

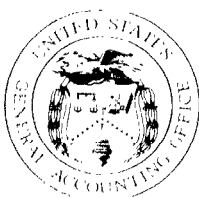
April 1992

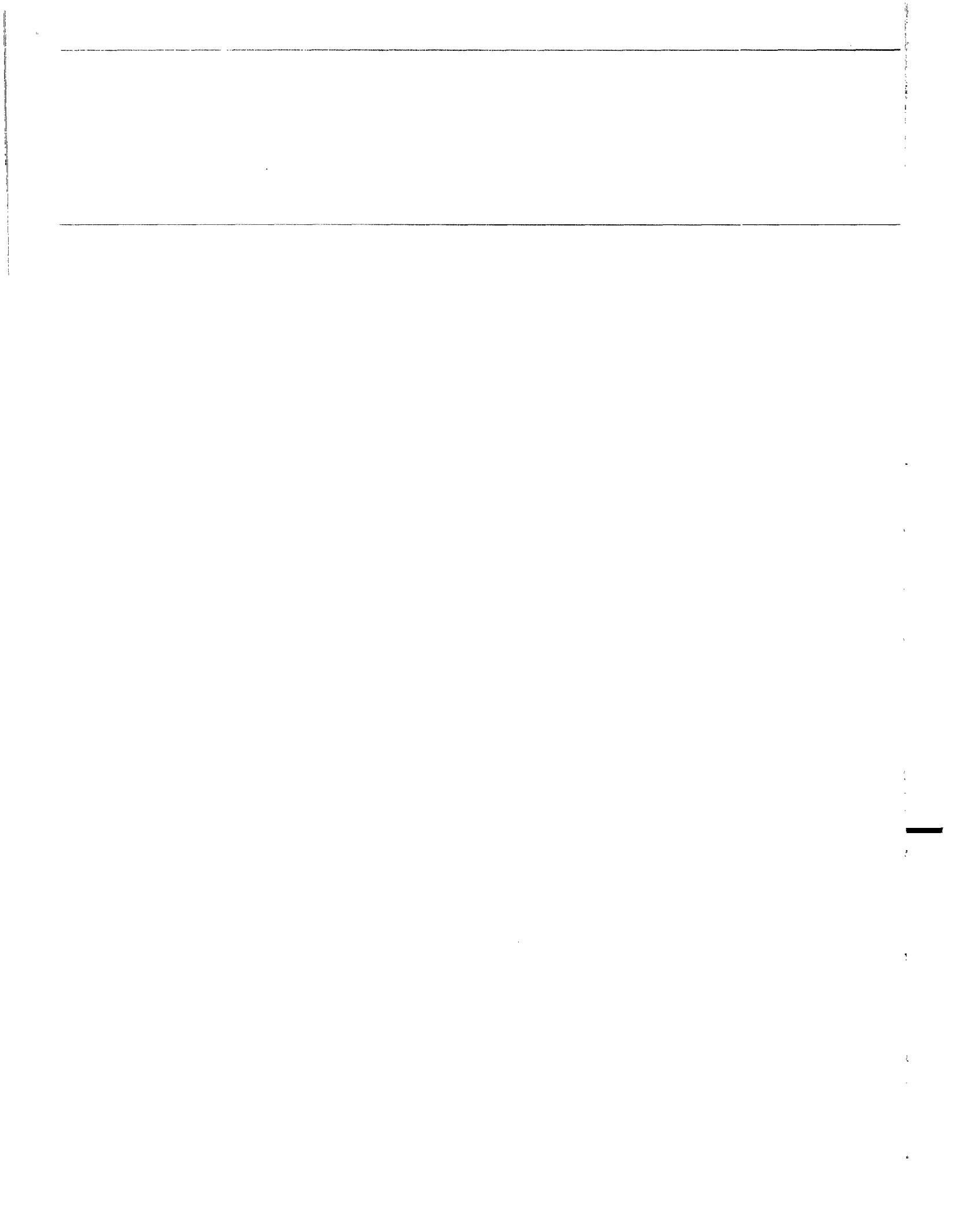
**TAX
ADMINISTRATION**

**IRS Undercover
Operations
Management Oversight
Should Be
Strengthened**



146527







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

General Government Division

B-246692

April 21, 1992

The Honorable Harry Reid
United States Senate

The Honorable Richard Bryan
United States Senate

This report responds to your request that we review the Internal Revenue Service's (IRS) management of its undercover operations. The report makes several recommendations that we believe would strengthen the management and oversight of IRS' undercover operations and reduce IRS' vulnerability to operational breakdowns and misuse of funds. Based on a separate request by you and Congressman James Bilbray, we are issuing a related report that specifically addresses your concerns about an IRS undercover operation known as Project Layoff, which was carried out in 1984 and 1985.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

Please contact me at (202) 275-6407 if you or your staff have any questions. Other major contributors to this report are listed in appendix IV.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Executive Summary

Purpose

Senators Harry Reid and Richard Bryan asked GAO to review how the Internal Revenue Service (IRS) manages its undercover operations. This request stemmed from concerns with IRS' management of an undercover operation, called Project Layoff, carried out in 1984 and 1985 during which IRS agents established a Las Vegas bookmaking business in an attempt to identify unreported gambling income. This operation has resulted in continuing allegations of misuse of funds and has prompted broader concerns over the adequacy of IRS' controls and oversight of its undercover operations. GAO addressed Project Layoff more specifically in a separate report.

Background

An undercover operation is a potentially risky investigative technique. IRS' Criminal Investigation Division (CID) uses undercover operations to help investigate illegal activities such as money laundering and fraudulent tax return preparation. In doing so, CID special agents assume identities other than their own. A special agent might pose as a taxpayer to obtain evidence that a tax return preparer is preparing fraudulent returns or as a financial consultant willing to launder money for a suspected drug dealer. During money laundering operations, which involve over half of IRS' undercover activities, IRS agents may come in contact with dangerous drug dealers, wear concealed recording equipment, and handle large sums of money. They also must avoid entrapping the subject of the investigation.

Undercover operations are generally carried out and managed by CID staff in IRS district offices, but the largest, most costly, and most sensitive operations—known as Group I operations—must be approved at the National Office by the Assistant Commissioner (Criminal Investigation). Less costly or shorter operations—known as Group II operations—are approved by a regional commissioner. Once approved, district office CID staff members are to manage and monitor the operations in accordance with detailed operational and financial guidelines. In fiscal year 1990, CID used undercover operations in 152 of its 5,280 criminal investigations, at a cost of about \$1.4 million.

GAO did audit work at IRS' National Office, four regional offices, and eight district offices and based its work on IRS' guidelines for conducting undercover operations. GAO reviewed 183 undercover operations completed during fiscal years 1988 through 1990, including 33 Group I operations and 150 Group II operations. Two-thirds of the Group I operations involved investigations of alleged money laundering.

Results in Brief

IRS has procedures in place that if consistently implemented should help minimize the risks associated with conducting undercover operations. However, GAO found that these procedures were often not observed, increasing IRS' vulnerability to the operational breakdowns and misuse of funds that were alleged in Project Layoff. For example, IRS staff did not do required operational and financial reviews on some of the projects that IRS categorized as the largest and most sensitive operations. GAO's review did not disclose substantive breakdowns or misuse of funds. However, by not following IRS' established procedures, CID faces increased risk of potentially embarrassing or costly problems.

While IRS has a good set of procedures in place, they could be enhanced to better protect against operational vulnerability. For example, GAO found that the process for approving undercover operations does not include a written assessment of alternative investigative techniques to help ensure that this sensitive technique is the most cost-effective or appropriate way to achieve intended results. Further, IRS does not use baseline measures to periodically evaluate completed operations and provide feedback on operational effectiveness. Without such feedback, IRS has no way of ensuring that the lessons learned from a given operation or group of operations are used to help improve future operational performance.

Given the problems that could potentially result from misuse of funds and operational breakdowns, GAO believes that more management attention and priority needs to be given to the oversight of these projects. First, IRS needs to reaffirm the importance of monitoring and auditing the operations and expenditures of each project. This monitoring and auditing is especially important for those large and sensitive projects approved by the Assistant Commissioner. Second, the agency could further reduce its exposure to risk by requiring that the approval process document that other investigative techniques have been considered prior to the authorization of an undercover operation. Third, the National Office should take a stronger role in evaluating and measuring the results of completed operations so that lessons learned could be applied to future operations.

Principal Findings

CID Often Did Not Follow Required Controls

GAO found that CID often did not follow required operational and financial controls intended to aid in managing undercover operations and safeguarding government funds. For example, CID staff did not do operational reviews for 25 percent (6 of 24) of the Group I operations or closing financial reviews in 46 percent (75 of 156) of all operations in which funds were expended. In one operation in which financial reviews were not done, funds from a subsequent undercover operation were used to pay overdue business expenses incurred during the original operation. Other control problems noted by GAO included failure to document preoperational planning meetings in 38 percent (70 of 183) of the operations and instances in which operational funds were not promptly deposited in an interest-bearing account, as required.

Request to Initiate an Undercover Operation Should Include an Assessment of Alternatives

To begin an undercover operation, special agents are required to prepare an undercover request, which is to be approved by IRS regional management or, in the case of the larger, more sensitive, Group I projects, the Assistant Commissioner. Although a request provides information about operational objectives, the plan of action, and estimated costs, GAO found that the request does not include a written assessment of alternative investigative techniques that may have been considered by field operatives and regional oversight officials. For example, an alternative to using an undercover agent during an investigation of an alleged fraudulent return preparer would be using an informant or a client either to testify against the return preparer or to gather evidence during a meeting with the return preparer while wearing concealed monitoring equipment.

Because a request lacks documentation about alternative techniques, IRS managers who authorize these operations cannot readily see which techniques have been considered, cannot identify alternatives for consideration, and cannot ensure that an undercover investigation is the most appropriate way to achieve CID's objectives. GAO believes the undercover request could better serve IRS management if it included an assessment of alternative techniques.

**National Office Oversight
Should Be Strengthened**

Although the Assistant Commissioner decides which Group I undercover operations are to be undertaken, GAO found that his staff members did not actively oversee these operations, sometimes because of staffing or budgetary constraints. Thus, the Assistant Commissioner had little assurance that the projects for which he was accountable were being carried out so as to minimize the potential for operational breakdowns and misuse of funds. For instance, although National Office staff members were notified in advance, GAO found that they participated in only 2 of 29 (7 percent) preoperational planning meetings and only 2 of 18 (11 percent) quarterly operational reviews that were done for the more costly and sensitive Group I operations. Although their absence may not have adversely affected these operations, the National Office staff and, ultimately, the Assistant Commissioner, lost the opportunity to affect the planning and implementation of these operations.

GAO also found that National Office staff members did not monitor whether required financial audits were done and that, when they were done, CID district office agents were used to conduct these audits. Although only 18 percent of IRS' undercover operations that GAO reviewed were Group I operations, they have cost as much as \$200,000. GAO believes that using Internal Audit staff to do financial audits of the more costly and sensitive Group I operations would provide organizational independence, a general standard for government auditing.

**IRS Should Use Benchmarks
to Evaluate Completed
Operations and Improve
Future Performance**

IRS uses operational closing reports to assess the results of individual undercover operations. However, GAO found that IRS does not use available data to establish criteria or benchmarks—such as prosecutions, convictions, or the identification of potential targets—to measure the effectiveness of IRS' undercover activities. This kind of performance data could be used both to compare performance trends over time and across IRS' field offices. The results could provide preliminary indications or early warnings of potential problems. Moreover, the results could be used to identify successful practices which could then be disseminated throughout the CID.

Recommendations

GAO recommends that the Commissioner of Internal Revenue take several actions designed to strengthen the management and oversight of IRS' undercover operations. (See pp. 34 and 47.)

Agency Comments

In written and oral comments on a draft of this report, IRS agreed in principle with all but one of GAO's recommendations and has taken steps or plans to take steps to strengthen the management and oversight of its undercover operations. IRS disagreed with the recommendation that Internal Audit be responsible for audits of the more costly and sensitive Group I operations because of resource limitations and the belief that Internal Audit staff should not be used to supplement required management reviews.

GAO did not intend to suggest that Internal Audit be used to supplement CID's normal management responsibilities for controlling undercover operations nor that Internal Audit become involved in all CID operations. However, GAO continues to believe that the cost and sensitivity of some of the larger Group I operations—especially those involving money laundering or the operation of an undercover business—combined with the basic principle that audits should be done by an independent entity, warrant Internal Audit involvement. (See pp. 34 through 37 and 47 through 48.)

Contents

Executive Summary		2
Chapter 1		10
Introduction	Background	10
	Project Layoff	11
	Objectives, Scope, and Methodology	12
Chapter 2		15
IRS' Use of Undercover Operations	The Number and Cost of IRS' Undercover Operations	15
	Focus of Criminal Investigations and Undercover Operations Shifted From Tax Violations to Money Laundering	16
	Use of Undercover Operations Varied by Region	18
Chapter 3		20
Controls Over Undercover Operations Were Not Consistently Followed and Should Be Strengthened	IRS Guidelines for Undercover Operations	20
	Undercover Operation Requests Should Include Alternatives Considered	23
	Operational and Financial Controls Were Not Always Followed	24
	Financial Controls Should Be Strengthened	29
	Too Early to Judge Effect of Recent Changes to Undercover Operation Guidelines	32
	Conclusions	33
	Recommendations	34
	Agency Comments and Our Evaluation	34
Chapter 4		38
National Office Management Should Strengthen Its Oversight of Undercover Operations	CID National Office Staff Did Not Actively Oversee Ongoing Undercover Operations	38
	CID Information Could Be Used to Enhance the Effectiveness of Undercover Operations	42
	Conclusions	46
	Recommendations	47
	Agency Comments and Our Evaluation	47
Appendixes		
	Appendix I: Summary Data on Non-Grand Jury Undercover Operations	50
	Appendix II: Summary Data on Grand Jury Undercover Operations	52

Appendix III: Comments From the Internal Revenue Service	53
Appendix IV: Major Contributors to This Report	58

Tables

Table 2.1: The Number and Cost of Undercover Operations From FY 1985 Through FY 1990	15
Table 2.2: Overall Increases in Money Laundering Undercover Operations and Narcotics/White-Collar Criminal Investigations From FY 1985 Through FY 1990	16
Table 2.3: Number and Cost of Completed Non-Grand Jury Undercover Operations for Selected Regions From FY 1988 Through FY 1990	18
Table 2.4: Types of Completed Non-Grand Jury Undercover Operations for Selected Regions From FY 1988 Through FY 1990	19
Table 3.1: Extent to Which Preoperational Meetings Were Not Documented by Selected Regions for Group I and Group II Undercover Operations From FY 1988 Through FY 1990	25
Table 4.1: Undercover Operations That Met Objectives for Selected Regions From FY 1988 Through FY 1990	44

Abbreviations

CID	Criminal Investigation Division
CIMIS	Criminal Investigation Management Information System
CM&TRS	Case Management and Time Reporting System
DEA	Drug Enforcement Administration
FBI	Federal Bureau of Investigation
LEM	Law Enforcement Manual
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
RUPM	Regional Undercover Program Manager

Introduction

In 1984 and 1985, the Internal Revenue Service (IRS) carried out an undercover operation called Project Layoff, during which IRS agents established a Las Vegas bookmaking business in an attempt to identify illegal bookmakers and their ties to organized crime. This operation resulted in allegations of misuse of funds and negative media coverage for IRS. Because of concerns about Project Layoff, Senators Harry Reid and Richard Bryan asked GAO to review IRS' overall management of its undercover operations.

Background

The Internal Revenue Code contains a comprehensive array of criminal penalties to punish various types and degrees of noncompliance with the internal revenue laws. Section 7608 of the Code grants IRS criminal investigators broad police powers to enforce any of the criminal provisions of the Code or any other provision of law in which they have jurisdiction, such as the provisions in Titles 18 and 31 of the U.S. Code concerning illegal financial transactions like money laundering.

To carry out its law enforcement responsibilities, IRS' Criminal Investigation Division (CID) investigates suspected criminal violations and recommends prosecution when warranted. Like other law enforcement agencies, CID uses a number of investigative techniques, including undercover operations wherein one or more IRS special agents are authorized to assume identities other than their own for the purpose of obtaining necessary evidence. These operations are used during investigations of such illegal activities as money laundering, fraudulent tax return preparation, and skimming of business profits. For example, a CID special agent may pose as (1) a taxpayer to obtain evidence that a tax return preparer is preparing fraudulent returns, (2) a financial consultant willing to launder money for a suspected drug dealer, or (3) a potential buyer of a business in order to identify a business owner who is falsifying the business records to avoid taxes.

An undercover operation is a potentially risky investigative technique. For example, IRS agents may come in contact with dangerous drug dealers and handle large sums of money during a money laundering operation, all the while having to avoid entrapping the subject of the investigation. As a result, IRS requires that these operations be limited to situations considered to be particularly significant. Consequently, undercover operations are used in only a small number of IRS' total criminal investigations. From October 1989 through September 1990 IRS did 5,280 criminal

investigations, of which 152, or 2.9 percent, involved undercover operations at a cost of about \$1.4 million.

IRS' authority to do undercover operations has never been successfully challenged in court. The Supreme Court has long recognized that, in order to apprehend individuals engaged in criminal activities, the government is entitled to use decoys and conceal the identity of its agents. More specifically, lower courts have cited both statutory authority and case law to uphold IRS' authority to use the undercover technique. In one case, the court concluded that undercover operations are well within IRS' authority to investigate all persons who may be liable for any internal revenue tax and noted that IRS has broad discretion to determine what reasonable methods may be necessary or useful in collecting taxes (United States v. Little, 753 F.2d 1420 [9th Cir. 1984]). In another case, the court cited the constitutionality of undercover operations in general and noted that there is no authority that differentiates IRS from other agencies (United States v. Walker, 760 F.2d 144 [7th Cir. 1985]).

Project Layoff

In April 1984, IRS initiated Project Layoff in which IRS undercover agents, with the help of a confidential informant, established an illegal bookmaking operation in Las Vegas, Nevada. The objectives of the operation were to identify whether major illegal bookmakers throughout the United States were earning unreported gambling income and to obtain information about whether they were involved with organized crime. IRS terminated the operation in June 1985 before achieving all of its objectives because of threats to the participating IRS undercover agents.

Project Layoff lasted 15 months and, excluding salaries, cost about \$376,000. This amount includes the living expenses of three IRS undercover agents and the confidential informant and the costs of the bookmaking business office used during the operation. At the conclusion of the operation, IRS paid the informant \$50,000 for his contributions to the operation and gave him a 1979 Cadillac that was purchased for his use during the operation. Information from Project Layoff was the impetus for a subsequent undercover operation in another IRS District Office. This second operation resulted in nine individuals that either pled guilty or were convicted of criminal tax violations.

At the conclusion of Project Layoff, IRS' Internal Audit staff reviewed the financial records of the bookmaking business and concluded that, due to the inconsistencies in the records maintained, they were unable to

determine the ongoing cash position of the business or the amount of money, if any, that should have been on hand at the close of the project. For instance, Internal Audit found that detailed business records were not maintained during the first three months of the operation.

During May 1990 hearings on IRS employee integrity held by the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, the IRS Commissioner testified that there were significant problems with the overall management of Project Layoff. These included inadequate planning, insufficient training and supervision of the undercover agents that were assigned to the operation, and a general lack of financial controls. We have addressed Project Layoff more specifically in a separate report.

Objectives, Scope, and Methodology

Senators Reid and Bryan asked us to review how IRS manages its undercover operations. Specifically, we were asked to examine (1) how undercover operations are planned, approved, carried out, and concluded, (2) the extent and nature of these operations, (3) the adequacy of operational and financial controls over these operations, (4) the overall results of these operations, and (5) the potential effect of recent changes IRS made in its undercover operation guidelines.

To meet our objectives, we met with officials from the IRS National Office, the Midwest, North Atlantic, Southeast, and Western Regional Offices, as well as the Atlanta, Boston, Chicago, Jacksonville, Los Angeles, Manhattan, Milwaukee, and San Francisco District Offices. We selected the four regions in which we conducted our detailed review to provide wide geographic coverage as well as to reflect the varying extent and nature of undercover operations from region to region. These regions included (1) the Southeast Region, which frequently uses undercover operations, particularly during money laundering investigations, (2) the North Atlantic Region, which occasionally uses undercover operations, usually during investigations of fraudulent return preparers, (3) the Western Region, in which Project Layoff was done, and (4) the Midwest Region, which does a wide variety of undercover operations. The Assistant Commissioner (Criminal Investigation) indicated that undercover operations carried out by these regions would be representative of IRS undercover operations in general. In addition, we selected undercover operations for review that were completed during fiscal years 1988 through 1990 to assess the procedures used by IRS when conducting these operations.

We interviewed IRS regional office and district office officials to gather consistent information concerning such issues as the emphasis on using undercover operations; the criteria for approving undercover operation requests; the adequacy of controls over undercover operations; how the results of undercover operations are measured; and the potential impact of proposed changes to IRS' undercover operation guidelines. To find out how undercover operations are planned, approved, carried out, and concluded, we discussed operating procedures with national, regional, and district office officials. We also obtained and analyzed the undercover operation guidelines in both the IRS' Internal Revenue Manual (IRM) and the Law Enforcement Manual (LEM). To determine the extent and nature of IRS' undercover operations, we obtained and analyzed IRS National Office and regional office statistics concerning the number and types of operations conducted from fiscal years 1985 through 1990, and we identified trends related to these data.

We also reviewed the IRM and the LEM guidelines to identify the required operational and financial controls over undercover operations. Further, to determine CID's adherence to these operational and financial controls, we reviewed regional and district office undercover operation case files for operations that were completed during fiscal years 1988 through 1990. In addition, we met with IRS Internal Audit staff and reviewed Internal Audit reports involving recent reviews of IRS' undercover operations.

In selecting specific undercover operations for review, we obtained from the IRS National Office a list of 286 undercover operations that were completed in the Midwest, North Atlantic, Southeast, and Western Regions from fiscal year 1988 through fiscal year 1990. Of the 286 completed operations, we reviewed in detail 183 operations (64 percent) that IRS officials indicated did not contain grand jury information. For each of these operations, we analyzed the IRS regional office administrative file and the IRS district office operational file, as well as National Office status reports showing the number of investigations, prosecutions, and convictions that resulted from them. In addition, we completed a standardized Data Collection Instrument that was designed to capture such information as overall management involvement with the operation, individual operational expenses, and whether the operation met its objectives. We then analyzed these data to determine the number, types, costs, and results of the undercover operations conducted by the four IRS regions overall, as well as by the individual regions and selected district offices.

We are precluded from having access to grand jury information by Rule 6(e) of the Federal Rules of Criminal Procedure. As a result, we were unable to review the remaining 103 completed undercover operations (36 percent) in detail because they included grand jury information as defined by IRS' Chief Counsel. CID National Office officials told us that the IRS Chief Counsel conservatively defines what constitutes grand jury information in an effort to avoid IRS' inadvertent violation of Rule 6(e) of the Federal Rules of Criminal Procedure. For these 103 operations, we obtained selected statistical data from the IRS National Office, such as the nature, duration, cost, and overall results.

To determine the overall results of undercover operations, we obtained and analyzed the regional and district office case files mentioned above as well as the National Office status reports indicating the number of investigations, prosecutions, and convictions resulting from such operations. To evaluate the accuracy of the National Office status reports, as well as to identify any tax assessments that were attributable to the operations that we reviewed, we obtained the specific results of these operations from the IRS district offices in which they were done.

To determine the potential effects of recent changes to IRS' undercover operation guidelines, we obtained and reviewed the guideline revisions that were effective in November 1990 as well as January and April 1991. We also discussed the revisions with national, regional, and district office officials to get their opinions concerning the potential impact of these changes. Additionally, we reviewed a report issued by the Commissioner's Review Panel on IRS Integrity Controls, in which the panel discussed problems with IRS' management of undercover operations.

We met with officials from five other agencies that conduct undercover operations to discuss their overall management and controls over these operations. They included the Federal Bureau of Investigation (FBI), the Drug Enforcement Administration (DEA), the Customs Service, the Secret Service, and the U.S. Army Criminal Investigation Division. We did not review individual undercover operations conducted by these agencies.

We did our work between March 1990 and November 1991. Our work was done in accordance with generally accepted government auditing standards. The Internal Revenue Service provided written and oral comments on a draft of this report. These comments are presented and evaluated in chapters 3 and 4. The written comments are included in appendix III.

IRS' Use of Undercover Operations

IRS uses undercover operations in the course of doing some of its criminal investigations, but the technique is used sparingly because an undercover operation can be risky. From fiscal year 1985 through fiscal year 1990 IRS conducted 33,033 criminal investigations with 1,137 (3.4 percent) involving an undercover operation. Overall, the number of undercover operations initiated during this period declined from 244 in fiscal year 1986 to 152 in fiscal year 1990. However, undercover operations targeting money laundering increased from 22 percent to 54 percent of IRS' total undercover operations, with a concomitant reduction in operations targeting more traditional tax violations, such as fraudulent return preparation. This parallels a similar trend in IRS' overall criminal investigations.

The Number and Cost of IRS' Undercover Operations

Over the years, IRS has used undercover operations in a variety of criminal tax investigations of matters such as tax shelter schemes, prosecutable under Title 26 of the U.S. Code. IRS has also used undercover operations during the investigation of tax-related financial crimes prosecutable under Titles 18 and 31 of the U.S. Code. Between fiscal years 1985 and 1990, the number and cost of undercover operations conducted by IRS has varied from year to year. Table 2.1 shows the number of operations and their cost from fiscal year 1985 through fiscal year 1990.

Table 2.1: The Number and Cost of Undercover Operations From FY 1985 Through FY 1990

Dollars in millions		
Fiscal year	Number of operations	Cost of operations
1985	244	\$1.5
1986	240	1.7
1987	154	2.2
1988	176	1.8
1989	171	2.0
1990	152	1.4

Source: Special Investigative Techniques Branch, Criminal Investigation Division, IRS National Office.

The overall expenses for the 183 non-grand jury undercover operations that we reviewed were \$890,464. The largest individual expense was \$139,569 (16 percent) for money laundering fees. Other significant expenses included \$111,033 for transportation, \$101,137 for lodging, and \$70,094 for per diem for undercover agents. IRS also spent \$69,088 for payments to confidential informants.

Focus of Criminal Investigations and Undercover Operations Shifted From Tax Violations to Money Laundering

During fiscal year 1985, illegal tax shelters were the most frequently targeted criminal activity, involving about 30 percent of all undercover operations. However, according to the former Chief of CID's Undercover Branch, the Tax Reform Act of 1986 reduced the number of opportunities for tax shelters and, as a result, the number of tax shelter investigations involving undercover operations decreased significantly.¹ Since fiscal year 1986, money laundering has been the most frequently targeted illegal activity, involving about 45 percent of all undercover operations. Overall, undercover operations related to money laundering investigations increased from 22 percent in fiscal year 1985 to 54 percent in fiscal year 1990. The remaining undercover operations targeted fraudulent return preparers, skimming of business profits, tax havens, tax protestors, and other similar activities.

Table 2.2 shows the extent to which money laundering undercover operations increased as a percent of all undercover operations and the corresponding increase in the percent of narcotics and white-collar crime investigations relative to all CID investigations.

Table 2.2: Overall Increases in Money Laundering Undercover Operations and Narcotics/White-Collar Criminal Investigations From FY 1985 Through FY 1990

Undercover operation trends	FY85	FY86	FY87	FY88	FY89	FY90
All undercover operations	244	240	154	176	171	152
Money laundering operations	53	70	69	93	86	82
As a percent of all operations	22	29	45	53	50	54
Criminal Investigation trends						
All criminal investigations	6,065	5,861	5,511	4,899	5,417	5,280
Narcotics/ white-collar criminal investigations	3,814	3,597	3,736	3,316	4,211	4,071
As a percent of all investigations	63	61	68	68	78	77

Source: Office of Review and Information Systems Management, Criminal Investigation Division, IRS National Office.

CID national and regional office officials told us that the increase in the number of undercover operations targeting money laundering was related to an overall increase in the number of IRS criminal investigations targeting

¹In July 1990, CID's Undercover Branch was renamed the Special Investigative Techniques Branch.

narcotics violations and white-collar crime—the two investigative program areas in which most money laundering undercover operations were done. As shown in table 2.2, from fiscal year 1985 through fiscal year 1990, criminal investigations involving narcotics violations and white-collar crime increased from 63 percent to 77 percent of all criminal investigations initiated by IRS.

The increase in undercover operations targeting money laundering, prosecutable under Title 18 or Title 31 of the U.S. Code, occurred at a time when operations resulting from investigations of violations prosecutable under Title 26 of the U.S. Code, such as fraudulent return preparers, declined. For example, between fiscal year 1985 and fiscal year 1990, the number of criminal investigations related to the general category of abusive tax compliance dropped from 18 percent to 10 percent of all investigations initiated.

The shift in emphasis to money laundering undercover operations and their related investigations reflects the expansion of the nation's efforts to deal with tax-related financial crimes and narcotics trafficking. However, the growing IRS role has raised some concerns both within and outside IRS. A recent report by an American Bar Association group, endorsed by eight former IRS Commissioners, concluded that the deterrent effect of criminal tax enforcement has been substantially reduced by IRS' increased emphasis on "special enforcement" criminal investigations, such as money laundering, narcotics, and bank fraud. In addition, the Commissioner's Review Panel on IRS Integrity Controls also cited concerns with the evolving emphasis on criminal nontax investigations. In its October 1990 report, the Panel indicated that, with the increase in investigations and prosecutions of nontax cases, traditional tax investigations have been somewhat neglected; those that are developed tend to be the ones that require little time or skill; and, it is questionable whether IRS can still attract, train, and retain a cadre of competent traditional tax investigators.

Some CID officials told us that these concerns may be unwarranted because undercover operations involving money laundering are often used to identify potential tax violations, such as failure to file a return or underreporting of income. Nonetheless, IRS convened a study group—comprised of officials from IRS, the Department of the Treasury, and the Justice Department—to examine CID's workload and activities. Among the reasons for the review were the many changes in CID's workload and activities during the 1980's that gave rise to questions about whether the workload was properly balanced between different types of

enforcement efforts. In August 1991, the study group concluded that the CID's current direction is not well defined and made recommendations regarding CID's mission, strategies to accomplish that mission, and CID management and organization. In January 1992, IRS' Executive Committee approved most of the study's recommendations and directed the Assistant Commissioner (Criminal Investigation) to develop an action plan for program changes based on those recommendations.

Use of Undercover Operations Varied by Region

Our review of undercover operations done in four IRS regions showed that the frequency of use of this investigative technique as well as the specific types of operations conducted varied by region. For instance, the Southeast and Western Regions used undercover operations more frequently than the two other regions, particularly the North Atlantic Region. Table 2.3 shows the variation in the number and cost of undercover operations for fiscal year 1988 through fiscal year 1990 among the four regions.

Table 2.3: Number and Cost of Completed Non-Grand Jury Undercover Operations for Selected Regions From FY 1988 Through FY 1990

Region	Number of completed operations	Total cost of operations
Southeast	74	\$212,685
Western	62	370,447
Midwest	32	186,929
North Atlantic	15	120,403
Total	183	\$890,464

Note: This table does not include any figures for Project Layoff, which was carried out during 1984 and 1985 in the Western Region.

Source: GAO analysis of CID case files.

IRS regional and district offices have substantial flexibility to determine when and how frequently they use undercover operations. North Atlantic Region officials told us that they take a conservative approach to using this investigative technique and will use an undercover operation only when there are no alternatives available to obtain needed evidence, such as using an informant to testify against the subject of the investigation or having an informant electronically monitor an illegal act by the subject of the investigation. Southeast Region officials stated that they take a more aggressive approach to using undercover operations. Not only will they use an undercover operation when it appears to be the only investigative technique available to obtain needed evidence, but they also will use an

undercover operation if it appears to be the most cost-effective method to obtain evidence.

Regions also have flexibility in determining the types of operations they conduct. According to CID National Office staff, those regions with substantial drug activity and related money laundering, such as the Southeast Region, tend to do more undercover operations than other regions. They also cited fraudulent return preparers as a likely target of undercover activity in the North Atlantic Region. Our analysis of undercover operations conducted in four IRS regions showed wide variations in the type or focus of operations, as shown in Table 2.4. For example, the Southeast and Midwest Regions focused most of their undercover effort on money laundering, while the North Atlantic Region concentrated on fraudulent return preparers. The Western Region conducted a substantial number of operations involving both money laundering and fraudulent return preparers.

Table 2.4: Types of Completed Non-Grand Jury Undercover Operations for Selected Regions From FY 1988 Through FY 1990

Type of operation	Southeast		Western		Midwest		North Atlantic	
	number	percent	number	percent	number	percent	number	percent
Money laundering	31	42	26	42	12	38	1	7
Fraudulent return preparers	13	18	27	44	5	16	10	67
Business opportunities ^a	19	26	1	2	2	6	1	7
Others ^b	11	15	8	13	13	41	3	20
Totals^c	74		62		32		15	

^aBusiness opportunities involve investigations of individuals alleged to have skimmed business profits.

^bOthers include undercover operations used during investigations of general tax evasion, tax shelter and tax haven schemes, and organized crime activities.

^cPercentages do not total 100 because of rounding.

Source: GAO analysis of CID case files.

Controls Over Undercover Operations Were Not Consistently Followed and Should Be Strengthened

In May 1990, during congressional hearings focusing on IRS employee integrity, the IRS Commissioner testified that an undercover operation known as Project Layoff, which cost about \$376,000, suffered from a general lack of financial controls. Our review of 183 undercover operations completed during fiscal years 1988 through 1990 did not disclose any operations that were as costly or problematic as Project Layoff. Nonetheless, our review showed that CID regional and district office staff failed to consistently follow some of the key operational and financial controls that IRS had in place to manage these sensitive operations. Without full adherence to IRS' procedures, CID management did not have reasonable assurance that undercover operations were being properly carried out or that funds were properly spent. Without this assurance, CID risks the occurrence of problems like those attributed to Project Layoff.

In response to earlier hearings on IRS employee misconduct in 1989, IRS revised its undercover operational guidelines effective January 1991. The revisions included procedures to get IRS' district counsel more involved in operational planning and implementation and the use of a standardized checklist during preoperational meetings to ensure that all important aspects of the operation are discussed. While it is too early to determine their full impact on the management of undercover operations, these revisions could result in standardizing undercover operation procedures throughout the agency. However, given the potential for operational breakdowns and misuse of funds, we believe that IRS should make some additional changes, particularly to the undercover operation request and to the way financial audits are done, that would further enhance its management of undercover operations.

IRS Guidelines for Undercover Operations

Due to the sensitive nature of undercover operations, IRS has a detailed set of guidelines governing how they should be approved, carried out, and monitored. The purpose of these guidelines is to assure IRS management that an operation's objectives are properly addressed, costs are adequately controlled, and, where applicable, criminal violations are prosecuted. The guidelines recognize the risks associated with undercover operations, including the legal issue of entrapment and the physical security of undercover agents and government funds. For example, the guidelines encourage that the IRS district counsel be given the opportunity to provide legal advice when CID plans and conducts operations and that the security of undercover agents and government funds be discussed during various operational meetings and reviews.

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

CID classifies its undercover activities as either Group I or Group II operations, depending on the scope and cost of the particular operation. Group I operations, which are to be approved by the Assistant Commissioner (Criminal Investigation), are defined as those that are projected to exceed either 3 months in duration or \$10,000 in cost or to involve unusual or sensitive issues, such as potential corruption by public officials. Group II operations, which are to be approved by a regional commissioner, are defined as those that are not expected to last longer than 3 months or cost more than \$10,000. These operations, which represent about 75 percent of IRS' undercover activities, may be extended for 3 months with the regional commissioner's approval, provided their costs do not exceed \$10,000.

**Planning and Approving
Undercover Operations**

The planning and approval phase for undercover operations is to begin with preparation of an undercover operation request, which is usually initiated by a district office special agent. The request usually results from either an ongoing criminal investigation or allegations of potential criminal activity. The criminal investigation for which the undercover operation is requested may have resulted from a referral by the district office Examination or Collection Divisions, or from a service center function such as the Questionable Refund Program.

The undercover operation request is to provide the operation's objectives, the plan of action that will be taken, and the estimated costs that will be incurred. Before review by the district director, the undercover operation request is to be reviewed by various CID managers such as the CID chief in the district office. The request is also to be discussed informally with a regional undercover program manager (RUPM)—a regional office CID official who is responsible for reviewing all undercover operations done within the IRS region to keep management aware of undercover activities. According to a RUPM in one region, the informal discussions between the RUPM and the district office CID staff focus on such things as the safety and security of the undercover agents and undercover funds, as well as on why an undercover operation is needed and on alternative investigative techniques that were considered.

After an undercover operation request has been approved by the district director, it is to be formally reviewed by the RUPM and the assistant regional commissioner (Criminal Investigation) before it is submitted to the regional commissioner for approval. Requests for Group I operations are then to be submitted for review and approval to the National Office.

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

Requests for Group II operations are to be reviewed by the National Office if they include a request for recoverable funds. These are funds provided by the National Office when large sums are needed, such as for money laundering transactions; they are required to be returned at the conclusion of an operation.

At the National Office, undercover operation requests are to be reviewed by an advisory Undercover Committee composed of two senior CID officials and the Assistant Chief Counsel (Criminal Tax). The committee is to submit the request and its recommendations to the Assistant Commissioner, who ultimately decides whether or not to approve the operation.

Either Group I or Group II undercover operations may be approved subject to specific conditions imposed by the regional or National Office pertaining to the objectives, the actions to be taken, or the costs to be incurred.

**Carrying Out, Monitoring,
and Concluding Undercover
Operations**

Undercover operations are usually done by one or more of about 100 CID special agents who have specific training and experience with this investigative technique. Some Group II operations, such as those involving only one or two meetings with a suspected fraudulent return preparer, may be done by other special agents who have received limited undercover operation training.

In addition to the special agents who actually go undercover, three other agents normally participate actively in an operation. These are (1) the contact agent, who is to be responsible for the security and support of the undercover agent and who is to monitor the daily activity, progress, and expenses of the operation; (2) the case agent, who is to conduct the overall criminal investigation associated with the undercover operation; and (3) the group manager, who is to oversee the overall investigation, including the undercover operation.

As noted, these three agents all play a role in monitoring the operation. However, a critical monitoring role is also to be carried out by the RUPM, who is to (1) attend a preoperational meeting held at the beginning of the operation and (2) do periodic operational reviews of the operation and provide the crucial information link, on the basis of these reviews, to the regional commissioner and the National Office.

When an operation is completed, the district office CID chief is to prepare a closing report summarizing all the operation's critical elements, including

whether objectives were accomplished, the potential results, and the overall cost of the operation. The closing report is to be provided to the regional commissioner and the Assistant Commissioner (Criminal Investigation).

Undercover Operation Requests Should Include Alternatives Considered

CID can begin an undercover operation only after management review and approval of a detailed undercover operation request describing the objectives of the proposed operation, how it will be conducted, and its estimated duration and cost. In our view, a key component of this critical approval process hinges on informal discussions between the RUPM and CID staff regarding the need for an undercover operation in lieu of other less risky investigative techniques. Given the risk involved in undertaking this investigative technique, we believe the approval process would be enhanced if IRS required that each request document alternative investigative techniques that had been considered and the reasons that an undercover operation is deemed necessary. This would provide IRS management additional information in deciding whether an undercover operation is the most appropriate way to achieve CID's objectives and in ensuring that potential alternatives have been considered.

Chapter 900, Section 910, of the Internal Revenue Manual (IRM) states that undercover operations can be controversial and potentially dangerous undertakings that require significant financial and personnel resources. The manual also calls for "judicious decision-making with respect to the use of undercover techniques" and requires that agents submit a request for authorization to do an undercover operation (IRS Form 8354).

The IRM further requires that the request contain a narrative section that details various significant aspects of the operation, such as its objectives, plan of action, estimated costs and need for recoverable funds, and the information obtained to date indicating that the target is in violation of the law. However, the IRM does not require that the request also include information about whether other investigative techniques were considered or attempted in lieu of the undercover operation. Although the RUPM may informally discuss alternatives to an undercover operation, other IRS managers with responsibility for approving these operations cannot readily tell which options have been considered. Such information would permit those responsible to consider more fully the other possible options—such as using an informant rather than an undercover agent to gather needed evidence or using an informant or client to testify against the subject of the

investigation—and whether a less risky or costly alternative may be more appropriate for a given situation.

During our review, we noted instances where it was not apparent from the request why an undercover operation was considered necessary and whether any alternatives had been considered. For example, one operation was initiated based on a business card that offered the opportunity to own a luxury car, wear fine clothes, and earn substantial monthly income, even though there was no indication of criminal activity on the part of the individual who distributed the card. The purpose of the undercover operation was to determine if this was a “get rich” scheme and if there were violations of tax laws by any individuals participating in such a scheme. The undercover operation was terminated when it was determined that the “target” was involved in a legitimate business and had apparently not violated any tax laws. Although only \$820 was expended during this operation, it required time and effort on the part of the CID agents involved, even though there were no alleged improprieties on the part of the subject of the investigation.

IRS needs to be judicious in using the undercover technique, because undercover operations (1) can be risky and potentially dangerous and (2) require the expenditure of financial and personnel resources that might be better used on other investigations. Accordingly, we believe that the alternatives that were considered to an undercover operation should be included in the narrative section of the undercover operation request. This would facilitate management’s decision on whether to approve an undercover operation and would provide assurance that other alternatives have been considered.

Operational and Financial Controls Were Not Always Followed

In recognition of the risk associated with undercover activities, IRS has an extensive set of guidelines for carrying out such operations. These guidelines contain detailed operational and financial controls designed to ensure that the actions taken during an operation achieve its objectives and that the funds used are adequately accounted for and safeguarded. We found that undercover operation requests were consistently documented with the appropriate levels of approval, and closing reports were submitted for all operations in which there was undercover activity. Nonetheless, CID field officials often misinterpreted IRS guidelines and consequently did not always adhere to some key operational and financial procedures, such as documenting preoperational meetings and conducting periodic operational reviews and financial audits.

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

We believe that IRS' established controls are an appropriate means to assure IRS management that undercover operations are being carried out in the manner agreed to by management when the undercover operation request was initially approved. However, CID regional and district offices need to ensure that field staff understand and consistently adhere to these controls to avoid potentially dangerous, embarrassing, or costly problems. The following sections discuss the various operational and financial controls that CID did not consistently follow.

Preoperational Meetings

After a request to perform a Group I or Group II undercover operation is approved, the IRS agents involved are required to hold a preoperational meeting. The Law Enforcement Manual (LEM) requires that this meeting be held before the operation starts in order to allow discussion of long- and short-term objectives, the plan of action, administrative matters, and the security of undercover agents and government funds. The contact agent is required to prepare a memorandum documenting the preoperational meeting.

Our review of undercover operation files in four IRS regions indicated that preoperational meetings were not always documented. Thus, it was not clear whether all of the potential risks and outcomes associated with these operations were considered. Table 3.1 shows that preoperational meetings were not documented in 70 (38 percent) of the 183 operations we reviewed.

Table 3.1: Extent to Which Preoperational Meetings Were Not Documented by Selected Regions for Group I and Group II Undercover Operations From FY 1988 Through FY 1990

Region	Number of operations conducted	Preoperational meetings not documented	
		Number	Percent
Southeast	74	39	53
Western	62	27	44
Midwest	32	4	13
North Atlantic	15	0	0
Total	183	70	38

Source: GAO analysis of CID case files.

During the period of our review, there was a discrepancy between the IRM and the LEM requirements for holding preoperational meetings. The IRM required preoperational meetings only for Group I undercover operations, while the LEM required them for both Group I and Group II operations. According to regional office officials, this may have caused confusion

among district and regional staff, leading to the inconsistent use of preoperational meetings for Group II operations. However, in November 1990 and January 1991, IRS revised the guidelines and consolidated all of its requirements for preoperational meetings in the LEM, including a requirement that preoperational meetings be held for both Group I and Group II operations. Since these revisions were made during our review, we were unable to assess their impact.

**Undercover Operation
Reviews and Financial Audits**

IRS requires periodic operational reviews and financial audits of undercover operations to ensure that operations are properly carried out and that funds are appropriately spent. IRM Chapter 900, Section 980, makes the RUPM responsible for reviewing an ongoing undercover operation at 3-month intervals. This quarterly operational review is an important part of regional management's oversight of the progress and results of an undercover operation. IRM Chapter 900, Section 9(13)0 requires that the CID chief or his designee must perform an audit of each operation every 90 days and at its close. According to CID officials, this requirement was instituted in 1986 based on recommendations by IRS Internal Audit and due, in part, to some of Internal Audit's findings regarding Project Layoff. These financial audits are intended to help assure management that the expenses of an operation are justified and adequately documented and that agents properly accounted for any unused government funds.

Our review of the files on the 183 selected undercover operations indicated that quarterly operational reviews, quarterly financial audits, and closing financial audits were not always done. As a result, IRS management had no assurance that the projects were properly managed, that expenses were properly documented, and that unused funds were properly accounted for. For instance, our review of the case files showed the following:

- Quarterly regional operational reviews were not done in 6 of 24 (25 percent) Group I operations that lasted longer than 90 days, including 5 of 8 in one region.
- Quarterly financial audits were not done in 12 of 23 (52 percent) Group I operations that lasted longer than 90 days and in which funds had been expended, including 1 in which CID used confidential informants to establish an undercover business and to pay the operational expenses of the business.
- Closing financial audits were not done in 15 of 32 (47 percent) of the Group I operations in which funds had been expended, including 1 operation in which \$201,404 was expended.

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

Overall, we found that closing financial audits were not done in 75 of 156 (48 percent) of the Group I and Group II operations in which funds had been expended, including 12 operations in one region with funds expended ranging from \$209 to \$101,299. No funds were expended in the other 27 operations that we reviewed.

Discussions with IRS regional and district office officials indicated that the failure to do some required reviews and audits was based on their interpretation of the IRM requirements. For example, one regional office official told us that he believed that the requirement for a closing financial audit was only intended to be for large operations, such as the Group I operations. A district office official in another region said that he believed that quarterly financial audits were necessary only if the region planned on doing a quarterly operational review. However, according to the IRM, these financial audits are required for all operations in which funds have been expended and, in our view, help assure IRS district office, regional office, and National Office management that undercover operations are being carried out as agreed upon when management approved the requests for such operations. We also believe that failure to adhere to these controls can lead to the types of problems that arose during Project Layoff.

For example, we found that quarterly financial audits were not done for an undercover operation in which confidential informants were used to establish a business as part of the operation's cover. While doing a review of IRS undercover operations, Internal Audit found that, for this particular project, the informants had failed to pay some of the business expenses associated with the operation. As a result, CID had to carry out a subsequent undercover operation to provide funds to pay these business expenses without revealing IRS' involvement with the business. CID might have been able to avoid the need for the subsequent undercover operation if timely financial reviews had been done during the initial undercover operation.

Recoverable Funds

IRS guidelines also contain financial controls for recoverable funds, which are funds used temporarily in undercover operations involving such activities as money laundering. After approval by the Assistant Commissioner (Criminal Investigation), the National Office is to provide the requested recoverable funds with the understanding that the funds must be returned after the operation has been completed. IRM Chapter 900, Section 9(12)3 requires that, when they are received, recoverable funds are to be maintained in an interest-bearing account or, if immediate access

Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened

to the funds is necessary, in a safe-deposit box. Any interest earned on recoverable funds is to be transmitted to the General Fund of the Treasury at the conclusion of an operation.

Our review of CID's undercover operation files showed that they usually kept recoverable funds in either an interest-bearing account or a safe-deposit box and transmitted any interest earned to the General Fund at the conclusion of the operation. However, interest was not always earned when possible. Of 33 undercover operations that we reviewed involving recoverable funds, no interest was earned during 13 operations. For 8 of the 13 operations, it is unlikely that interest could have been earned because the funds were held by the district office for less than one month or were used by the district office immediately upon receipt. The remaining five operations involved recoverable funds ranging from \$5,000 to \$60,000 that were held by the district offices from 2 to 7 months.

In one of the five operations, recoverable funds were deposited in a safe-deposit box even though the request stated they would be deposited in a bank account; in two others, funds were deposited in a non-interest-bearing checking account. In another operation, the recoverable funds were maintained in a district office imprest fund, rather than either a bank account or a safe-deposit box. IRS officials could not determine where the funds were kept for the fifth operation, but were able to show that they were returned to the National Office at the conclusion of the operation.

IRS regional and district office CID officials said that it is not always possible to keep recoverable funds in an interest-bearing account, and we agree. However, we believe that IRS should do so whenever possible, particularly when relatively large sums of money are held for extended periods of time. Although interest was earned in over half of the operations involving recoverable funds that we reviewed, there may have been opportunities to earn interest in 5 of the 13 operations in which none was earned. For example, CID could use interest-bearing checking accounts for recoverable funds as is done with funds used for routine operational expenses, which generally involve lesser sums of money. We believe CID should make every effort to keep recoverable funds in interest-bearing accounts.

Financial Controls Should Be Strengthened

As mentioned earlier, CID is to do an audit of the records of each undercover operation at its conclusion. However, CID is not required to include a detailed itemization of the expenses incurred during an operation in the closing financial audit report. Our study indicated that the financial audit has basically been a reconciliation of the funds advanced for an operation and the funds expended during the operation, without any analysis of the reasonableness of the expenditures or a comparison of proposed versus actual costs. As a result, IRS management has not had sufficient information to determine whether funds were used in the approved manner. We believe that the management controls over undercover operations could be strengthened to provide management with added assurance that only necessary and reasonable expenses are incurred during these operations. We especially believe that financial audits of the more costly and sensitive undercover operations should be done by IRS' Internal Audit staff to provide organizational independence.

The IRS requirement is set forth in IRM Chapter 900, Section 9(13)0, which provides that CID field offices do financial audits at the close of all undercover operations or document why they were not done. The IRM further requires the preparation of a report of the financial audit to describe the documents reviewed and the analyses done during the review. However, the IRM does not require field officials to prepare an itemization of the various expenses incurred during the operation, a statement concerning the reasonableness of these expenses, and a comparison of the proposed versus actual expenses of the operation as part of the audit report.

We found that, although some financial audit reports included the total expense of the undercover operation, very few included an itemization of these expenses. For example, of 81 financial audit reports we analyzed, 6 included an itemization of expenses, 22 included the total expenses, and 53 did not mention the expenses of the operation. Without this itemization, IRS management is not apprised of any expenses incurred that were not included in the undercover operation request.

These reports also lacked a statement concerning the reasonableness of the expenses incurred. Such a statement would assure IRS management that the funds used during the undercover operation were not subject to waste and/or misuse. For example, we noted some expenses charged to the individual undercover operations reviewed—a word processor, software, large amounts of film, batteries, cassettes, and hotel movie rentals—that did not seem to be necessary for these operations. In one operation

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

involving two or three visits by two undercover agents to an alleged fraudulent return preparer, about \$650 in film, batteries, and cassettes were charged to the operation. According to a CID regional official, it appeared that the agents were stocking up on supplies for other potential operations. Although these expenses were approved, district management might have been more likely to question these expenses had their reasonableness been questioned in a closing financial audit.

After reviewing a draft of our report, CID officials told us that, even though CID uses the term “audit” in the IRM, they do not consider the periodic and closing financial reviews to be formal audits because they do not believe CID employees can independently audit undercover operations involving other CID officials. We agree. To recognize the significance of the difference between a financial review and an independent financial audit, CID officials told us that they plan to change the IRM to state that field personnel should do financial “reviews”—not financial “audits.” On the basis of our recommendation, CID also agreed to revise the IRM to strengthen accountability for expenses as part of the operational closing report instead of the closing financial “audit.” We believe these proposed changes are positive ones—they are discussed in the agency comments and evaluation section at the end of this chapter.

**Organizational Independence
and Financial Audits**

IRS could also strengthen the controls over undercover operations by ensuring that financial audits are performed by individuals who are organizationally independent of CID. Until recently, any CID special agents not involved in an undercover operation could perform closing financial audits. In January 1991, IRS changed its procedures to require that specially trained CID contact agents are to do the undercover operation financial audits. Now, as discussed above, CID plans to use the operational closing report as its principal means of financial control. Although this change will help ensure that employees familiar with undercover activities are reviewing the financial aspects of an undercover operation, the lack of an independent assessment of the more costly and sensitive undercover operations leaves IRS vulnerable to potentially embarrassing problems like those that arose as a result of Project Layoff. We believe that such questions could be avoided by having IRS Internal Audit staff do financial audits on the more costly and sensitive undercover operations.

IRS has already positioned Internal Audit staff to do audits of some undercover operations. Section 7608(c) of the Internal Revenue Code exempted IRS undercover operations from certain laws and allowed IRS to

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

use the proceeds from business-type operations to pay for or offset necessary and reasonable expenses incurred during the operation.¹ Further, the Crime Control Act of 1990 required IRS to do detailed financial audits for closed undercover operations involving the offset authority in which (1) the gross receipts (excluding interest) exceed \$50,000 or (2) recoverable and nonrecoverable expenses (excluding salaries) exceed \$150,000.² The law is silent on which unit within IRS should do the detailed financial audit. However, IRS has decided that these audits, the results of which are to be reported to the Secretary of the Treasury and Congress, will be performed by IRS' Internal Audit.³

In a July 1991 report entitled IRS Experience Using Undercover Operations' Proceeds to Offset Operational Expenses (GAO/GGD-91-106), we discussed IRS' use of undercover operations involving the offset provision and found that offsetting, although used sparingly, is a potentially valuable funding mechanism for carrying out business-type undercover operations. However, we pointed out that questions about controlling funds remain to be answered because (1) none of the 19 operations involving the offset provision had met the statutory criteria requiring a detailed financial audit and (2) Internal Audit may not have sufficient access to all the information needed to do a thorough audit because it does not now have complete access to information considered by CID to be under the control of the grand jury. Nonetheless, we pointed out that questions about organizational independence could be avoided by having Internal Audit do all audits of undercover activities involving offsetting; and we recommended that the Commissioner direct IRS' Chief Inspector to ensure that Internal Audit expand its financial audits to include all undercover operations involving offsetting, regardless of the amount of expenditures or proceeds. At the time of our review, CID officials said that it would be feasible for Internal Audit to do the detailed financial

¹The offset provision allows IRS to carry out high cash flow operations—such as money laundering—that might not be otherwise possible within IRS' undercover budget. Using its offset authority, IRS is exempt from several laws controlling the use of government funds and from certain contracting and budgeting procedures. However, the income earned from an individual undercover operation can only be used to offset the expenses of that particular operation, and any income remaining at the end of the operation is to be transferred to the General Fund.

²The act defines a closed operation as one in which all criminal proceedings other than appeals are concluded or all covert actions are concluded, whichever occurs later.

³IRS' offset authority expired on December 31, 1991, but the Department of the Treasury has recommended that it be reinstated.

audits after the covert phase of an operation is completed but before criminal proceedings are concluded.

Most of IRS' undercover operations do not involve offsetting and are therefore not exempt from the normal controls over appropriated funds. However, we believe that financial audits of the most costly and sensitive operations should be done by Internal Audit to ensure organizational independence. In our view, this is especially important for those operations that involve the operation of an undercover business or other types of operations involving large sums of money.

Too Early to Judge Effect of Recent Changes to Undercover Operation Guidelines

In response to hearings on IRS employee misconduct held by the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, IRS established a task force to review its undercover operation guidelines. The task force made several recommendations that were incorporated in revised undercover guidelines effective in November 1990 and January 1991. These included such revisions as increasing the role of IRS district counsel in reviewing undercover operation requests, requiring the use of a preoperational meeting checklist, and requiring documentation when financial reviews are not performed. In April 1991, in response to continuing concerns regarding Project Layoff, IRS further revised its undercover operation guidelines to get IRS' Controller more involved in financial controls over undercover operations involving businesses. The guidelines now encourage that before beginning a business-type operation, agents consult with the Controller to ensure that CID establishes adequate controls over business records and finances.

On the basis of discussions with IRS regional and district office officials, it appears that many of the recent revisions to the undercover guidelines primarily involved formalizing procedures that had already been established in many of the regional and district offices in which we conducted the review. For example, one revision is that IRS counsel be given the opportunity to provide legal advice when an undercover operation is planned and conducted and to attend preoperational meetings. However, assistant district counsels in one region stated that they had been reviewing undercover operation requests and attending preoperational meetings for the past several years.

We believe that it is beneficial to formalize undercover operation procedures that may be used in some offices and not in others to

standardize the way undercover operations are carried out and managed. Although it is too early to tell what impact most of these changes will have on IRS' management of its undercover operations, we believe that one change—getting the Controller involved in establishing controls over undercover business operations—is a positive step in dealing with some of the concerns associated with Project Layoff.

In our report entitled Undercover Operations: IRS' Management of Project Layoff (GAO/GGD-92-80, Apr. 21, 1992), we discuss the need to get the Controller involved in all business-type undercover operations. In that report we recommend that the Commissioner direct the Assistant Commissioner (Criminal Investigation) to require (not encourage) that CID include the Controller in all operations involving an undercover business. In their oral comments on that recommendation, CID officials said that the current financial records required for these types of operations have been reviewed and approved by the IRS Controller. In addition, they said that they would change the IRM to require that CID contact the Controller for any undercover businesses for which the currently approved types of financial records would not be adequate.

Conclusions

IRS has an extensive set of operational and financial controls for approving and carrying out undercover operations that, if appropriately followed, should help avert potentially embarrassing or costly problems such as those that arose during Project Layoff. However, CID's adherence to these controls varied in the undercover operations that we reviewed. In particular, we noted that regional quarterly operational reviews and both quarterly and closing financial audits were not always done as required, often due to misinterpretation of the requirements for such reviews. We believe these reviews are necessary in order to provide IRS management with reasonable assurance that these operations are adequately controlled and that funds are not misused.

We also believe that both the undercover operation approval process and the financial controls over undercover operations could be improved. To strengthen the approval process, the narrative section of the undercover operation request could be used to document the field staff's discussion of alternatives to each operation. Such documentation would better ensure that CID field staff have considered all appropriate alternatives to doing an undercover operation and would inform upper-level management of why the alternatives were found to be impractical. This information would aid

management in making a decision on whether to approve an operation and help avoid unnecessarily risky or costly operations.

In addition, we believe that controls over undercover operations could be strengthened by requiring that the operational closing report include an itemization of the expenses incurred during each operation, a statement of the reasonableness of these expenses, and a comparison of the proposed costs versus the actual costs of the operation. This would help provide assurance that only those expenses necessary to an undercover operation had been charged to that operation. IRS could also use Internal Audit to do financial audits of the more costly and sensitive operations, which would provide organizational independence—a general standard for government auditing. This would give management further assurance that funds are properly spent and accounted for.

Recommendations

To ensure the consistent application of controls over undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to require that

- the undercover operation request include a section detailing the alternatives considered and the reasons they were judged to be inappropriate; and
- the undercover operational closing report include an itemization of the expenses incurred in the operation and a comparison of the proposed costs versus the actual costs of the operation, as well as a statement concerning the reasonableness of the expenses incurred during the operation.

In addition, we recommend that the Commissioner of Internal Revenue require that IRS' Internal Audit staff do financial audits of the most costly and sensitive operations.

Agency Comments and Our Evaluation

In written and oral comments on a draft of this report, IRS generally agreed with the thrust of our two recommendations concerning CID's need to ensure the consistent application of controls over undercover operations. However, IRS did not agree with our recommendation that Internal Audit do financial audits of the most costly and sensitive operations to provide organizational independence. The following provides our analysis of IRS' written and oral comments.

**Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened**

In its written response to our recommendation that CID document in the undercover operation request specific alternatives to an undercover operation that were considered, IRS said that it had already increased emphasis on its requirement that the request provide greater detail about the facts leading to an undercover operation, thereby exposing background information to greater scrutiny throughout the approval process. In subsequent discussions, CID National Office officials said they would include a statement in each request that “alternative investigative actions had been considered and the utilization of the undercover investigative technique has been determined to be the best investigative approach at this point in the investigation.”

If consistently applied, IRS’ emphasis on greater detail in the undercover request should give managers a better framework for deciding whether undercover operations should be approved. Further, including in the request a statement such as that proposed by CID would help ensure that alternatives had been considered before a conclusion was reached that the undercover technique was the best approach available. However, we still believe that the approval process would be enhanced if the request included a discussion about the options considered in lieu of an undercover operation. Even if no other options are considered feasible, we believe that non-CID managers who approve undercover operations—such as district directors and regional commissioners—would benefit from a brief discussion about why such an operation is considered to be the optimal technique for carrying out or contributing to a particular investigation.

In our draft report, we recommended that the Commissioner direct the Assistant Commissioner (Criminal Investigation) to require that the undercover operation closing financial audit report include an itemization of expenses incurred; a comparison of proposed and actual expenses; and a statement of the reasonableness of the expenses incurred. In its written comments, IRS generally agreed with our proposed recommendation but did not identify any particular steps that would be taken. Subsequent discussions with CID National Office officials led to agreement that the following steps would be taken to strengthen CID’s financial controls over undercover operations.

First, CID officials said they plan to revise the Internal Revenue Manual to state that CID field personnel should do financial “reviews” instead of financial “audits.” As mentioned earlier, the CID officials said that, although the IRM uses the term audit in describing the financial review called for at the end of an undercover operation, as a practical matter, it cannot be an

independent audit because it is done by CID employees. We believe this is a useful clarification that should avoid any inference that CID, or any other operational unit for that matter, can independently audit itself.

Second, to implement our recommendation for strengthening financial controls over undercover operations, CID said they would revise the IRM to (1) make the RUPM responsible for commenting on the reasonableness of expenses incurred as part of normal quarterly reviews, (2) require that operational closing reports, prepared by the CID Chief, include an itemization of expenses, a comparison of proposed and actual expenses, and an affirmative statement as to the reasonableness of expenses incurred during an operation, and (3) have the assistant regional commissioner (Criminal Investigation) attest to the reasonableness of expenses incurred during an operation prior to forwarding the operational closing report to the National Office.

We believe that CID's proposed changes to the IRM will help strengthen management oversight of the finances of individual undercover operations and should help raise awareness of accountability. They also will provide additional assurance that only necessary expenses incurred during an operation have been charged to it. CID is accountable for ensuring that each operation is properly managed and financial resources are properly accounted for, but CID cannot do independent audits of its own undercover activities. Therefore, the lack of an independent assessment of the larger, more sensitive operations still leaves IRS vulnerable to questions about the degree of assurance it has that funds are properly spent and accounted for and could contribute to potentially embarrassing problems like those that arose as a result of Project Layoff.

As mentioned earlier, IRS disagreed with our recommendation to require that IRS' Internal Audit staff do financial audits of the most costly and sensitive undercover operations. In its response, IRS said that the role of Internal Audit is not to supplement required management reviews and that significant undercover operations are adequately reviewed through Internal Audit's regular cyclical review of CID activities. IRS went on to say that requiring Internal Audit to audit all Group I operations could divert resources from more significant activities that need their attention.

We did not intend to suggest that Internal Audit be used to supplement the normal management reviews that are the responsibility of CID management and have revised the wording of our recommendation accordingly. Further, we recognize that requiring Internal Audit to audit all Group I operations

Chapter 3
Controls Over Undercover Operations Were
Not Consistently Followed and Should Be
Strengthened

would have some effect on its ability to audit other IRS activities. Consequently, we believe that Internal Audit and CID should establish criteria to have Internal Audit examine those Group I operations mutually considered to be the most costly or sensitive. We believe that the cost and sensitivity of these larger undercover operations, combined with the basic principle that audits should be done by an independent entity, lead to the conclusion that Internal Audit should be charged with that responsibility.

In our view, having Internal Audit do financial audits on the more sensitive and costly operations would be consistent with Internal Audit's role of auditing certain types of undercover operations, specifically those operations that use the income generated from an undercover business to offset operational expenses. We believe Internal Audit should also do financial audits of other sensitive and costly operations which do not involve an undercover business, such as money laundering operations involving large sums of money. This would heighten awareness of the need for accountability during undercover operations and help reduce IRS' vulnerability to the kinds of allegations of misuse of funds that surfaced following Project Layoff.

National Office Management Should Strengthen Its Oversight of Undercover Operations

IRS criminal investigations are usually planned by district office CID staff and approved and monitored by district office CID management. However, due to their sensitivity, undercover operations are to be approved by a regional commissioner. In addition, the Assistant Commissioner (Criminal Investigation) and his National Office staff are to review and approve initial requests and any subsequent requests for additional time or funds for Group I undercover operations and thus have a greater level of responsibility for the outcome of these undercover activities. Despite this responsibility, our review indicated that the National Office has not actively overseen these undercover operations once they are underway, sometimes because of staffing limitations or budgetary constraints. Further, although information is available about the results of individual undercover operations, the National Office has not taken steps to use a common set of standards or benchmarks against which to measure the performance of regions and districts in carrying out these operations.

We believe that CID could improve the management of this sensitive and risky law enforcement technique if the National Office strengthened its oversight over field activities, thereby providing greater assurance that operations achieve their objectives without unauthorized deviations from approved plans of action. Stronger oversight could help IRS avoid unnecessary risks to undercover agents and government funds and could prevent significant accountability problems. In addition, more effective evaluation of the results of an operation by the National Office could help CID agents and managers more readily assess the necessity for and the feasibility of proposed future undercover operations.

CID National Office Staff Did Not Actively Oversee Ongoing Undercover Operations

The Assistant Commissioner (Criminal Investigation) is responsible for approving all Group I undercover operations and is accountable for the outcome of all undercover activities. The Assistant Commissioner has established a Special Investigative Techniques Branch in CID's National Office to, among other things, generally oversee IRS' undercover activities. However, management of undercover operations is the responsibility of CID officials in IRS' regional and district offices. Because of the potential for operational breakdowns and misuse of funds, we believe that stronger oversight by CID's Special Investigative Techniques Branch would help the National Office ensure that undercover operations—especially the larger, more sensitive, Group I operations—are appropriately planned, monitored, and concluded. Enhanced oversight might also help ensure that procedures are consistently followed by the regions and district offices.

**Chapter 4
National Office Management Should
Strengthen Its Oversight of Undercover
Operations**

In general, criminal investigations are planned by district office CID staff and approved by district office CID management. The overall management of these investigations, including those involving undercover operations, is the responsibility of the district office CID chief. The regional commissioner and district director have direct line authority over the CID chief. However, in recognition of their sensitive nature, investigative techniques such as undercover operations are also subject to review by the assistant regional commissioner (Criminal Investigation). As mentioned in chapter 3, IRS also requires that the more costly and sensitive Group I operations be approved by the Assistant Commissioner (Criminal Investigation) at the National Office.

The Assistant Commissioner (Criminal Investigation) reorganized the National Office Criminal Investigation function in January 1989 and established an Undercover Branch—now called the Special Investigative Techniques Branch—in the Enforcement Division.¹ The Special Investigative Techniques Branch is designated to serve as the link between IRS' National Office and field offices by providing operational assistance to the field, coordinating inter-regional and national undercover activities, and performing operational reviews of undercover operations and recommending corrective actions. To do its work, the Special Investigative Techniques Branch maintains an administrative file for each approved operation; reviews original requests, as well as requests to extend an operation or deviate from its original objectives; reviews the results of regional quarterly operational reviews and district office operational closing reports; and maintains a database to help oversee undercover operations.

**National Office Involvement
in Preoperational Planning
and Operational Reviews**

For Group I operations, which the Assistant Commissioner must approve, the Special Investigative Techniques Branch is notified of pending preoperational meetings and quarterly regional operational reviews and may attend these sessions at its option. As mentioned in chapter 3, a preoperational meeting is required at the start of an undercover operation to discuss important aspects of the operation, such as the objectives, the plan of action, administrative matters, and the security of the undercover agent and government funds. Likewise, a quarterly regional operational review is required during the operation to assess the overall progress and costs of the operation.

¹In July 1990, as part of another reorganization, CID's Undercover Branch was renamed the Special Investigative Techniques Branch, and the Enforcement Division was renamed the Operations Division.

For the Group I undercover operations that we reviewed, National Office staff attended only 2 of 29 (7 percent) of the preoperational meetings that were held and 2 of 18 (11 percent) of the quarterly regional operational reviews that were done. Although the absence of the National Office staff may not have adversely affected these operations, the National Office staff and ultimately the Assistant Commissioner did not maximize their opportunity to affect how these operations were planned or conducted and, possibly, their eventual outcome. More importantly, in line with their overall responsibilities in relation to field offices, National Office staff did not have the opportunity to impart the knowledge, experience, and perspective they have about undercover operations in general.

Special Investigative Techniques Branch staff indicated that they attend preoperational meetings and quarterly regional operational reviews when there are no budget constraints and when staff are available. The Acting Chief of the Special Investigative Techniques Branch said that National Office staff should attend either the preoperational meeting or a quarterly regional operational review for each of the Group I operations to better monitor the progress of these more sensitive and costly operations.

Several concerns were raised by the Commissioner's Review Panel on IRS Integrity Controls about overall National Office oversight of its field activities. For example, in its October 1990 report, the Panel recommended that the National Office provide more effective and uniform direction to the CID field offices by setting standards for the authorization of sensitive investigative techniques. Furthermore, the Panel pointed out that if the Commissioner and his National Office staff are to be held accountable for outcomes in the field offices, they should exercise a commensurate degree of control over field personnel and operations, particularly where criminal investigation activities are concerned.

Discussions with IRS Internal Audit staff and our review of Internal Audit reports about CID's undercover activities indicated Internal Audit's similar concerns about the oversight of undercover operations, especially in regard to CID's adherence to operational and financial controls. For instance, in 1987, Internal Audit reported control breakdowns in such areas as planning undercover operations and accounting for assets and funds. In July 1991, Internal Audit reported that while CID had developed a good system of procedures both for authorizing and executing undercover activities, it had not implemented the oversight necessary to ensure the adherence to these procedures.

**Chapter 4
National Office Management Should
Strengthen Its Oversight of Undercover
Operations**

In its July 1991 report, Internal Audit suggested that CID “increase formal oversight to ensure the implementation of existing procedures for management review of operation activities, cover documents, and funds.” Internal Audit went on to say that “increased oversight will ensure the execution of authorized activities and the safety of agents, informants, and witnesses.” Among other things, Internal Audit also pointed out that the National Office should ensure that

- undercover operational planning addresses all aspects of an operation and communicates objectives and procedures to all participants;
- all open operations are comprehensively reviewed and the information is available to district, regional, and National management;
- all closed operations are reviewed and that the reviews evaluate operational propriety and account for the assets used and acquired; and
- funds are accurately accounted for and used according to established procedures.

Regional and district office officials told us that, although the National Office is adequately involved during the undercover operation approval process, it should be more involved in monitoring the progress of ongoing undercover operations rather than simply monitoring whether required paperwork is submitted when due. One Regional Commissioner suggested that more National Office involvement in monitoring the operations approved by the Assistant Commissioner may be warranted given the sensitivity and cost of these operations. On the other hand, another Regional Commissioner stated that, for practical reasons, the National Office should be directly involved with only the most sensitive or problematic operations.

We met with National Office officials from five other agencies that conduct undercover operations to discuss how they carry out and monitor their operations. All of these officials told us that they emphasize National Office oversight of their undercover operations, including both operational and financial reviews, to ensure that they are fully aware of the progress and costs of their operations.

For example, Drug Enforcement Administration (DEA) undercover operation guidelines require National Office undercover staff to conduct an operational review for all operations after 90 days and then every 6 months. In addition, DEA officials told us that National Office staff perform financial reviews every 6 months and at the conclusion of all operations. Also, the Federal Bureau of Investigation’s (FBI) undercover program

coordinator stated that FBI's National Office conducts separate operational and financial reviews every 90 days for all of the Bureau's Group I operations.

CID Information Could Be Used to Enhance the Effectiveness of Undercover Operations

CID gathers and maintains information about the results of undercover operations such as whether an operation's objectives were met, the number of investigations initiated as a result of an operation, and the number of prosecutions and convictions resulting from investigations involving undercover operations. However, CID's Special Investigative Techniques Branch has not used this information to systematically evaluate the effectiveness of undercover operations or the performance of individual regions and districts in carrying out this sensitive investigative technique. CID is now implementing its new Criminal Investigation Management Information System (CIMIS). Along with other information maintained at the National Office, CIMIS could help the Special Investigative Techniques Branch better oversee undercover operations. Further, this information could be used to develop benchmarks or standards against which CID could measure the effectiveness of operations among regional and district offices and enhance the execution of future undercover operations.

At the conclusion of each operation, district CID staff are to prepare an undercover operation closing report and send it to the Special Investigative Techniques Branch. This report is to include the short-term results of the operation, such as whether the objectives were achieved, as well as estimates of potential criminal charges and civil assessments. As follow-up, the Special Investigative Techniques Branch is to receive periodic undercover operation status reports that detail the long-term results of the operation, such as the number of investigations initiated, prosecutions recommended, and convictions. These computer-generated reports, prepared by CID's Office of Review and Information Systems Management in the National Office, are to be based on district office input to CID's new information management system, CIMIS.

According to CID National Office staff, CIMIS became operable during the early part of fiscal year 1992. The system is designed to replace CID's old Case Management and Time Reporting System (CM&TRS), which contained data that, according to CID's National Office staff, were not consistently complete, accurate, or timely. We compared the results of CM&TRS-generated undercover operation status reports with similar data we obtained from selected district offices. Our comparison showed that CM&TRS generally understated the results of undercover investigations in

**Chapter 4
National Office Management Should
Strengthen Its Oversight of Undercover
Operations**

the selected district offices. For example, prosecutions were understated by 41 percent and convictions by 40 percent.

CID National Office staff told us that, for the most part, discrepancies between National Office and district office data used to occur because of the time it took for updated information from the district offices to be reflected in CM&TRS reports. They also pointed out that the old system was limited in that it could not track the eventual results of undercover operations if the undercover operation number was not recorded on the input document by district CID staff. Likewise it was not able to fully track the various violations under which a target may be prosecuted and convicted. For example, convictions under Titles 31 and 18, as well as certain Title 26 violations currently targeted by CID, are listed as "other" on the status report.

We did not test CIMIS to determine if the new system was able to provide more complete, timely, and accurate data. Also, at the conclusion of our review, the Special Investigative Techniques Branch was not yet receiving undercover operation status reports based on CIMIS. However, CID National Office staff told us that CIMIS will be able to maintain a record of multiple undercover operations associated with a project, which is impossible at present. Also, an analyst with CID's Office of Review and Information Systems Management told us that a new program can be developed to produce a standard undercover operations status report based on the current needs of the Special Investigative Techniques Branch. For example, a report including all U.S. Code violations currently targeted by CID could be generated.

Further, it appears that the new system will be able to produce more timely reports. The Special Investigative Techniques Branch will be able to generate its own status reports without waiting to receive them from the Office of Review and Information Systems Management, as was the practice under the old system. In addition, the district offices, as well as the Special Investigative Techniques Branch, will be on-line with the central computer system, which should expedite receipt of the undercover operation status reports by the National Office.

**Benchmarks Could Be Used
to Evaluate the Effectiveness
of IRS' Undercover Activities**

One way that IRS determines the success of an undercover operation is whether the operation achieves its objectives. Although it may be unrealistic to expect every operation to fully achieve its objectives or result in a conviction, IRS could use the information it has available from CIMIS and other sources to develop benchmarks so that it can evaluate its overall performance in carrying out these sensitive operations. Information on such things as the cost of operations, the number of prosecutions and convictions, and the number of potential targets identified during an operation could be used to compare performance from operation to operation and across regions and districts. Likewise, trend data and lessons learned from individual operations could be used to better manage ongoing undercover operations and enhance the approval process and execution of future undercover activities.

As shown in table 4.1, our analysis of the closing reports prepared by CID district office staff for the operations we reviewed indicated that they determined they had met their objectives in 95 of 183 operations (52 percent).

Table 4.1: Undercover Operations That Met Objectives for Selected Regions From FY 1988 Through FY 1990

Region	Objectives			
	Met	Percent	Not met	Percent
Western	39	63	23	37
Southeast	29	39	45	61
Midwest	17	53	15	47
North Atlantic	10	67	5	33
Totals	95	52	88	48

Source: GAO analysis of CID case files.

Forty-eight percent of these operations did not meet their objectives for various reasons, such as there was no apparent criminal activity, the subject of the investigation would not cooperate with the IRS undercover agent, or the confidential informant became uncooperative. However, CID management would not necessarily consider these operations unsuccessful because of the variety of ways that the success of such operations can be viewed. We asked several CID officials to provide their ideas about what constituted a successful undercover operation. They told us they would consider an operation successful for any of the following reasons:

- The operation resulted in the target's conviction.

- The evidence obtained during the operation supported a prosecution recommendation.
- The operation resulted in obtaining a search warrant.
- The operation proved or disproved allegations.
- The operation generated publicity which serves as a deterrent.
- The operation identified other targets.
- The chief was satisfied with the agent's performance.
- CID properly managed the operation.
- The agent got out of the role in as short a time as possible.
- No funds were stolen.
- No one was killed or injured during the operation.

Because objectives vary so much among operations, they may be of limited value as specific performance indicators. Also, if success is measured only against an operation's original objectives, operations with more ambitious objectives may fare worse in comparison with projects having limited goals. However, a set of performance indicators based on various factors such as cost, timeliness, arrests and convictions, and the identification of potential targets might give management the tools to help field staff design and carry out operations that more readily meet their objectives.

On the basis of the wide range of acceptable outcomes mentioned above, we believe that benchmarks or a common set of criteria would help IRS better evaluate individual undercover operations and enable IRS to assess the overall effectiveness of this sensitive investigative technique. These benchmarks could be established using information IRS already collects, including information on cost, timeliness, and the achievement of the operation's objectives; the prosecution and conviction of the operation's target; the assessment of additional taxes and penalties; and the initiation of other criminal investigations. IRS could then compare results among districts; and the practices of districts with the highest level of performance could be assessed for possible IRS-wide applicability. Those offices with lower performance levels could view the results as a signal calling for self-examination of operational effectiveness.

The National Office would obviously have to take the lead in using information about undercover operations to develop performance indicators. Further, we would envision a larger National Office role in using this information to improve the performance across the districts. For example, the National Office would evaluate those districts with the highest levels of performance to ascertain whether their practices could be adopted by the rest of the organization. Another option would be to

incorporate measurable performance standards for undercover operations in CID's annual business plan—a document setting forth National Office goals in guiding regional operations. A region's performance against these standards would then be assessed as part of the annual business review process, wherein teams of IRS officials from various National Office functions evaluate each region against national benchmarks.

Conclusions

Although National Office CID management is required to approve Group I undercover operations, it has not been actively monitoring them once they are underway. For instance, National Office staff members have participated infrequently in preoperational meetings, during which key aspects of the operations are discussed, such as their objectives and plan of action. Nor have they often taken part in quarterly operational reviews, during which the progress of the operations is determined. We believe that stronger oversight, including more active participation by National Office staff during these meetings and reviews, could help ensure that management is sufficiently cognizant of the risks and costs associated with these operations and could help maintain a focus on the operations' goals and objectives. Further, enhanced oversight would enable National Office CID staff to better gain and transmit knowledge and perspective based on the undercover operation experiences and practices of CID field staffs throughout the country.

Undercover operation status reports indicating the eventual results of operations concerning prosecutions and convictions could improve now that CIMIS is on-line. We believe that this system has the potential to be a useful tool for monitoring and evaluating individual undercover operations and performance across regions and districts. The National Office could use data from the new system along with other information to establish benchmarks or measurable standards for evaluating the effectiveness of these operations. Such standards would enable IRS to track the results of operations across IRS' district offices, identify ways to improve overall performance, and enhance the planning and execution of future operations.

Recommendations

To enhance IRS' management oversight of its undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to

- ensure that the CID National Office staff more actively oversee IRS' undercover operations, such as attending preoperational and quarterly meetings, especially for more costly and sensitive Group I operations;
- ensure that CIMIS provides data that are accurate, timely, and complete so that the Special Investigative Techniques Branch can better monitor, evaluate, and oversee undercover operations; and
- establish benchmarks for evaluating operations and their results and use these benchmarks to measure the performance of individual regions and districts.

Agency Comments and Our Evaluation

IRS generally agreed with our recommendations in this chapter. In its comments on our recommendation that IRS ensure that the National Office staff more actively oversee IRS' undercover operations, IRS agreed and said that it has increased the authorized staffing in its unit responsible for operational reviews of major undercover operations. CID officials told us that they now have three full-time analysts assigned who, because they are criminal investigators, are qualified to attend preoperational meetings and quarterly reviews. They also said that the analysts are scheduled to attend preoperational meetings or quarterly reviews during each sensitive Group I operation and the National Office Director of Operations visits field offices to attend preoperational meetings for the most sensitive operations. CID has also requested that one additional analyst be added to its oversight staff.

In regard to our recommendation that IRS ensure that CIMIS provides data that are accurate, timely, and complete so that it can better monitor, evaluate, and oversee operations, IRS agreed and said that the recommendation is being integrated into the new CIMIS program. IRS did not specify in its written comments how it planned to implement our recommendation, but the CID Director of Operations recently sent a memorandum to the CID staff responsible for CIMIS that outlines the information needed by the National Office to oversee undercover operations, such as the number of investigations generated or associated with the operations, the number of investigations recommended for prosecution, and the number of acquittals and convictions.

**Chapter 4
National Office Management Should
Strengthen Its Oversight of Undercover
Operations**

IRS also agreed in principle with our recommendation that it use benchmarks to evaluate its performance but fell short of saying it would develop and use benchmarks for evaluating undercover operations and their results and for measuring the performance of regions and districts. In its comments, IRS said that it is institutionalizing benchmarking to evaluate program effectiveness as reflected in investigations and said that undercover operations are a technique used in some of these investigations and are judged in terms of their contributions to the overall success of the particular investigation.

We support the institutionalization of benchmarking to evaluate program effectiveness in CID investigations, but believe that benchmarking needs to be extended to include undercover operations. We recognize that undercover operations are a technique or tool that is sometimes used during full-blown criminal investigations. However, because of the sensitivity of undercover operations, IRS plans, approves, carries out, and terminates undercover operations as discrete entities. Further, the information IRS already has available about these operations lends itself to performance measurement and management improvement through comparisons from operation to operation and place to place. If CIMIS works as intended, CID's benchmarking capability for undercover operations could be further enhanced.

In a subsequent meeting to clarify CID's responses to our recommendations, CID officials told us that it is conceivable that benchmarks for sensitive investigative techniques like undercover operations might be considered once CID has had experience and is comfortable with benchmarks established for overall investigations.

Summary Data on Non-Grand Jury Undercover Operations

This appendix presents a summary of 183 non-grand jury undercover operations completed by IRS' Midwest, North Atlantic, Southeast, and Western Regions in fiscal years 1988 through 1990. It is broken down into the following sections: undercover operation characteristics, undercover operation costs, and undercover operation results.

Undercover Operation Characteristics

- One hundred and fifty operations (82 percent) were categorized Group II and 33 (18 percent) were categorized Group I.
- Seventy operations (38 percent) targeted money laundering. The next most frequently targeted violations included 55 fraudulent return preparers (30 percent), 23 business opportunities (13 percent), and 8 tax shelters (4 percent). The remaining 27 operations (15 percent) targeted various other violations.
- Thirty-eight operations (21 percent) involved joint undercover activity with another agency, usually with either the FBI, DEA, or state and/or local law enforcement agencies. The other 145 operations (79 percent) were conducted solely by IRS.
- One hundred and three operations (56 percent) involved the use of a confidential informant, usually either as the source of information or for introduction to the subject of the investigation. The remaining 80 operations (44 percent) did not involve the use of an informant.
- Six operations (3 percent) involved establishing an undercover business, basically involving financial consulting services. The other 177 operations (97 percent) did not involve establishing an undercover business.
- The 183 operations lasted from 1 day to 24 months.

Undercover Operation Costs

- The costs of the undercover operations ranged from \$6 to \$201,404, with 29 operations (16 percent) terminated prior to incurring any costs.
- The 154 operations in which costs were incurred resulted in \$890,464 in total costs. The greatest individual costs for these operations were as follows: fees charged by alleged money launderers to launder money for IRS undercover agents—\$139,569 (16 percent); transportation—\$111,033 (12 percent); lodging—\$101,137 (11 percent); per diem—\$70,094 (8 percent); payments to informants—\$69,088 (8 percent); and local transportation—\$61,235 (7 percent).

Undercover Operation Results

The results of the investigations involving undercover operations were as follows:

- Seventy-three of 183 operations (40 percent) have resulted in generating 170 additional investigations, 130 prosecution recommendations, and 35 convictions.
- Twenty-five of 183 operations (14 percent) have resulted in about \$16 million in additional tax assessments.

Summary Data on Grand Jury Undercover Operations

This appendix presents a summary of statistical data related to 103 grand jury undercover operations completed by IRS' Midwest, North Atlantic, Southeast, and Western Regions in fiscal years 1988 through 1990.

- Sixty-three operations (61 percent) were categorized Group II and 40 (39 percent) were categorized Group I.
- Seventy-three operations (71 percent) targeted money laundering, 17 (17 percent) targeted organized crime, and 4 (4 percent) targeted tax shelters. The remaining 9 operations (9 percent) targeted various other violations.¹
- The 103 operations lasted from 2 days to 18 months.
- The costs of the undercover operations ranged from \$7 to \$288,171, with 17 operations (17 percent) terminated prior to incurring any costs. The 86 operations in which costs were incurred resulted in \$1,191,441 in total costs.
- Sixty-one of the 103 operations (59 percent) have resulted in generating 224 additional investigations, 171 prosecution recommendations, and 82 convictions.

¹These percentages do not total 100 because of rounding.

Comments From the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAR 03 1992

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: IRS Undercover Operations Management Oversight Should Be Strengthened."

As noted in your report, we have an effective set of procedures in place designed to minimize the risks associated with conducting undercover investigations. We appreciate your efforts to assist us in implementing and improving these procedures. As suggested, we will continue to give priority attention to this productive, but sensitive, investigative tool.

We have enclosed detailed comments on the report which provide clarification of our position on each of the six recommendations you set out. Please note that in the course of our continuing review of this delicate area, we have recently amended our procedures to correct problem areas which you have also noted as areas of concern.

Thank you for the opportunity to review this report. We hope you find these comments useful.

Best regards.

Sincerely,

A handwritten signature in cursive script, appearing to read "Shirley D. Peterson".

Shirley D. Peterson
Commissioner

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX ADMINISTRATION: IRS UNDERCOVER OPERATIONS
MANAGEMENT OVERSIGHT SHOULD BE STRENGTHENED"

Recommendation 1:

To ensure the consistent application of controls over undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation), to require that the undercover operation request include a section detailing the alternatives considered and the reason they were judged to be inappropriate.

Comments:

We concur in the need to ensure consistent application of controls over undercover operations. An increased emphasis has been placed on our requirement that the operational facts leading to an undercover operation be presented in greater detail within an undercover request. This background information is therefore exposed to scrutiny throughout the entire review process. At each step, these facts along with other considerations, are reviewed to determine whether or not an undercover operation is the optimum investigative tool which should be used to develop the facts in question.

Recommendation 2:

To ensure the consistent application of controls over undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to require that the undercover operation closing financial audit report include an itemization of the expenses incurred in the operation and a comparison of the proposed costs versus the actual costs of the operation, as well as a statement concerning the reasonableness of the expenses incurred during the operation.

Comments:

We concur that there is a need to conduct financial reviews of undercover operations which include a comparison of proposed costs to the actual costs of each operation. We also agree that reviews should include a determination of the reasonableness of expenditures.

**Appendix III
Comments From the Internal Revenue Service**

The funding for undercover operations is approved at the Assistant Commissioner (Criminal Investigation) level as a total amount. The itemization of proposed expenditures contained in each undercover request is provided to outline the reasonableness of the total funds requested. Once the request is approved, the chief of the operational district has the authority to approve expenditures within the total authorized amount. This authority includes the reasonable and necessary expenses of the operation, regardless of the itemized categories in the original request.

The expenditure of funds in each undercover operation is monitored on a continuous basis. In addition to regular operational reviews, the chief of the operational district certifies that all expenditures are reasonable and necessary on a monthly basis. The Regional Undercover Program Managers and the Contact Agents each do independent 90-day reviews during the operation. Requests for additional funding as well as the closing financial reviews consider both the reasonableness of funds expended and a comparison of requested funds to actual expenditures.

Recommendation 3:

To ensure the consistent application of controls over undercover operations, we recommend that the Commissioner of Internal Revenue require that IRS' Internal Audit staff do the closing financial audits of the most costly and sensitive operations, (Group I operations), to provide organizational independence.

Comments:

We do not believe that it would be in the Service's best interest to require that IRS' Internal Audit do the closing financial reviews. The function of Internal Audit is not to supplement the required and necessary management reviews of the operation. Instead it should be left to concentrate on ensuring the sufficiency of the review process by appropriate management officials as a part of its independent audit process.

The current reviews required by the Internal Revenue Manual Chapter 900, Section 9(13)0 are Criminal Investigation management's way of helping them to ensure that the expenses of an operation are justified and adequately documented, and that agents properly account for any unused government funds. These reviews are part of Criminal Investigation's management oversight which is part of every well managed operation. They are not intended to and do not replace the independent audits conducted by Internal Audit.

Appendix III
Comments From the Internal Revenue Service

The Service believes that significant undercover operations are adequately reviewed through Internal Audit's regular cyclical review of Criminal Investigation activities. The draft GAO report itself cites past internal audits and recommendations made to improve Criminal Investigation activities. These findings and recommendations are from Internal Audit's cyclical coverage. As we noted in the response to the GAO report entitled, "Tax Administration: IRS Experience Using Undercover Operations Proceeds to Offset Operational Expenses" (GGD-91-106, July 3, 1991), increased cyclical coverage may be warranted due to the high risk nature of these type operations. Internal Audit annually considers program coverage of Criminal Investigation when developing its annual audit plan.

The Service's Internal Audit function will continue to be responsible for conducting cyclical audits of IRS' undercover operations. These reviews include the more significant undercover operations and the scope of the audit includes an evaluation of the financial records in these operations. In addition to Internal Audit's activities, the Criminal Investigation function should continue their own management reviews of this area. Management reviews are an important part of the process used to ensure that all operations occur as intended.

Requiring Internal Audit to audit all Group I undercover operations could divert audit resources from other more significant activities that need their attention.

Recommendation 4:

To enhance IRS' management oversight of its undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to ensure that the CID National Office staff more actively oversee IRS' undercover operations, especially the more costly and sensitive Group I operations.

Comments:

We concur. The Special Investigative Techniques Branch of the Office of Operations, Criminal Investigation, is currently dedicated to operational reviews of major undercover operations. Their authorized staffing has been expanded to enhance this portion of their function.

**Appendix III
Comments From the Internal Revenue Service**

Recommendation 5:

To enhance IRS' management oversight of its undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to ensure that the new Criminal Investigation Management Information System provides data that is accurate, timely, and complete so that the Undercover Branch can better monitor, evaluate, and oversee undercover operations.

Comments:

We concur. This recommendation is being integrated into the new CIMIS program.

Recommendation 6:

To enhance IRS' management oversight of its undercover operations, we recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to use benchmarks for evaluating operations and their results, and use these benchmarks to measure the performance of individual regions and districts.

Comments:

We concur. We are institutionalizing benchmarking through the Annual Business Plan process to evaluate our program effectiveness as reflected in our investigations. The use of undercover operations is a technique which we use in some of these investigations and is judged in terms of its contribution to the overall success of the particular investigation.

Major Contributors to This Report

**General Government
Division, Washington,
D.C.**

John M. Lovelady, Assistant Director, Tax Policy and Administration Issues
John F. Mortin, Assignment Manager

**Office of Special
Investigations,
Washington, D.C.**

William L. Davis III, Assistant Director

**New York Regional
Office**

Andrew F. Macyko, Regional Assignment Manager
Robert C. McKay, Evaluator-in-Charge

**Kansas City Regional
Office**

Cecelia M. Ball, Senior Evaluator

**San Francisco Regional
Office**

Kathleen E. Seymour, Senior Evaluator

Ordering Information

The first copy of each GAO report is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877**

Orders may also be placed by calling (202) 275-6241.

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

**Official Business
Penalty for Private Use \$300**

**First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100**