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February 1998

**TAX  
ADMINISTRATION**

**IRS' Use of Information  
Gathering Projects**



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**General Government Division**

B-277868

February 5, 1998

The Honorable Paul Coverdell  
United States Senate

Dear Senator Coverdell:

As part of its mission, the Internal Revenue Service (IRS) strives to maintain the highest possible level of tax compliance. IRS annually audits a number of tax returns to determine whether taxpayers have voluntarily complied with the tax laws and paid the proper amounts of tax. In selecting returns for audit, IRS' computer assigns a score<sup>1</sup> to each filed return to help find those having audit potential—that is, those for which an audit would be likely to change the reported tax because of noncompliance.

Because such computer-aided selection techniques rely solely on information on filed returns, IRS' Examination Division collects information from other sources to identify areas of potential taxpayer noncompliance. Information Gathering Projects (IGP) are one technique that IRS uses to collect information on noncompliance and to identify returns with audit potential.

Due to your concerns about IGPs being misused in auditing tax returns, you asked us to study IRS' use of IGPs in identifying returns for audit. This report responds to your request for information on the (1) number of IGPs nationwide and in IRS' Georgia District during fiscal years 1994 through 1996, (2) descriptions and results of IGPs in the state of Georgia during fiscal years 1994 through 1996, and (3) controls and procedures IRS has in place for IGPs. We focused on fiscal years 1994-1996 because accurate and verifiable data for prior years were unavailable.

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## Background

An IGP is a study or survey undertaken to identify noncompliance with the tax laws. IGPs can be proposed at any level—district, regional, or national—within IRS but are generally initiated at one or more of IRS' 33 district offices. IRS staff propose IGPs on the basis of past audits or studies that have shown noncompliance for selected taxpayer populations, such

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<sup>1</sup>This computer-generated score is called discriminant function (DIF). IRS has computed such a score since the 1960s by using a formula created from the results of compliance audits of randomly selected tax returns filed by individuals and other taxpayer populations. Through tax year 1988, IRS did these compliance audits about every 3 years. Using the score, IRS sorts returns into those having and not having audit potential. DIF is IRS' major source for objectively identifying tax returns to audit.

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as those in a particular occupation, industry, geographic area, or economic activity, or those claiming a particular tax exemption, deduction, or credit.

During an IGP, IRS staff usually audit a limited number of taxpayers within the selected population. For IGP audits, IRS staff are to select tax returns after reviewing information available within IRS and from non-IRS sources such as banks, licensing and trade organizations, or other third parties. IRS believes that IGPs help IRS staff to select potentially noncompliant tax returns for audit that would not otherwise be identified as having audit potential. In this vein, IGPs have served as 1 of over 30 sources that IRS' Examination Division uses to identify returns with audit potential. In recent years, IGPs have accounted for less than 5 percent of the total number of returns selected for audit.

In addition to using IGPs to identify noncompliance and take enforcement action, IRS also intended to use them to determine the reasons for noncompliance and recommend ways to reduce it. However, IRS has historically used IGPs as tools for enforcing tax laws rather than as research tools for collecting data about compliance within taxpayer populations. Our past work has discussed some of the problems with attempts to research noncompliance and related solutions through IGPs.<sup>2</sup> For example, we raised concerns about whether IGPs (1) focused on taxpayer populations with significant compliance shortfalls and (2) collected statistically valid data that could be generalized to a larger population. As for IRS' management of IGPs, we pointed to the benefits of enhanced coordination across IGPs in order to avoid unnecessary duplication and to make fuller use of IGP results.

In recent years, IRS has been going through a transition involving its framework for doing compliance research, including the use of IGPs as research tools. Under its 1997 compliance initiative proposal (CIP), IRS is attempting to link IGPs to a larger research framework and better manage IGPs to make them more useful for doing compliance research. In fact, IRS intends to refer to IGPs as "compliance initiatives."<sup>3</sup> Recognizing these changes, IRS Examination officials continue to view IGPs as essential

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<sup>2</sup>Tax Administration: Profiles of the Major Components of the Tax Gap (GAO/GGD-90-53BR, Apr. 4, 1990), Tax Administration: Compliance 2000—A Worthy Idea That Needs Effective Implementation (GAO/T-GGD-92-48, June 3, 1992), Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, Aug. 2, 1994), and Tax Research: IRS Has Made Progress but Major Challenges Remain (GAO/GGD-96-109, June 5, 1996).

<sup>3</sup>The term "compliance initiative" refers to and replaces all activities/projects, such as IGPs, to study, measure, or improve tax compliance.

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enforcement tools and sources for data on specific types of noncompliance.

The revised framework also includes IRS' recent efforts to develop a more comprehensive and statistically valid approach to compliance research. Under this approach, IRS has created new research methods and tools as well as research units in each district to do compliance research and to oversee compliance efforts, such as IGPs. IRS hopes that this approach will produce valid research data to better identify significant noncompliance and the reasons for it, as well as to better test ways to reduce the noncompliance.

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## Results in Brief

IRS reported that it had about 1,000 IGPs open nationwide during both fiscal year 1995 and fiscal year 1996. Data on the nationwide number of IGPs in fiscal year 1994 were not readily available. According to IRS officials, nationwide IGP tracking records were discarded or lost during IRS' reorganization efforts, which involved consolidating 63 districts into 33 and shifting responsibility for IGP records.

Of the 76 IGPs that were open in Georgia during fiscal years 1994 through 1996, over half focused on (1) business taxpayers that potentially underreported their income or overreported expenses; (2) business taxpayers that potentially did not properly report or pay taxes, such as the excise tax on fuels; (3) individual taxpayers who potentially claimed an improper exemption, filing status, or earned income credit; and (4) business and individual taxpayers who potentially did not file required tax returns. Of these 76 Georgia IGPs, 41 had closed as of June 1997. The duration of these closed audits varied from several months to several years. The audit results, such as additional taxes recommended plus penalties, also varied, with the additional tax amounts ranging from \$0 to \$269 million. For most of these IGPs, IRS audited relatively few tax returns. IRS closed about three-quarters of these IGPs after auditing fewer than 50 returns, including 9 that closed without any audits being done.

For years, IRS has had several controls and procedures designed to limit the vulnerability of IGPs to misuse as an audit selection technique. IRS has always required that proposed IGPs undergo review and approval processes at high levels within the Examination Division in each of the districts. To oversee IGPs, IRS has a unit at each of its 33 district offices. These units monitor how returns were selected for audit and whether the audit results justified continuance of the project.

Further, IRS recently has started adding processes to enhance the contribution of IGPs to compliance research. In 1997, IRS began implementing CIP processes. IRS is involving its Research Division in the processes for approving and overseeing IGPs in the hopes of making IGPs more useful for research purposes.

## IGPs Nationwide and in Georgia

IRS Examination staff can run IGPs in IRS' National Office, its 33 district offices, and its 10 service centers. Table 1 shows the reported number of IGPs for IRS nationwide and for the Georgia District.

**Table 1: IGPs Open Nationwide and in the Georgia District During Fiscal Years 1994 Through 1996**

IGP area	1994	1995	1996
Nationwide	<sup>a</sup>	1,097	931
Georgia District	53	38	37

<sup>a</sup>IRS could not provide data on the number of IGPs during fiscal year 1994 because records were discarded or lost during IRS reorganizing and restructuring.

Source: IRS data for fiscal years 1994 through 1996.

Because most IGPs start in one fiscal year and close in a later year, the total number of individual IGPs is smaller than the sum of IGPs for the 3 fiscal years. For the Georgia District, the total number of individual IGPs reported was 76, but the sum of the IGPs shown as open in the 3 fiscal years in table 1 was 128.

## Recent IGP Results in IRS' Georgia District

For fiscal years 1994 through 1996, IRS provided information on 76 IGPs that were open at some time during these years in the Georgia District. Over half of these IGPs (44) focused on four types of taxpayers: (1) businesses that potentially underreported income or overreported expense deductions; (2) businesses that potentially did not properly report or pay taxes, such as excise taxes on fuel, chemicals, or heavy vehicle use; (3) individual taxpayers who potentially claimed an improper exemption for dependents, a filing status (e.g., head of household), or earned income credit; and (4) businesses and individual taxpayers who potentially did not file required tax returns. The remaining 32 IGPs dealt with a wide range of suspected noncompliance involving topics such as the misclassification of employees as independent contractors, income from wagering, income from timber sales, and taxable events for individual partners or shareholders.

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We tracked the duration and audit results of Georgia IGPs that had closed at the time we did our work. Of the 76 IGPs, 41 were closed as of June 1997. The length of time that these 41 IGPs had remained open varied from 5 months to several years; more specifically, 23 of the 41 IGPs lasted 2 or more years. The audit results for the 41 IGPs also varied widely. These results included the number of returns audited, the additional taxes and penalties recommended, and the percent of audited returns that recommended no tax changes. For example:

- The number of returns audited ranged from 0 to 516 but usually involved fewer than 50. Of the 41 closed projects, 32 involved audits, and 9 involved no audits.<sup>4</sup> Of the 32 projects involving audits, 23 were closed after auditing fewer than 50 returns each.
- The additional recommended tax plus penalty amounts per IGP ranged from \$0 (in the 9 IGPs closed without any audits) to \$269 million; of the 32 IGPs with audits, 11 recommended total additional tax amounts that exceeded \$500,000, and 7 recommended total amounts exceeding \$1 million.
- Of the 32 IGPs with audits, 3 closed with a no-change rate that exceeded 50 percent, meaning that over half of the audited tax returns in these 3 projects were deemed compliant and that the audits recommended no tax changes. Across all 32 IGPs, this no-change rate ranged from 0 percent to 60 percent, and the median no-change rate was about 20 percent.

Appendix I to this letter provides specific details on IGPs in Georgia during fiscal years 1994-1996. Tables I.1 and I.2 provide brief descriptions of projects that were not yet closed as well as of those that were closed as of June 1997. Table I.3 reports the audit results of projects that were closed as of June 1997.

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## IGP Controls and Procedures

For years, IRS has had various controls and procedures in using IGPs as audit selection tools, including the approval and review of proposed projects, independence in the selection of returns, and limits on the duration of the audit phase. These controls and procedures are designed to guard against any improprieties and misuse of IGPs, as well as to better ensure productive use of audit resources. We did not test whether and how well these controls and procedures have worked. The following describes what these IGP controls and procedures have included.

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<sup>4</sup>An IGP can close without any audits when the information gathering phase indicates that audits or further study of the selected population is not warranted.

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IRS requires that IGPs be authorized by a district director or higher level management official for a specified length of time. According to IRS officials, the process generally starts out informally when an IRS employee, usually a revenue agent, discovers an area of potential noncompliance. The revenue agent discusses the issue with a manager and IGP coordinator (who is to oversee and track all IGPs). If these parties agree about the potential for noncompliance, an Information Gathering Project Authorization (Form 6545) is prepared and forwarded, along with supporting documents, through various organizational levels for review and approval.

IRS officials also review IGP proposals to ensure that the project conforms with Internal Revenue Manual requirements on IGPs. Among other things, the officials are to look at the (1) purpose and objective of the project; (2) data (such as compliance measures) that support the need for the project; (3) description of the data needed to do the project, including why and how the data will be used; and (4) time frames and resources necessary to complete the project. In addition, officials are to ensure that the project does not duplicate other IGPs and that the potential noncompliance, which is the focus of the project, can meet or exceed the noncompliance that would otherwise be identified through audits initiated under DIF criteria.

If approved at each level, the proposal continues to move up the chain of command. At a district office, this chain of command generally includes the

- group manager of the revenue agent proposing the IGP;
- branch chief for that audit group manager;
- the chief of the Examination Division, who is responsible for all Examination activity in the district; and
- the district director, who is responsible for ultimate approval of the IGP as well as various other types of IRS activities within the district.

In addition, other district Examination staff play a role in reviewing and approving IGPs. After the branch chief's review, the IGP coordinator and the chief of the Planning and Special Programs office (who is to oversee and track various types of Examination programs) have a role in coordinating any further review and approval. Once approved by the chief of the Examination Division, proposed projects are to be routed through the chief of the District Office of Research and Analysis, who is either to concur or not concur. The District Disclosure Office also reviews each IGP



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request. Following this, the district director reviews the proposal. If the director approves, work on the project can begin.

Approved IGPs normally include an information gathering phase and an audit phase. During the information gathering phase, the project coordinator and/or project team—usually two or more agents developing the IGP—collect and analyze information on a particular type of taxpayer, such as child care providers. Techniques and sources for collecting information may include interviews with third parties as well as reviews of internal<sup>5</sup> and external data related to the IGP. By analyzing the information, the project coordinator is to identify whether the apparent noncompliance is significant enough to warrant audits and, if so, which types of tax returns have audit potential and should be audited.

In a 1994 report,<sup>6</sup> we raised two concerns about the selection of returns to be audited under IGPs. We found that the controls and procedures (1) were not adequate to prevent Examination staff from selectively targeting individual taxpayers for audit, and (2) did not require a separation of duties between staff who identified the types of returns to audit and staff who selected the specific returns for audit. In July 1995, IRS issued new guidance to address these two concerns about IGP controls and procedures.

Under this new guidance, the project coordinator is to work with the IGP coordinator to identify returns to be audited according to set criteria, such as the type of tax return, filing status, dollar threshold, and compliance issue being reviewed. The IGP coordinator is responsible for ordering the returns for audit under the project that meet these criteria. When the returns are received, the IGP coordinator (who is located in Planning and Special Programs) is responsible for getting them manually reviewed to check audit potential using the criteria selected by the project coordinator. Returns with audit potential are assigned for audit according to such criteria as the location of the taxpayer, grade levels of the agents, and their knowledge about the issues that are the focus of the IGP.

The duration of the audit phase for an IGP depends on whether (1) the project team continues to find tax returns that fit into the defined category

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<sup>5</sup>A primary internal data source is the Midwest Automation Compliance System (MACS). IRS can use MACS to identify returns that fit the criteria established for the particular type of potential noncompliance being covered by a specific IGP.

<sup>6</sup>Tax Administration: IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly (GAO/GGD-95-14, Oct. 26, 1994).

of taxpayers, and (2) the auditors find sufficient levels of noncompliance on the audited returns. More specifically, the IGP audits should find more noncompliance than that uncovered in audits routinely selected by IRS using the computer-generated score produced under DIF. Because of these controls, some IGPs terminate after a small number of returns are audited, compared to the number ordered and assigned. Upon termination of the IGP, IRS requires that a termination report be submitted to the IGP coordinator to document audit and other results.<sup>7</sup>

In 1997, IRS began implementing additional processes under CIP that cover all compliance initiatives, including IGPs. IRS intends for these processes to introduce more rigor so that the results from IGPs and other projects can be used for research purposes. CIP guidelines require substantially more documentation for proposed compliance projects than previously required. The proposals must identify the methodology to be used and the extent to which the project will improve compliance within the district. A district planning council<sup>8</sup> is to submit the required documentation to the district director together with its recommendation to approve or disapprove the proposed project. Upon completion of an approved project, the results are to be reported to the planning council, which will make a recommendation to the district director to either continue, expand, or terminate the project, or to transform it into a fuller research project at the local or national level.

## Scope and Methodology

To accomplish each objective, we interviewed responsible officials at IRS' National Office, the Atlanta District Office, and the Southeast Regional Office and collected data relevant to IRS' use of IGPs to detect noncompliance with the tax laws.

To identify the number of IGPs open both nationwide and in Georgia in fiscal years 1994 through 1996, we reviewed available records from IRS' National Office and Georgia District. We did not verify the accuracy of IRS' data on the total number of IGPs conducted nationwide. IRS' National Office could not locate data on the total number of IGPs nationwide during fiscal year 1994. According to officials, IRS began a total restructuring in fiscal year 1994 that reduced the number of district offices from 63 to 33 and

<sup>7</sup>In addition to the audit results, the termination report provides (1) an assessment as to whether the tax adjustments justified the time spent on the project, (2) descriptions of procedures and audit techniques, (3) explanations of difficulties encountered during the project and how they were resolved, and (4) suggestions for reducing the specific area of noncompliance in the future.

<sup>8</sup>The district planning council is a group that oversees district activities, such as compliance initiatives, to ensure that they are carefully planned and consistent with IRS' mission.

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shifted the responsibility for maintaining IGP records. Officials also told us that IRS has no requirement to retain records on the number of IGPs.

To describe the IGPs in the Georgia District and their results, we collected and reviewed all available IGP authorization and termination reports for fiscal years 1994 through 1996. In addition, we reviewed Examination Division data for individual project results, such as the number of returns audited, total taxes recommended per audit hour and per audited return, additional taxes recommended plus penalty amounts, and the percentage of tax returns for which the audit recommended no tax change. We focused our efforts on all IGPs that were open at any time during fiscal years 1994 through 1996.

To describe the controls and procedures for IGPs, we collected and reviewed relevant IRS documents and manuals as well as interviewed responsible IRS officials in the National Office and the Georgia District. These controls and procedures included those established for the approval of proposed IGPs, the independent selection of tax returns to be audited, and the duration of the audit phase in an IGP. We did not test how well these controls and procedures for IGPs worked. Further, we collected documentation and did interviews with the responsible IRS officials on the new processes being implemented during 1997 under the CIP guidelines.

We conducted our review from June to September 1997 in accordance with generally accepted government auditing standards.

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## Agency Comments and Our Evaluation

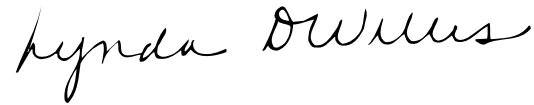
In a letter dated December 12, 1997, IRS' Acting Chief Compliance Officer commented on a draft of this report (see app. II). He said the report fairly presented the information and he elaborated on information dealing with IRS' controls over IGP and the new CIP.

As we arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 30 days from its date of issue. We will then send copies to the Commissioner of Internal Revenue and Members of the Georgia congressional delegation. We also will make copies available to others upon request.

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Major contributors to this report are listed in appendix III. Please contact me on (202) 512-9110 if you or your staff have any questions about the report.

Sincerely yours,

A handwritten signature in cursive script that reads "Lynda D. Willis".

Lynda D. Willis  
Director, Tax Policy and  
Administration Issues

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## Abbreviations

CIP	compliance initiative proposal
DIF	discriminant function
IGP	Information Gathering Project
IRS	Internal Revenue Service
MACS	Midwest Automation Compliance System

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# Summary of IGP Activity in the Georgia District, Fiscal Years 1994-1996

**Table I.1: Profile of Georgia District IGPs Open During Fiscal Years 1994-1996 and Not Yet Closed as of June 1997**

Project	Start date	Purpose
Auto dealerships	02/14/92	To identify auto dealerships that are diverting rebates from insurance and warranty contracts sold to customers. The project also focuses on (1) overstating inventory (cost-of-goods-sold) and other expenses due to an error in utilizing the LIFO (last-in-first-out) inventory method and (2) underreporting issues stemming from related finance companies and producer owned insurance companies.
Construction contractor and subcontractor compliance	03/13/92	To increase contractor and subcontractor compliance with (1) income tax filing and reporting requirements and (2) 1099 filing requirements. This project also focuses on the issue of contractors building homes and transferring them to themselves for less than fair market value, resulting in a significant dividend.
Scrap and recycling dealers	04/16/92	To determine whether the entities who receive income from selling scrap products (paper, metal, glass, etc.) to companies dealing in recycling are reporting the income.
Land condemnation awards	04/26/92	To determine if taxpayers are properly reflecting land condemnation awards (in which real estate is acquired under the condemnation) on their tax returns.
Personal service corporations	05/12/92	To identify personal service corporations that do not use the required 34-percent tax rate and to adjust their tax computation accordingly.
Printing industry	05/15/92	To (1) gain knowledge of a very large growth industry, (2) identify the areas of noncompliance with the tax laws, and (3) develop techniques and procedures to deal with the noncompliance in the industry. Potential issues include excessive management compensation and changes in accounting methods resulting in large adjustments.
Child support recovery	06/17/92	To identify individuals who may be using improper filing statuses, claiming exemptions they are not entitled to, and erroneously receiving Earned Income Credit (EIC). The project focuses on those individuals making child support payments and filing incorrect tax returns in an attempt to receive an income tax refund.
Earned income credit (EIC)	02/04/93	To determine (1) the level of compliance in reporting EIC, and (2) whether taxpayers who filed as single or heads of household and claimed EIC are actually entitled to the credit.
Invalid 1120-S elections (i.e., corporate returns)	02/04/93	To identify those individual shareholders who claim losses stemming from an 1120-S corporation on their return, when the corporation either has not filed the Form 2553 (Request for 1120-S status) or has been denied 1120-S status. The project also focuses on taxpayers' returns where the 1120-S election was approved for a subsequent year, but the loss was taken in the current year, for which the 1120-S status was not granted.
Wagering	02/10/93	To identify those individuals engaged in gambling activities and to determine their compliance with the tax laws.
Tax return preparers	02/24/93	To determine whether individuals who own tax return preparation businesses are filing their own individual income tax returns. This project also focuses on preparers who have claimed losses from their tax return preparation businesses.
Illegal income	03/04/93	To identify individuals who fail to report income from drug-trafficking activities. A potential issue is that substantial amounts of money and assets are connected with drug-trafficking activities and that individuals involved do not report their income.
Nonfilers identified by the Criminal Investigation Branch	03/25/93	To develop cases on taxpayers who have not filed tax returns for at least 1 year. The project focuses on those taxpayers identified by the Criminal Investigation Branch of the Atlanta Service Center.

(continued)



**Appendix I  
Summary of IGP Activity in the Georgia  
District, Fiscal Years 1994-1996**

<b>Project</b>	<b>Start date</b>	<b>Purpose</b>
Heavy vehicle use tax	05/24/93	To determine the degree of compliance of Georgia taxpayers with the reporting and paying of heavy vehicle use tax.
Duplicate address returns	06/10/93	To determine which taxpayer is actually entitled to the head of household filing status and the related tax exemptions when the same mailing address is duplicated by several taxpayers all claiming the same filing status and exemptions.
Contract nurses	06/17/93	To identify nurses or respiratory therapists who work as subcontractors through placement agencies. A potential issue is that a number of these nurses and therapists do not file tax returns or claim erroneous expenses.
Excessive deductions	07/15/93	To identify potential areas of abuse and noncompliance by taxpayers filing at the Atlanta Service Center. The project focuses on individuals who may be taking excessive deductions on their income tax returns.
Unreported tip income	08/14/93	To determine the extent of compliance in tip reporting by employees and employers of large food and beverage establishments.
Tow trucks and wreckers	09/09/93	To identify individuals and corporations in the vehicle towing industry that are substantially underreporting gross receipts. The project focuses on three different types of towing services in which taxpayers are known to be the most noncompliant: (1) contract wrecker services for the government, (2) private impounding services for the government and private property owners, and (3) private towing services for individuals and businesses.
Bars and restaurants	02/01/94	To gain knowledge of the restaurant industry, identify areas of noncompliance with the tax laws, and develop techniques and procedures to properly audit the industry.
Fuel excise tax	02/20/94	To determine the extent to which taxpayers are claiming allowable fuel excise tax credits on form 4136 and whether individuals are filing correct income tax returns and complying with the fuel excise tax laws.
Corporate used auto sales	06/14/94	To determine whether corporate used auto dealers are properly reporting the income and finance charges (from financed sales) on the accrual basis and properly accounting for their ending inventory.
Voluntary Employee Beneficiary Association (VEBA)	07/10/94	To identify employers who utilize a VEBA to pay employee fringe benefits in a manner that results in significant tax deductions. These deductions are not in compliance with tax laws.
Healthcare industry	08/18/94	To determine whether (1) technical issues present in the Coordinated Examination Program (CEP) returns are present in the returns of health care providers not included in the CEP, and (2) fraudulent physician compensation issues are present in the returns filed by exempt, for-profit providers.
Alimony	02/09/95	To determine whether taxpayers who are (1) paying alimony are properly deducting it and (2) receiving alimony are properly reporting the income as required by tax laws.
Plumbing, heating, and air conditioning	02/20/95	To determine whether plumbing, heating, and air conditioning contractors and subcontractors are correctly reporting income and using the proper method of accounting. A potential issue is that this industry widely operates on a cash basis and uses inventory as a significant income-producing factor.
Form 8300 compliance	04/15/95	To (1) determine the level of compliance by taxpayers in filing Form 8300 and (2) identify fraud where the nonfiling of form 8300 is deliberate. Tax law requires all cash payments received in a trade or business in excess of \$10,000 to be reported on a form 8300.
Schedule C truckers	06/21/95	To identify truckers who have claimed excessive deductions for repairs and maintenance on their Schedule C. The goal is to have truckers deduct only necessary repairs paid in the tax year and to depreciate any capital expenditures.

(continued)

**Appendix I  
Summary of IGP Activity in the Georgia  
District, Fiscal Years 1994-1996**

<b>Project</b>	<b>Start date</b>	<b>Purpose</b>
Automotive industry—District Office of Research and Analysis Study	07/18/95	To determine whether individuals in the automotive industry are filing correct income tax returns and complying with the tax laws. The project focuses on those who appear to be filing questionable returns because they report (1) less than \$25,000 in gross receipts on their Schedule C and (2) insufficient income over multiple years to support the expenses.
Real estate partnerships	08/25/95	To increase compliance with tax law requirements for subchapter K partnerships (distributions and transfers of interest) in the construction and real estate industry.
Adult entertainment	12/05/95	To identify those adult entertainment clubs that classify their dancers as independent contractors, instead of as employees, and have set up a payment arrangement that avoids any type of form 1099 or W-2 reporting requirements. The project also focuses on tax compliance, nonfiler, and underreporting issues.
Chemical tax	05/16/96	To determine the level of compliance in reporting excise tax on chemicals and whether individuals are filing correct income tax returns and complying with the tax laws.
Reclassification of 1120-S distributions to wages	06/19/96	To determine whether 1120-S shareholders are receiving salary in the form of distributions, instead of wages, to avoid the payment of Social Security and Medicare taxes and the withholding of income tax.
Lump-sum timber sales to individuals	06/28/96	To determine whether land owners who cut or sell timber are accurately reporting timber sales, using form T, filing form 1099, and computing basis. (Form T is the form used for lump-sum contract sales and retained pay-as-you-cut interest contracts.)
Schedule C filers qualifying for EIC	07/15/96	To identify Schedule C filers who underreport their net Schedule C income to qualify for EIC and receive an income tax refund. Potential issues include questionable situations involving Schedule Cs and EIC. In these cases, the taxpayer underreports business income and overreports business expenses to get the maximum amount of EIC and therefore generate a refund.

Source: IRS data for 1994-96.

**Table I.2: Profile of Georgia District IGPs That Were Closed by June 1997**

<b>Project</b>	<b>Dates</b>	<b>Purpose</b>
Bail bond companies	01/17/92 - 01/13/95	To promote compliance in the bail bond industry and determine whether bondsmen were correctly reporting income from deferrals and cooperative arrangements. Potential issues included whether some bond companies deferred income on monies received from clients whose bonds were bound over to state court. Also, bondsmen often cooperated with bondsmen in other cities in writing bonds for their clients but underreported income received under the cooperative agreement.
Automobile dealers	02/14/92 - 03/01/97	To determine whether automobile dealers overstated their inventory (cost of goods sold) due to an error in the inventory method utilized.
Corporate employee embezzlement	03/03/92 - 04/30/94	To determine whether corporate employees who embezzled funds reported the income.
Construction revisited	03/13/92 - 01/31/95	To conduct a follow-up review of the construction industry. A prior project was run in 1987 to determine the level of compliance in the construction industry with reporting and paying income taxes.

(continued)

**Appendix I  
Summary of IGP Activity in the Georgia  
District, Fiscal Years 1994-1996**

<b>Project</b>	<b>Dates</b>	<b>Purpose</b>
Timber sales	03/16/92 - 12/31/93	To determine whether individuals who sold timber were reporting the income from such sales. Form 1099s were not required to be issued to payees by purchasers of timber.
Construction of personal residence	03/16/92 - 03/31/95	To determine the level of compliance in reporting correct income and expenses of taxpayers who constructed their personal residences at a cost of over \$100,000.
Child care providers	03/26/92 - 04/05/94	To determine whether child care providers were complying with tax laws. Potential issues include whether some providers cared for many more children than that allowed by the state, but only reported money earned from the "state allowed" number. Another issue was that the providers who qualified for food reimbursement from the state failed to report it on their tax return.
Poultry industry	04/16/92 - 10/27/93	To determine whether the industry was in compliance with the income reporting requirements of the tax law.
Hazardous waste sites	04/16/92 - 01/23/95	To determine the degree of compliance in the industry, including whether companies assessed fines or penalties for environmental law violations deducted such penalties on their tax returns.
Customizing shops (vans and cars)	04/23/92 - 03/24/94	To determine whether automobile customizing shop owners were complying with tax laws and filing income tax returns. The project also focused on individuals and customers who frequent these businesses and spend large amounts of cash on customizing their cars, vans, etc.
Advertising industry	06/15/92 - 05/22/95	To determine the degree to which the advertising industry was in compliance with the income reporting requirements under tax law. Issues included cash versus accrual method accounting and inventory costs associated with the production activities of an advertising agency.
Casino report	06/15/92 - 05/31/96	To identify those individuals who gambled at various casinos, purchased large amounts of chips in cash, and were either not filing or filing fraudulent income tax returns.
Ozone depleting chemicals	06/17/92 - 12/30/93	To determine whether taxpayers were filing correct income tax returns and complying with the excise tax laws on chemicals.
Fraud referral follow-up	06/17/92 - 03/31/94	To determine whether taxpayers who had been referred for fraud penalties in prior years were complying with the tax laws.
Self-prepared business returns	06/22/92 - 12/31/93	To determine whether the complexity of the Internal Revenue Code contributed to the level of noncompliance among business taxpayers who prepared their own tax returns.
Nude dancers	06/29/92 - 04/01/94	To determine whether nude dancers complied with tax laws and filed income tax returns. A potential issue identified from a televised news report was that many dancers reportedly earned \$50,000 and up annually and never filed tax returns.
Asbestos removal	08/03/92 - 10/31/94	To determine whether taxpayers who removed asbestos from properties they own were in compliance with tax law. A potential issue was that asbestos removal costs were deducted instead of capitalized. Tax law prohibits the deduction of costs associated with permanent improvements that increase the value of any property. Asbestos removal enhances market value.
Auto salvage auctions	08/06/92 - 10/03/94	To increase compliance in filed tax returns and reported income from the sale of salvage automobiles by used car dealers and repair shops.

(continued)

**Appendix I  
Summary of IGP Activity in the Georgia  
District, Fiscal Years 1994-1996**

<b>Project</b>	<b>Dates</b>	<b>Purpose</b>
Unmatched information returns	08/31/92 - 06/30/95	To determine whether amounts that were reflected on mismatched information returns were reported by the taxpayer.
Accounting and legal professions	09/10/92 - 09/30/95	To determine whether individuals in the accounting and legal professions were filing correct income tax returns and complying with the tax laws.
Laundromats	10/10/92 - 02/06/96	To identify those laundromats that understated cash sales. Potential issues included whether the understatement was due to incomplete or fraudulent records of daily cash receipts. The project also focused on unreported income, nondeductible expenses, gains and losses in connection with the sale of laundromats, loans to and from shareholders, and unfilled income tax returns.
Livestock sold by gentlemen farmers	11/02/92 - 05/02/94	To identify gentlemen farmers who failed to report income from the sale of livestock through stockyards.
Original issue discount (OID) exclusions on bonds	11/04/92 - 12/31/96	To determine whether taxpayers who were holders of bonds issued by a certain corporation were correctly reporting income. IRS found that some taxpayers included OID income as taxable interest income on their returns but then backed out the same income as an ordinary loss from unpaid accrued interest thus excluding the income. The taxpayers claimed that the corporation became insolvent and was incapable of paying the interest.
Medical transportation	11/24/92 - 06/30/96	To increase compliance among individuals who generated income by furnishing medical transportation to Medicaid patients. A potential issue was that these individuals substantially overstated their business expenses or claimed expenditures of a personal nature as business expenses.
Peanut and other crop quotas	02/09/93 - 07/31/94	To increase compliance among individuals who failed to report or underreported income from the sale of crop quotas for peanuts, tobacco, and other products. The project also focused on those individuals who improperly treated crop quotas as depreciable or amortizable assets. Crop quotas that may be sold can be obtained from the Agricultural Stabilization and Conservation Service.
Water transportation companies	02/24/93 - 12/31/93	To determine (1) the level of compliance in the water transportation industry and (2) whether these companies were bona fide companies, tax shelters, or hobby losses.
Employee versus independent contractor (registered representative)	05/12/93 - 09/30/94	To determine whether securities firms treated their salespersons as employees or as independent contractors. According to IRS, the Securities and Exchange Commission has a regulatory interest in assuring that all broker-dealers maintain the control and supervision required under the Securities and Exchange Act. The control required would indicate that the salesmen should be considered employees.
Video stores	05/24/93 - 09/30/95	To determine whether video stores were correctly following tax law requirements, which state that video cassettes should be depreciated using either the straight-line or income forecast method of depreciation.
Financial products	06/01/93 - 09/30/94	To identify taxpayers who were involved in the use of financial products (options, swaps, futures contracts, etc.) and determine whether proper characterization of gains or losses was made in accordance with tax laws.
Discharge of indebtedness	09/02/93 - 08/31/94	To determine whether taxpayers properly included their discharge of indebtedness in income. A potential issue was that taxpayers had mortgages secured by bonds issued by their counties. When the bonds were paid off early, the county notified the mortgage company and the remaining mortgage was forgiven. Tax laws require that taxpayers include this discharge of debt in income in the year the discharge occurs.

(continued)

**Appendix I**  
**Summary of IGP Activity in the Georgia**  
**District, Fiscal Years 1994-1996**

<b>Project</b>	<b>Dates</b>	<b>Purpose</b>
Timber sales	11/02/93 - 11/18/94	To determine whether individuals who sold timber were reporting income from such sales. Form 1099s are not required to be issued to payees by purchasers of timber.
Nonfiler partnerships	12/02/93 - 12/31/95	To encourage all partnership entities that had ceased filing tax returns to file income tax returns and comply with the tax laws.
Lottery businesses	12/14/93 - 06/22/94	To determine whether business owners were filing correct income tax returns and complying with the tax laws. The project focused on those business owners who filed applications with the state to sell lottery tickets but were refused permission to sell the tickets as a result of their failing to meet state criteria.
Georgia nonfilers	02/01/94 - 01/31/96	To determine whether Georgia taxpayers were filing federal income tax returns. The project focused on three different segments of Georgia taxpayers who were potential federal nonfilers: (1) taxpayers who filed under the Georgia Amnesty program, (2) taxpayers who applied for licenses to sell lottery tickets, and (3) taxpayers identified with state sales tax information.
Farm credit association members	02/04/94 - 09/30/94	To determine whether farmers who did business with farm credit associations, and who submitted crop checks as payment on their loan accounts, complied with the tax law requirements of reporting receipts as part of gross income.
Title VII discrimination settlements	03/14/94 - 03/10/95	To determine whether taxpayers who received awards based on a discrimination complaint were including the correct amount in income.
Vaccine floor stock compliance	04/20/94 - 04/30/96	To determine the level of compliance in reporting the vaccine floor stock tax that was due 2/28/94. This was a one-time tax.
Mortuaries and funeral homes	04/20/94 - 05/31/96	To determine the degree to which the funeral home industry was in compliance with federal tax law requirements for funeral home income and information return (forms W-2 and 1099) reporting and proper matching of income with expenses.
Underground storage tank cleanup costs	05/04/94 - 10/13/94	To identify noncompliance with the tax treatment of underground storage tank cleanup costs (capital versus current expenses).
Depreciation on tax-exempt bonds	07/14/94 - 07/27/95	To ensure depreciation compliance by taxpayers who received private tax-exempt activity industrial development bonds. A potential issue was that taxpayers often used the other-method and life depreciation methods instead of the straight-line alternative and required-life depreciation methods that are required by tax law.
Debenture conversions	07/14/94 - 07/31/95	To determine whether income (gains) from the conversion of debentures was reported in accordance with the tax law requirements.

Source: IRS data for 1994-96.

**Appendix I**  
**Summary of IGP Activity in the Georgia**  
**District, Fiscal Years 1994-1996**

**Table I.3: Results of Georgia District IGPs Closed by June 1997**

<b>Project</b>	<b>Returns audited</b>	<b>Tax amount per audit hour</b>	<b>Tax amount per audited return</b>	<b>Total amount of taxes plus penalties</b>	<b>Percent of no change returns</b>
Bail bond companies	142	\$578	\$10,874	\$1,544,105	22%
Automobile dealers	516	16,363	521,320	269,001,321	12
Corporate employee embezzlement	18	6,662	154,342	2,778,147	0
Construction revisited	105	848	12,605	1,323,563	8
Timber sales	9	240	1,441	12,969	33
Construction of personal residence	25	540	18,934	473,351	12
Child care providers	24	957	3,826	91,824	13
Poultry industry	7	8	164	1,148	57
Hazardous waste sites	27	589	18,379	496,222	22
Customizing shops (vans and cars)	5	81	2,045	10,226	60
Advertising industry	46	720	15,833	728,318	23
Casino report	80	497	18,887	1,510,960	20
Ozone depleting chemicals	90	1,096	1,096	98,640	1
Fraud referral follow-up	21	519	4,031	84,658	19
Self-prepared business returns	24	418	14,704	352,899	20
Nude dancers	0	n/a	n/a	n/a	n/a
Asbestos removal	a	a	a	a	a
Auto salvage auctions	21	768	30,702	644,742	23
Unmatched Information returns	25	1,957	12,210	305,250	0
Accounting and legal professions	19	609	13,694	260,180	37
Laundromats	139	206	4,023	559,254	25
Livestock sold by gentlemen farmers	6	78	1,400	8,400	33
Original issue discount (OID) exclusions on bonds	60	6,975	153,440	9,206,400	13
Medical transportation	53	930	12,332	653,573	0
Peanut and other crop quotas	0	n/a	n/a	n/a	n/a
Water transportation companies	0	n/a	n/a	n/a	n/a
Employee versus independent contractor (registered representative)	a	a	a	a	a
Video stores	21	576	8,554	179,628	14
Financial products	16	705	13,309	212,946	31
Discharge of indebtedness	0	n/a	n/a	n/a	n/a
Timber sales	21	265	2,118	44,478	24
Nonfiler partnerships	0	n/a	n/a	n/a	n/a
Lottery businesses	0	n/a	n/a	n/a	n/a
Georgia nonfilers	234	1,036	6,218	1,455,012	0

(continued)

**Appendix I**  
**Summary of IGP Activity in the Georgia**  
**District, Fiscal Years 1994-1996**

<b>Project</b>	<b>Returns audited</b>	<b>Tax amount per audit hour</b>	<b>Tax amount per audited return</b>	<b>Total amount of taxes plus penalties</b>	<b>Percent of no change returns</b>
Farm credit association members	0	n/a	n/a	n/a	n/a
Title VII discrimination settlements	0	n/a	n/a	n/a	n/a
Vaccine floor stock compliance	10	1,463	11,701	117,010	60
Mortuaries and funeral homes	31	335	7,527	233,325	23
Underground storage tank cleanup costs	14	1,228	13,506	189,090	7
Depreciation on tax-exempt bonds	<sup>a</sup>	<sup>a</sup>	<sup>a</sup>	<sup>a</sup>	<sup>a</sup>
Debenture conversions	0	n/a	n/a	n/a	n/a

Note 1: All tax amounts are the taxes recommended in the audits and may include some penalties, if any.

Note 2: As reflected by the zeros in the table above, IRS auditors may sometimes find during the information gathering phase of the IGP that initial data indicate a smaller/lesser compliance problem than originally expected or that data collected do not warrant further study of the taxpayer group. As a result, the IGP is terminated without any returns audited.

Note 3: n/a = not applicable.

<sup>a</sup>IRS disclosure rules preclude us from revealing audit information when fewer than four taxpayers are involved.

Source: GAO analysis of IRS data.

# Comments From the Internal Revenue Service



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

CHIEF COMPLIANCE OFFICER

December 12, 1997

Ms. Lynda D. Willis  
Director, Tax Policy and Administration Issues  
United States General Accounting Office  
Washington, DC 20548

Dear Ms. Willis:

Thank you for the opportunity to review your recent draft report titled "Tax Administration: IRS' Use of Information Gathering Projects". The opportunity to provide additional clarifying information was appreciated. We believe the overall report fairly states the Service's approach to Information Gathering Projects (IGPs). In particular we note the emphasis the report places on the significant controls that the Service has had in-place governing the conduct of IGPs. This includes, as you indicate, the review and approval process that any proposed IGP must undergo before it can be initiated. The objective of these significant controls is indeed "to guard against any improprieties and misuse of IGPs". As you further state, the Service has recently added "more rigor to the approval and oversight of IGPs" through the new Compliance Initiative Program (CIP) process. We will continue to work to assure that IGPs or any program designed to identify noncompliance has sufficient safeguards to prevent any abuse.

If you have any questions, please feel free to contact Assistant Commissioner Thomas J. Smith (Examination) at 202-622-4400.

Sincerely,

  
John M. Dalrymple  
Acting Chief Compliance Officer



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