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Report to Congressional Requesters

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UNDERCOVER OPERATIONS

IRS' Management of Project Layoff

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The Honorable Harry Reid
United States Senate

The Honorable Richard Bryan
United States Senate

The Honorable James H. Bilbray
House of Representatives

On June 17, 1991, you asked us to review an Internal Revenue Service (IRS) undercover operation, carried out in 1984 and 1985, known as Project Layoff. Specifically, you asked us to identify problems with the operation and ways to prevent similar problems from arising in the future. Your request stemmed from concerns about operational breakdowns and the potential for misuse of funds associated with Project Layoff, during which IRS agents set up a Las Vegas bookmaking business in an attempt to identify unreported gambling income. This report provides information about how IRS planned and carried out Project Layoff, the costs and results of the operation, problems we noted with Project Layoff, and changes IRS has made since the operation to prevent similar problems in future operations. We will also issue a separate report, based on an earlier request by Senators Reid and Bryan, that addresses IRS' overall management of its current undercover operations and provides recommendations to the Commissioner of Internal Revenue designed to strengthen the management and oversight of these activities.

To identify problems with Project Layoff, we obtained and reviewed available IRS records applicable to the operation and obtained and analyzed the results of audits and investigations performed by IRS' Internal Audit and Internal Security Divisions. We also interviewed current and former IRS employees involved in Project Layoff at IRS' National Office and at regional and district office levels, and discussed Internal Audit and Internal Security findings with the IRS staff responsible for these reviews. Appendix I contains a more detailed discussion of our objectives, scope, and methodology.

Results in Brief

IRS initiated Project Layoff in April 1984 because of its concerns about tax evasion, particularly evasion of the wagering excise tax. The undercover operation was intended to gather intelligence about the extent of illegal bookmaking in Las Vegas and to develop investigative leads about illegal bookmaking operations and their ties to organized crime in other cities throughout the United States. IRS terminated Project Layoff in June 1985—sooner than originally planned—at a cost, excluding salaries, of about $376,000. Although IRS did not fully develop information about ties between illegal bookmakers and organized crime, it was able to use information developed from Project Layoff in a second undercover operation in another district office, which resulted in nine criminal prosecutions and netted approximately $300,000 in criminal fines and about $1.2 million in additional taxes, penalties, and interest. However, to achieve these results, this second undercover operation took an additional 2 years and cost about $64,000 to complete.

Although Project Layoff contributed to tangible results, the operation was costly in terms of IRS' credibility and image with taxpayers. Over the last few years, media attention and congressional hearings have raised questions about IRS' management of Project Layoff, including allegations about possible misuse of funds by IRS employees involved in the operation. While neither we nor IRS were able to substantiate such allegations, our review did show that IRS was not fully prepared to carry out and manage an illegal bookmaking operation of the magnitude of Project Layoff. In the absence of detailed guidelines for accounting for business receipts and disbursements at the time of Project Layoff, IRS agents did not develop or use an adequate recordkeeping system or controls to keep track of the approximately $22 million in wagers and $2.5 million in cash that flowed through the operation. Further, there was insufficient management oversight to ensure that these funds were properly accounted for and safeguarded during the operation. Thus, IRS Internal Audit was unable to reconstruct the ongoing cash position of the business or determine how much money, if any, should have been on hand at the close of the project. Neither we nor IRS were able to determine whether funds were embezzled from the operation.

IRS acknowledges that Project Layoff suffered from control and management weaknesses and has taken steps to strengthen its management of undercover operations, particularly those that involve the operation of an undercover business. Although it is impossible to be certain that these changes will prevent problems like those encountered during Project Layoff, they should help IRS better plan and manage its undercover activities. Nonetheless, to reduce the risks and enhance the chances for success of undercover activities like Project Layoff, we believe that (1) the IRS Controller should be involved in planning financial recordkeeping for all business-type undercover operations and (2) the National Office should be involved in planning and overseeing how intelligence gathered during large-scale operations will be used after the operations have been completed.

Background

In carrying out its law enforcement responsibilities under the Internal Revenue Code, IRS' Criminal Investigation Division (CID) uses various investigative techniques as part of its work. The approach IRS chose to carry out Project Layoff—the undercover operation—is a potentially dangerous and risky investigative technique whereby one or more IRS special agents are authorized to assume identities other than their own for the purpose of obtaining necessary evidence. IRS may also use an informant to assist IRS special agents in obtaining needed evidence or may establish an undercover business as part of the cover necessary to achieve credibility with the subject of the investigation. IRS' undercover operations often focus on money laundering and fraudulent tax return preparation, but may also target such activities as tax shelter schemes and the failure to report illegal sources of income from narcotics and gambling.

Although IRS' undercover operations are usually planned and carried out by CID district office staff and approved by a regional commissioner, the larger and more sensitive operations—those expected to exceed 3 months or cost more than $10,000—must be approved at the National Office by the Assistant Commissioner (Criminal Investigation). Once an undercover operation is approved, district office CID staff are to follow a prescribed set of operational and financial guidelines for carrying out the operation.

The Reno District Office started Project Layoff in 1984 to identify major illegal bookmakers throughout the United States.[1] Because the operation was initially projected to cost about $180,000 and last for 1 year, it was reviewed and approved by the Assistant Commissioner (Criminal Investigation). At the time of Project Layoff, CID had specific guidelines in its Internal Revenue Manual (IRM) concerning how to account for operational expenses, such as the day-to-day expenses of undercover agents and informants. However, the IRM contained no specific guidelines

[1]The district office was moved from Reno to Las Vegas in 1985 after Project Layoff began.

concerning how to account for the income and expenses resulting from an undercover business—particularly an illegal bookmaking business.

IRS Initiated Project Layoff Because of Concerns About Tax Evasion

IRS initiated Project Layoff because it was concerned about tax evasion, particularly evasion of the wagering excise tax under Section 4401 of the Internal Revenue Code. The project was first proposed in 1981 by Reno District Office CID agents because of their concern that they had not had a major impact on the wagering excise tax compliance problem. They believed that an undercover operation could help IRS identify illegal bookmakers who failed to pay required wagering excise taxes. The agents who proposed the project indicated that although wagering excise tax evasion was a significant nationwide problem, Las Vegas played a major role in the national scope of bookmaking activities. They cited IRS estimates that unreported wagering excise taxes in Las Vegas were approximately $4 million per year. The agents further pointed out that the interstate character of the bookmaking operations in Las Vegas could help IRS identify and develop evidence against major bookmakers throughout the United States, many of whom were alleged to have ties to organized crime.

In their initial request, Reno District Office CID staff proposed an undercover operation, to be known as Project Layoff, in which two informants were to assist an IRS undercover agent in establishing and running an illegal bookmaking business in Las Vegas. The Western Regional Commissioner approved the proposal and IRS' National Office Criminal Investigation staff also viewed it favorably. However, the Assistant Commissioner (Compliance) disapproved the proposal in July 1981 because of concerns about the motives of one of the informants and whether this informant had sufficient expertise.[2]

In February 1984, Reno District Office CID staff again proposed an undercover operation known as Project Layoff. This time, agents proposed using a former informant of another government agency to assist an IRS undercover agent in establishing and running an illegal bookmaking business. Although this informant had a prior arrest record for illegal bookmaking and a history of organized crime connections and drug abuse,

[2]At the time of the original request, the Assistant Commissioner (Compliance) was responsible for approving funding for undercover operations. IRS transferred this responsibility to the newly established position of Assistant Commissioner (Criminal Investigation) in October 1983, when IRS reorganized the National Office.

he had extensive bookmaking experience. This proposal was approved by the Assistant Commissioner (Criminal Investigation) who, at the time of the 1981 request, had been Assistant Regional Commissioner for Criminal Investigation in the Western Region. Also, the CID Group Manager who helped develop the 1981 request for Project Layoff was, in 1984, part of the Assistant Commissioner's National Office staff when the request was ultimately approved. In a recent interview, he indicated that the Assistant Commissioner (Criminal Investigation) was more willing than his predecessor to use the criminal investigation function, including using undercover operations.

As proposed in 1984, the primary objective of Project Layoff was to develop information and evidence necessary to obtain indictments and convictions against major illegal bookmakers throughout the United States. A further objective was to acquire information about related tax violations by individuals allegedly associated with organized crime—many of whom were suspected of narcotics trafficking and loan-sharking—who derived a major source of income from gambling. According to the CID Chief at the time that Project Layoff was planned and carried out, this objective was included at the suggestion of the U.S. Attorney for Nevada, who thought that U.S. Attorneys would be more likely to prosecute wagering cases with evidence of organized crime involvement, rather than cases strictly involving wagering.

Execution, Funding, and Results of Project Layoff

IRS began Project Layoff in April 1984, at the start of the baseball season, a time of increased gambling activity. As planned, IRS used the former informant of another government agency to assist CID undercover agents in setting up and running the illegal bookmaking business in Las Vegas. Although the operation was designed to include one undercover agent, two others were assigned during the early stages of the operation because of the large volume of bets generated by the bookmaking business and the need to better maintain the operation's business records. Other IRS agents who were involved in the operation on a day-to-day basis included a contact agent who accounted for the expenses of the undercover agents and a case agent who coordinated the overall investigation with the undercover agents, the informant, and local CID management.

At a March 1984 planning meeting, the special agents and officials from IRS' National Office, the Western Regional Office, and the Reno District Office decided that all operational expenses, such as the daily expenses of the undercover agents and the informant, would be paid from a CID investigative imprest fund established for this purpose. Only winning bets would be paid out of the bookmaking business income. Winning bettors would be paid in cash, since detailed accounting records were to be maintained and it was the nature of illegal bookmaking businesses to pay winners in cash. In addition to betting records maintained by the undercover agents, all bets were to be made by telephone and recorded on electronic recording equipment installed by IRS. This was another standard bookmaking practice to prevent bettors who lost from claiming that they had actually won, while also providing IRS with a backup record of all bets made. However, due to inconsistencies in the records maintained by the undercover agents and breakdowns of the electronic recording equipment, neither provided a complete accounting of all the betting activity that occurred during Project Layoff.

During the operation, the undercover agents maintained the financial records of the bookmaking business and handled all cash receipts and disbursements. The case agent determined which bettors should be paid by the undercover agents and which bettors owed money to the operation. The informant was used strictly to obtain bettors for the operation through his bookmaking experience, to adjust the odds on the basis of the volume of bets placed with the operation, and to identify and place bets with other illegal bookmakers around the country. He was not allowed to handle cash during the operation. To minimize the potential for financial losses during the operation, bets made with the bookmaking business were "layed off" with other bookmakers. This is a common practice among bookmakers whereby bets placed by a bettor with one bookmaker are then made, or "layed off," with another bookmaker. Thus, the bookmakers can break even on the bet but still make a profit from a commission that they charge the bettor for placing the bet.

IRS anticipated that Project Layoff would, over time, make a profit. However, IRS also expected that the operation would incur a rather significant amount of uncollected accounts receivable. This was because IRS could not use the normal methods bookmakers use to collect unpaid debts, such as threats, bodily harm, or loan-sharking. In fact, an unpaid bet led to the eventual termination of Project Layoff. In March 1985, one of the IRS undercover agents brandished a firearm to protect himself against the threat of bodily harm by associates of a bettor the agents refused to pay because the bettor had not paid them for some earlier losing bets. A few days later, the CID Chief recommended closing the operation in an orderly fashion. IRS records indicated that the Federal Bureau of Investigation (FBI) subsequently notified IRS that it had received an anonymous death threat against two bookmakers, believed to be the IRS undercover agents. At this time, CID staged a phony raid on the Project Layoff bookmaking business office to provide a cover whereupon CID removed the wagering records and equipment and moved the agents and the informant to the Lake Tahoe area in Nevada.

The undercover agents told us that they disagreed with the decision to close the operation because they believed the threat had been adequately dealt with by the IRS case agent. The case agent had made arrangements with two Las Vegas police detectives to pose as corrupt police officers who provided protection for the operation. Nonetheless, the undercover agents were moved to Lake Tahoe with the understanding that they would attempt to collect or, if necessary, pay any bets associated with the operation. The operation was officially closed in June 1985. Afterward, district office CID staff compiled information on individuals and businesses identified during the operation as illegal gamblers and bookmakers and sent this information to other IRS offices around the country for their consideration as potential targets for criminal investigations.

IRS' Use of Funds to Pay for Project Layoff

IRS records showed that a total of $381,253 was approved for Project Layoff—$180,795 for the original authorization and $200,458 for subsequent authorizations. Of the total amount authorized, according to IRS' operational closing report, IRS spent $375,770 to carry out the operation. IRS estimates that an additional $200,000 in staff salaries was expended, which would have been incurred whether or not Project Layoff was done.

IRS' operational closing report for Project Layoff did not itemize the individual costs of the operation. However, our analysis of the initial request and three subsequent funding requests showed that IRS planned to spend about $108,000 for the undercover agents' living expenses, such as apartment and vehicle rentals; $88,000 for the informant's living expenses, including a weekly salary of about $500 and apartment rental expenses; $62,000 for the cost of the bookmaking business office, such as office rental and telephone expenses; and $60,000 for a wagering bankroll.[3]

IRS officials told us that, at the conclusion of Project Layoff, the informant was paid $50,000 for his contributions to the operation—half of the

[3]This was for deposits with local legal bookmakers to enable the undercover business to lay off bets with them when they could not do so with other illegal bookmakers.

amount originally authorized had the operation met all of its objectives. The informant was also given the 1979 Cadillac that was purchased for his use during the operation. The payment to the informant and the funds to purchase the automobile were authorized by IRS from the district office investigative imprest fund.

Results of Project Layoff

Project Layoff was terminated before IRS was able to get enough information to conclusively link nationwide bookmaking operations with organized crime. Nonetheless, the operation contributed to some significant convictions, fines, and tax assessments. After the operation ended, the Las Vegas District Office compiled information on 19 individuals and one business, which the office sent to other district offices for potential follow-up. Of these, 14 were unproductive, 4 resulted in audits in which a total of $34,219 in additional tax assessments were made, and for 1, IRS was unable to determine the results. The 14 referrals that were unproductive were based on determinations by CID staff in the districts to which the referrals were sent that the referrals did not have substantial prosecution potential. For example, three referrals to the Manhattan District Office were not followed up because the local U.S. Attorney told CID staff that he would not prosecute wagering cases.

Information from Project Layoff was also the impetus for a subsequent undercover operation in another IRS district office. This operation, which lasted 2 years and cost $64,267, involved two of the undercover agents associated with Project Layoff. As a result of this second operation, nine individuals either pled guilty or were convicted of violating various sections of the Internal Revenue Code. Of those, the government charged $295,000 in criminal fines, and six individuals received jail sentences. IRS also assessed $1,285,112 in additional taxes, penalties, and interest against six individuals and collected $1,151,618, or 90 percent, of the amount assessed. One of the six individuals who was assessed an additional $175,822 had failed to file tax returns from 1984 to 1988.

IRS Was Not Fully Prepared to Execute Project Layoff

After Project Layoff was terminated, allegations surfaced about operational breakdowns and the possible misuse of funds by IRS employees involved in the operation. While neither we nor IRS were able to substantiate such allegations, a review of Project Layoff by IRS' Internal Audit, our review of available records, and our discussions with current and former IRS officials associated with the operation indicated that IRS was not fully prepared to carry out and manage an illegal bookmaking operation of the magnitude of Project Layoff.

IRS Failed to Set Up and Maintain Adequate Controls and Records

Many of the problems and allegations associated with Project Layoff stemmed from (1) a lack of specific IRS guidelines concerning how to adequately account for business receipts and disbursements and (2) CID's failure to set up and maintain adequate recordkeeping and establish appropriate controls to ensure that betting transactions were properly managed and accounted for. IRS' Internal Audit estimated that, during the course of the operation, the undercover agents handled approximately $22 million in illegal wagers and about $2.5 million in cash associated with these wagers. None of these funds represented funds authorized for the expenses of the operation—rather, they were funds generated by operation of the illegal bookmaking business.

In 1985, after Project Layoff was concluded, IRS' Internal Audit reviewed the operation as part of an overall audit of IRS' undercover activities. In regard to Project Layoff, Internal Audit concluded that CID could properly account for funds used for the operational expenses paid from the CID investigative imprest fund, such as the day-to-day expenses of the undercover agents and informant. However, because of problems with the records maintained for the bookmaking business, Internal Audit was unable to reconstruct the ongoing cash position of the business or determine the amount of money, if any, that should have been on hand at the close of the operation. Our review of Internal Audit's report and associated workpapers showed that

- account records were unclear about whether customers were receiving payments from or making payments to the operation;
- detailed cash receipts and disbursements records were not consistently maintained during the time the business was operated and were not available at all for the first 3 months of the operation;
- two business bank accounts were used during the operation, but monthly bank statements could not be located for 6 of the 15 months of the operation;
- business receipts were used to pay expenses other than paying winning bets: agents purchased Super Bowl and boxing tickets for customers, and $279 was used to pay for an office Christmas party; and
- the case agent alone determined the overall results of the betting transactions—approximately $22 million in wagers and $2.5 million in

cash—and told the undercover agents who was to be paid and who owed money to the operation.

Internal Audit's work also prompted investigations of the Project Layoff undercover agents and case agent by IRS' Internal Security Division. One investigation involved two of the three CID undercover agents that participated in the operation and focused on allegations that the agents may have filed fraudulent travel vouchers and embezzled operational funds.[4] Internal Security's investigation disclosed no criminal misconduct by the agents relating to fraudulent travel vouchers or the embezzlement of Project Layoff funds. Another Internal Security investigation focused on an alleged embezzlement scheme by the IRS case agent and one of Project Layoff's major winning bettors. This investigation was coordinated with the U.S. Attorney in Las Vegas, who declined prosecution in December 1991 on the basis of insufficient evidence. The investigation was closed on March 12, 1992, because the statute of limitations was about to expire for alleged criminal violations that may have occurred during the time of Project Layoff—April 1984 through June 1985.[5] On the basis of our discussions with Internal Audit and Internal Security staff involved in these investigations and our review of their reports and workpapers, we were unable to determine whether funds were embezzled from Project Layoff.

IRS Failed to Adequately Oversee Project Layoff's Business Activities

We believe that IRS adequately monitored the expenses of the undercover agents, informant, and the bookmaking business office during Project Layoff, but the operation's business receipts and disbursements did not receive the same level of oversight by CID management. Given the volume of wagering and the amount of cash being handled during the operation, the nationwide importance of the intelligence being developed, and the fact that there were no specific guidelines in the IRM concerning the types of business records that should be maintained, close monitoring of the business receipts and disbursements by IRS management would have been essential to ensure that they were adequately accounted for. However, our interviews with IRS officials associated with the operation indicated that the oversight of Project Layoff's business records was very limited.

[4]A third undercover agent was assigned during the early stages of the operation to help keep track of the betting transactions. However, the agent became sick during the operation and eventually died of natural causes. IRS did not assign another agent to the operation.

[5]The Project Layoff case agent is no longer employed by IRS. His employment was terminated in 1989 for reasons unrelated to Project Layoff.

For instance, IRS requires that the CID Chief approve operational expenses—such as the daily expenses of the undercover agents and the informant—and oversee the progress of the undercover operation. The CID Chief for the Reno District Office at the time of Project Layoff delegated the oversight responsibility for this operation to a district office group manager, who, along with the case agent, provided briefings to the CID Chief and the District Director. The CID Chief during Project Layoff told us that he relied on the group manager to handle the brunt of the operational oversight, because he did not have an Assistant Chief to share the overall CID investigative caseload. Although the group manager monitored the operation, he relied on the case agent to determine the winning and losing bettors and the weekly financial position of the bookmaking business. As a result, the case agent was the only person deciding the outcome of the $22 million in wagers handled by the operation.

A Regional Undercover Program Manager (RUPM), who was a staff member of the Western Region's Assistant Regional Commissioner (Criminal Investigation), also played an important role in the oversight of Project Layoff. As required by IRS, the RUPM did operational reviews of Project Layoff in May, September, and December 1984, which focused on the progress of the operation and its operational expenses. The RUPM told us that he did not review the business records in detail.

The District Director also reviewed the operation in June, September, and November 1984, and in February 1985. However, the CID Chief told us that these reviews were basically briefings by the group manager and the case agent concerning the overall costs, progress, and future direction of the operation. In addition, the National Office Criminal Investigation staff visited the district and reviewed the operation in October 1984. The emphasis of this review, which included National Office and regional and district office management, as well as the participating agents, was on the operation's progress and future direction, and the potential targets identified to date. The National Office staff did not review Project Layoff's business records.

Other Observations About IRS' Handling of Project Layoff

Our discussions with individuals involved in Project Layoff led to other observations that we believe are germane to how IRS handled this operation and should be considered when planning future undercover activities. One of these observations concerned IRS' efforts to coordinate Project Layoff with other law enforcement agencies, particularly the FBI.

IRS district and National Office officials that were involved with Project Layoff told us that, initially, only the local U.S. Attorney and the Special Agent-in-Charge of the Las Vegas FBI office were notified about Project Layoff. Others in the Las Vegas FBI office apparently became aware of the operation in January 1985, when the FBI raided the Project Layoff business office. The raid was carried out in conjunction with raids of several other illegal bookmaking businesses in the area, just before the 1985 Super Bowl. In a memo discussing the FBI raid, the IRS District Director said that, in his opinion, the raid enhanced the credibility of the IRS bookmaking operation because it was raided along with other illegal bookmaking operations in the Las Vegas area and throughout the country.

District office CID staff told us that, other than local FBI management, other agencies were not notified of the operation to prevent information concerning the IRS operation from becoming known to the targets of the investigation. They also expressed the concern that coordinating this type of an operation with another law enforcement agency was a problem for IRS because of Internal Revenue Code Section 4424, which specifically prohibits IRS employees from disclosing wagering tax information to assist other agencies in the prosecution of criminal violations other than tax violations.

The lack of FBI involvement appeared to have little impact on IRS' ability to carry out Project Layoff, but IRS encountered some operational problems that might have been avoided if the FBI had been involved in the operation. An individual involved with Project Layoff at IRS' National Office told us that the operation would have benefited had IRS more closely coordinated the operation with the local FBI office, which could have helped IRS take advantage of their expertise in such areas as electronic surveillance. IRS experienced some breakdowns in the electronic telephone taping system during the operation, which resulted in a loss of backup records to those maintained by the undercover agents.

Another observation we made involved CID's overall use of information developed during Project Layoff. As mentioned earlier, IRS was able to use information from Project Layoff for an additional investigation, which produced convictions, fines, and tax assessments. However, this was the only substantive criminal investigation that was done out of the 20 referrals that the Las Vegas District Office sent to other IRS district offices based on information developed during Project Layoff. In addition, there were no follow-up criminal investigations in Las Vegas even though an estimated

$4 million annually in unreported wagering excise taxes in the Las Vegas area was part of the reason IRS initiated Project Layoff.

According to district office staff involved in Project Layoff, the reason no further criminal investigations were done in the Las Vegas area was that the leads developed during the operation were not sufficient to ensure a high likelihood of prosecution. In particular, most of the major illegal bookmakers identified during the operation were in other parts of the country, such as New York and Los Angeles. Also, the operation did not develop solid leads concerning Las Vegas bookmakers' ties to organized crime, which was an important factor in determining the prosecution potential of any subsequent IRS investigative efforts.

An official with IRS' National Office at the time of Project Layoff told us that an operation of this magnitude—designed to develop intelligence and investigative leads throughout the country—would have been much more effective if it could have been run by the National Office. This would have allowed the National Office to have had greater control over the progress and results of the operation, including how the various district offices used the intelligence that was gathered. He also stated that district office CID staff often prefer using their own leads rather than those developed by other district offices. Nonetheless, CID officials currently with IRS' National Office told us that, given CID's decentralized organizational structure, the National Office's role is to oversee and monitor undercover operations that are carried out and managed by the field offices.

In our opinion, greater National Office involvement in planning for the use of information developed in this type of operation might help IRS better determine if CID staff in other district offices, U.S. Attorneys, or IRS' Examination Division would likely use this information for prosecutions or examinations. If IRS were to use this approach, IRS might be less likely to carry out an operation that produced limited results, thereby avoiding a drain on limited staffing and financial resources. In addition, better "marketing" of intended results by the National Office before an operation might help IRS focus on results, thereby making the operation more efficient and effective.

IRS Has Made Changes to Strengthen the Management of Its Undercover Operations Since Project Layoff

Since Project Layoff was terminated in 1985, IRS has taken steps to strengthen its management of undercover operations. In October 1986, after IRS' Internal Audit had identified some of the shortcomings with IRS' recordkeeping during Project Layoff, IRS instituted a requirement that all undercover operations be audited quarterly and at their conclusion by CID district office staff not involved with the undercover operation. At the same time, IRS revised undercover operation guidelines to include a requirement that detailed business records be maintained for operations involving an undercover business. The guidelines included examples of the types of records to be maintained, such as the use of a detailed business ledger to record receipts and expenses, and a monthly profit and loss statement.

Project Layoff was also the catalyst for more recent changes to IRS' undercover operations. 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. He stated that these included inadequate planning, insufficient training and supervision of the undercover agents assigned to the operation, and a general lack of financial controls. He further stated that recommendations from both Internal Audit and an internal task force that reviewed IRS' overall undercover operation guidelines were to be used to implement improved operational procedures and controls over future undercover operations.

In response to the hearings, IRS made changes in CID's undercover guidelines to encourage that CID staff contact the IRS Controller when planning an undercover operation that involves running an undercover business. IRS made this revision to enable the IRS Controller to advise CID on the types of business records needed to fully account for the receipts and disbursements of the undercover business. This is particularly important in light of Section 7608(c) of the Internal Revenue Code, which gives IRS the authority to use the proceeds from an undercover business to offset the expenses of carrying out the undercover operation.[6]

IRS also agreed to make changes to its management of undercover operations in response to our report entitled Tax Administration: IRS Undercover Operations Management Should Be Strengthened

[6]This authority expired on December 31, 1991. The Department of the Treasury plans to propose legislation to reinstate it. We discussed IRS' authority to use proceeds from business-type undercover operations in a July 1991 report entitled Tax Administration: IRS' Experience Using Undercover Operations' Proceeds to Offset Operational Expenses (GAO/GGD-91-106, July 3, 1991).

(GAO/GGD-92-79, April 21, 1992). Although we found no operations as costly or problematic as Project Layoff, in that report we concluded that IRS could enhance its procedures to better protect against operational breakdowns or potential misuse of funds. We recommended several changes to strengthen the management and oversight of IRS' undercover operations, including reaffirming the importance of monitoring and auditing the operations; improving the undercover request by discussing the alternatives to undercover operations that were considered; and strengthening the evaluation and measurement of completed operations so that lessons learned can be applied to future operations.

In written and oral comments to that report, IRS agreed in principle with five of our six recommendations and has taken steps or plans to take steps to strengthen the management and oversight of its undercover operations. IRS disagreed with our recommendation that Internal Audit be responsible for audits of the more costly and sensitive undercover operations primarily because of resource limitations.

We recognize that having Internal Audit do these audits could affect its ability to audit other IRS activities. However, the cost and sensitivity of some operations like Project Layoff, combined with the basic principle that audits should be done by an independent entity, leads to the conclusion that Internal Audit should be charged with that responsibility. Such a measure would heighten awareness of the need for accountability during an operation involving cash transactions or large sums of money and reduce IRS' vulnerability to the kinds of allegations that surfaced following Project Layoff.

Conclusions

CID's objectives for conducting Project Layoff seem reasonable considering its concerns about unreported wagering excise taxes and its failure in the past to identify and convict individuals for noncompliance with these tax requirements. However, the operation suffered from a lack of adequate planning and oversight, which resulted in business records that were not sufficient to ensure that the wagering transactions and cash generated during the operation were properly accounted for. Given the operation's sensitivity and its nationwide scope, it would have benefited from a stronger role by IRS' National Office, which could have helped ensure that information from Project Layoff was used by other regions and districts.

As a result of Project Layoff, IRS has taken steps to strengthen its management of undercover operations, especially those involving the operation of an undercover business. We cannot be certain that these changes will prevent problems like those that occurred in Project Layoff, but they should help IRS better plan, manage, and account for its undercover activities in the future. We especially believe that IRS' procedural change encouraging that IRS' Controller be involved in the planning of business-type operations is laudable. However, we believe that the problems highlighted by Project Layoff indicate a need to require, not just encourage, that CID involve the Controller in planning the recordkeeping for all business-type operations. Further, we believe that greater National Office involvement in the planning and oversight of large-scale business-type operations such as Project Layoff would help IRS (1) ensure that an operation is properly managed and receipts are properly accounted for and (2) determine if other district offices, U.S. Attorneys, or IRS' Examination Division are likely to be receptive to using evidence or intelligence gathered during the operation.

Recommendations

We recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Criminal Investigation) to require (1) that CID staff involve the Controller in planning financial recordkeeping to adequately account for business receipts and disbursements during business-type undercover operations and (2) that National Office staff be involved in planning and overseeing how intelligence gathered and developed during large-scale operations will be used after the operations are completed.

Agency Comments and Our Evaluation

We obtained oral comments from the Assistant Chief Inspector, Internal Security, and the Deputy Assistant Chief Inspector, Internal Audit, with IRS' Office of the Chief Inspector and from the Director, Office of Operations, and the Chief, Special Investigative Techniques Branch, with the Criminal Investigation Division. Their comments included suggestions for minor word changes and technical corrections, which we have incorporated in the report as appropriate. Both Inspection and CID officials agreed with the accuracy of the draft report and with our recommendations.

In response to our recommendation that CID staff be required to involve the IRS Controller when planning financial recordkeeping for business-type undercover operations, CID officials said that the current financial records required for these types of operations have been reviewed and approved by the IRS Controller. They estimated that this would cover the majority of businesses that CID might use in its undercover operations. They also said that they would change the IRM to require that CID contact the Controller to plan the financial recordkeeping for any undercover businesses for which the currently approved types of financial records would not be adequate.

In our draft report we recommended that National Office staff be involved in planning and directing how intelligence gathered during large-scale operations is used. In their comments, CID officials agreed with the thrust of the recommendation but had concerns about the word "direct," because they said that their role is to oversee undercover operations, not direct them. We recognize that the National Office is not in a position to direct operations and have changed our recommendation to reflect their oversight capacity. However, we continue to believe that the National Office can play an important role in planning for the use of information developed during large-scale undercover operations. Stronger National Office involvement could help IRS better determine whether CID staff in other IRS district offices, U.S. Attorneys, or IRS' Examination Division would be likely to use this information for prosecutions or examinations. CID officials agreed that, during the undercover operation approval process, they would ensure that consideration is given to how information obtained during an undercover operation is to be used.

In light of the extensive reviews and investigations that have been done since Project Layoff was concluded, CID officials expressed concern with our statement that we were unable to determine whether funds were embezzled from Project Layoff. They said that this might continue to raise concerns about the possibility that funds may have been stolen from the operation.

Although the extensive audit and investigative efforts of IRS, as well as our own, have not produced evidence that funds were stolen from Project Layoff, we believe that IRS' failure to exercise adequate controls over this operation increased the opportunity for misuse of funds, including theft or embezzlement, by individuals involved in this operation. The same would hold true for any undercover operation without adequate controls over large sums of cash. However, we believe that strict adherence to IRS' current undercover operation guidelines, coupled with our recommendations to strengthen management and oversight of its undercover activities, should enable IRS to reduce the risk of potentially embarrassing problems such as those resulting from Project Layoff.

As agreed with your offices, we will make no further distribution of this report for 30 days. At that time, we will make copies available to others upon request.

Major contributors to this report are listed in appendix II. If you have any questions about this report, please call me on (202) 275-6407.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Objectives, Scope, and Methodology

We were asked to review IRS' management of Project Layoff to identify problems with the operation and ways to prevent similar problems from arising in future operations.

To meet our objectives, we obtained and reviewed IRS' existing records applicable to Project Layoff, including the initial and subsequent requests for approval and funding to carry out the operation; reports of district and regional management's operational reviews; the operational closing report; workpapers and reports prepared by IRS' Internal Audit Division; and investigative reports prepared by IRS' Internal Security Division. We also obtained and analyzed the results of additional investigations, prosecutions, and convictions related to the operation, as well as additional tax, interest, and penalties IRS assessed and collected as a result of these investigations. We were unable to review the detailed daily records prepared by the agents involved in the operation because IRS destroyed these records in accordance with CID record retention procedures outlined in the Internal Revenue Manual.

To get a better perspective on the events and problems allegedly associated with Project Layoff, we interviewed IRS officials who were involved with the operation at the National Office and at regional office and district office levels, including the undercover agents, the CID Chief, the Western Regional Commissioner, and a staff member to the Assistant Commissioner (Criminal Investigation) at the National Office. We did not interview the Project Layoff case agent or the confidential informant because they were both under investigation at the time of our review. However, we reviewed the Internal Security report of investigation of the case agent, which contained a recent Internal Security memorandum of interview of the case agent. We also interviewed IRS' Chief Inspector and the Internal Audit and Internal Security staff members involved in the subsequent reviews. Finally, we discussed Project Layoff with the current Assistant Commissioner and his staff at IRS' National Office.

We obtained comments from the Assistant Chief Inspector, Internal Security, and the Deputy Assistant Chief Inspector, Internal Audit, with IRS' Office of the Chief Inspector and from CID's Director, Office of Operations, and Chief, Special Investigative Techniques Branch. Their comments were incorporated where appropriate. We also provided a copy of the draft report to IRS' Office of Assistant Chief Counsel, Disclosure Litigation, which advised us that the draft contained no tax return information as defined by Section 6103 of the Internal Revenue Code.

We did our work from July 1991 through February 1992 at IRS' National Office, the Western and North Atlantic Regional Offices, and the Las Vegas District Office. We did our work in accordance with generally accepted government auditing standards.

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