax returns, which lowers the effective cost to the corporation. For the period 1987 to 1990, IRS' average effective interest rate was about 8 percent--lower than corporations' 14 percent average after-tax return on

investment during the same period. Last year, Congress increased the interest rate by 2 percentage points on a corporate underpayment that exceeds \$100,000. Corporations may also avoid interest charges by paying the recommended tax assessments and seeking a refund through a U.S. District Court or Claims Court.

As we continue our work, we will explore how effective these tools have been, whether IRS could make better use of them, and whether they should be revised.

HOW CAN CEP BE IMPROVED?

As our work continues, we will attempt to determine whether IRS' recent changes to CEP are effective and whether other changes are warranted. At this point, we know of three improvements that would help IRS to manage CEP better and ensure that large corporations pay their fair share of taxes.

First, Congress should take every opportunity to make IRS' very difficult job a little easier by simplifying sections of the Internal Revenue Code that are particularly troublesome for IRS to administer and for corporations to comply with. Some Code sections appear to be beyond IRS' ability to properly administer regardless of the level of training. For example, later this year we will issue a report that discusses how Congress could simplify the rules for amortizing the price of intangible assets

purchased in a corporate acquisition. Another GAO report will discuss ways to reduce foreign-owned corporations' disputes with IRS' determination of the costs of goods sold in the United States.

Second, we think it is vital that Congress and the administration be given accurate information to judge the effectiveness of CEP in generating real (rather than recommended) revenues. IRS needs to carry through on its efforts to develop that information.⁶ Until then, IRS will continue to spend resources on its examinations, including those in CEP, without knowing what those examinations produce.

Third, we believe that IRS employees assigned to CEP need far more training on our Nation's changing and complex tax laws. This training should emphasize the documentation and evidence needed to ensure that any recommended taxes can be sustained in appeals. Other recommendations may follow when we complete our work.

That concludes my statement, Mr. Chairman. My colleagues and I will be pleased to answer questions.

⁶Tax Administration: IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990).

CEP CASE STUDY

We developed the following case study to illustrate (1) the kinds of problems IRS often confronts when auditing a large corporation and (2) the rate at which CEP-recommended taxes were ultimately assessed against the corporation.

IRS began auditing a large corporation's returns for 2 tax years within 1 year of the latest return filed. At various intervals over the next 7 years, IRS expanded the audits to include 6 later tax years.

IRS estimated the audit of the earliest tax years would be completed within 7 months. The audit was not completed until about 8 years later.

Based on information from quarterly case status reports, IRS attributed most of the delays to the taxpayer refusing to provide IRS with records necessary to complete the audits. However, the IRS was slow to legally enforce its document request through the use of summonses. The following section shows the delays and other problems IRS confronted during the 8 years of audit work.

Within 3 months of the start of the audit, CEP team members had decided to examine, among other issues, the taxpayer's cost of

goods sold. The cost, if inflated, would cause the corporation's taxable income and taxes to be too low. Ultimately, this became the major audit issue on all 8 tax years.

The IRS team asked permission to visit the parent company's facilities to gather information needed to develop the issue. The parent company denied the request and advised IRS to obtain the information by other means. IRS requested the information by the means advised about 1 year after the start of the audit.

Although the taxpayer continued to refuse to provide the data, IRS did not serve summonses until 3 years after the initial request. The taxpayer refused to comply and the team forwarded a request for summons enforcement to Chief Counsel at IRS Headquarters.

After additional efforts failed to produce the information, hearings were set in the U.S. District Court about 4 years after the initial data request. The court ordered the taxpayer to turn over certain information. The taxpayer provided the information about 5 years after IRS' initial document request and 6 years after the start of the audits.

During the audits, the team confronted other problems internal to IRS. For example, we were told by a district official that IRS

economists were hesitant to take on such a complex issue and that its attorneys believed the case was too controversial. Seeking expert advice, IRS hired 2 consultants whose work was not used because IRS attorneys lacked confidence in their case preparation and costs theory--thus, relying again on its own economists. Also, IRS experienced a high turnover rate in the attorneys assigned to the case--4 in all. By comparison, the revenue agents turnover rate was low.

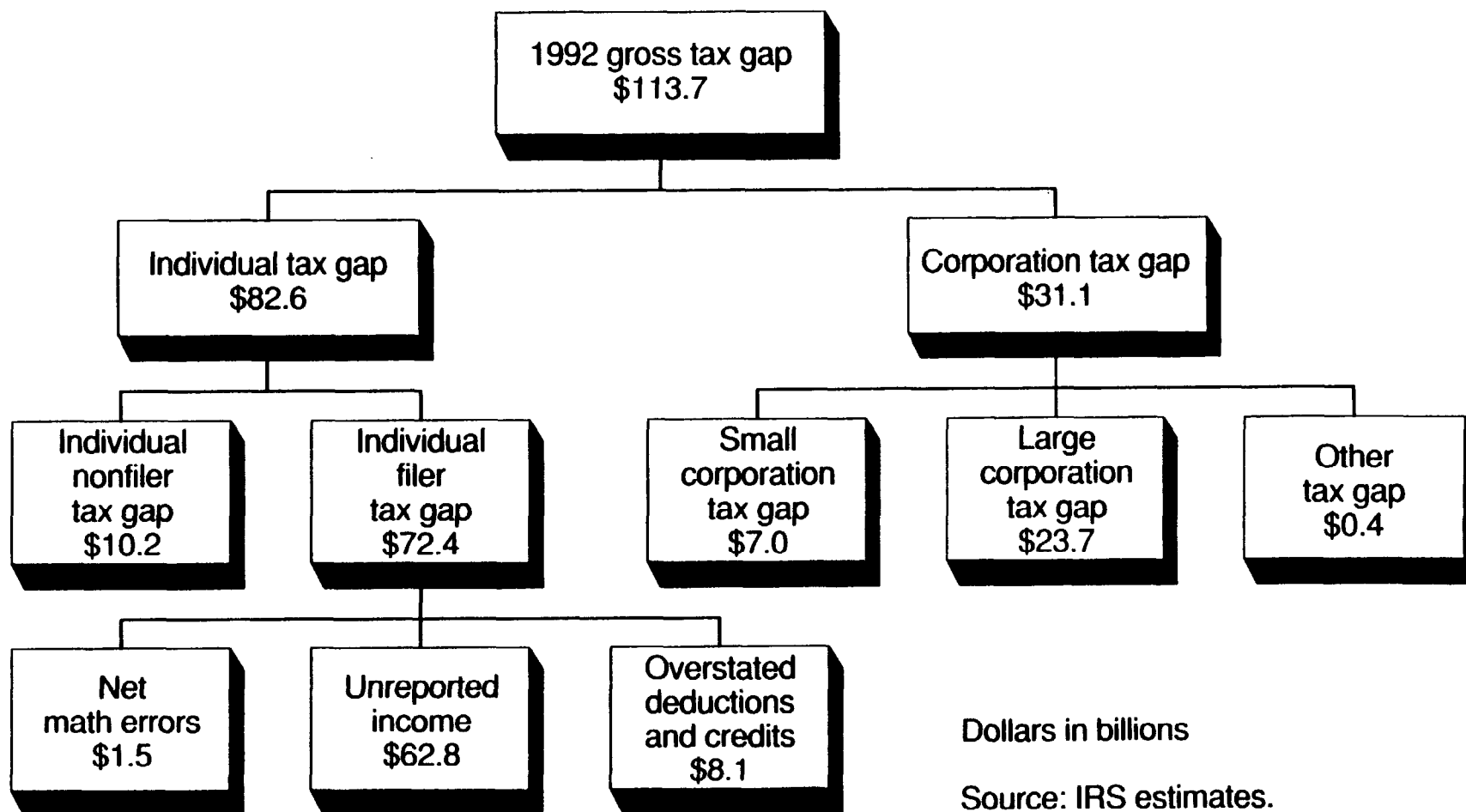
By the time the audits were completed, the team had spent about 10 revenue agent staff years auditing the 8 returns and recommended that the corporation pay additional taxes of about half a billion dollars. Information was not readily available on time spent on the case by IRS economists, attorneys and managers. The corporation agreed to pay about 1 percent of the CEP-recommended amount and appealed the balance.

The cases were sent, at the request of the taxpayer, to IRS' Office of Appeals about 18 months after IRS received the information it needed to develop cost data. Appeals officials, however, had the audit team perform additional audit work because they believed the issue was poorly developed. Within 2 years, the case was closed when IRS and the taxpayer agreed to settle for about 32 percent of the amount appealed.

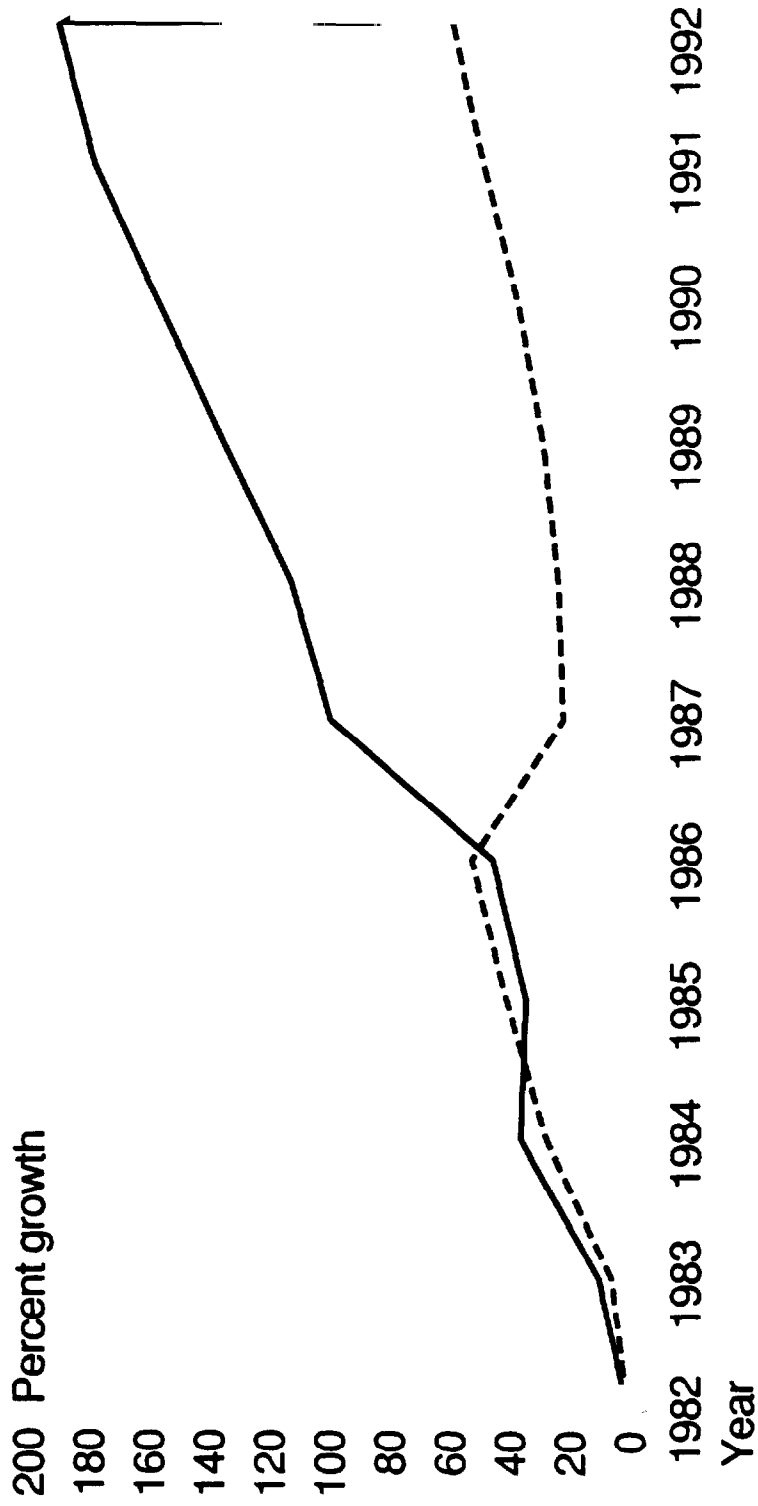
Adding the amounts settled in appeals to the amounts the corporation previously agreed to pay, the ultimate assessment represents an assessment rate of 33 percent of the original CEP-recommended amount. In addition, the corporation paid about the same amount in interest and penalties. The corporation finished making all the payments in about 10 years after the audit work first began.

IRS District Examination Officials told us that in their opinion, those revenues would have been even greater had they been allowed additional time to develop the cost of goods sold after they received the information from the taxpayer. However, they felt pressured by IRS headquarters into closing the case because of the length of the audits.

GAO Estimated 1992 Tax Gap



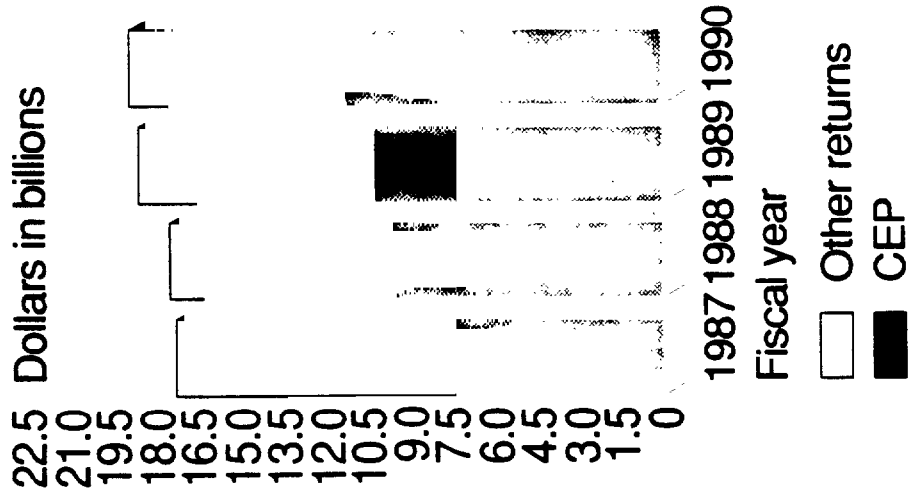
GAO Corporate & Individual Tax Gap Growth, 1982-1992



— Corporations
--- Individuals

Source: IRS data.

GAO Recommended Dollars, CEP & Other Returns, 1987-1990



Source: IRS data.

GAO CEP Management Problems Persist

Problem	1977/1978	1989/1990
Lack of reliable data	X	X
Insufficient training	X	X
Examinations not current	X	X
Insufficient support audits	X	X
Poor audit planning	X	X
Poor use of specialists	X	X
Poor coordination among functions, districts	X	X

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