THE AUDIT REVIEW PROCESS

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The Internal Revenue Service (IRS) devotes approximately thirty-five per cent of its total budget to its audit program. For the current fiscal year, out of our total budget of $1,862,000,000, $658,000,000 will be spent on the audit program. We estimate that we will audit a little over two million returns nationwide, or about 2.4% of income, estate, gift, partnership, and small business returns. This is a rather small audit coverage, and it is therefore obvious that the success of our tax system depends on voluntary compliance.

The primary purpose of the audit function is to encourage voluntary compliance. Given the very limited scope of our audit coverage, it is particularly important that these scarce recources be used as efficiently as possible. Over the last several years, the IRS' audit planning has received a great deal of attention and is continually being refined. Today, I would like to describe that process and discuss some of our continuing concerns.

A SURVEY OF THE AUDIT PROCESS

For the planning and return selection process, we divide taxpayers having similar economic characteristics into separate audit classes. For audit planning purposes, we have eight audit classes for individual returns and eleven classes for corporations. In the case of individual taxpayers, business returns are separated from nonbusiness returns and then grouped according to adjusted gross income (AGI), with the lower AGI returns being subgrouped according to the deduction method—standard or itemized—which the taxpayer employed.

Although the IRS has traditionally used AGI to classify taxpayers for a variety of statistical purposes, it has begun to question this classification method. There are returns buried in the lower AGI classes from taxpayers with high actual incomes largely offset by business or partnership losses. The IRS contends that these returns should be included in higher income classes where audit coverage is greater because of the complexi-

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ty of the returns and the potential for audit adjustments. Therefore, the IRS has given some consideration to changing the method of classifying returns to one which would take into account deductions taken in arriving at AGI.

By contrast, corporations are grouped according to the amount of gross assets. This is a better test for audit coverage than AGI, because AGI can vary from year to year or be low or nonexistent in any particular year. The IRS also has separate classes for estate and partnership returns. By grouping taxpayers in this manner, the IRS segregates the more complex returns from the simpler ones. As a result, it is better able to identify returns requiring examination and to allocate its resources more effectively.

I would like to first explain how we obtain data for developing our audit plan and return selection system. In the early 1960's, the IRS initiated a long range research program called the Taxpayer Compliance Measurement Program (T.C.M.P.) to provide basic statistical information concerning compliance. T.C.M.P. measures the size and nature of the audit workload and voluntary compliance levels and is used to improve the efficiency of return selection and resource allocation in ways that will be described later.

As a first step in preparing for T.C.M.P., representatives from several divisions identify sample income clases to be measured. The IRS' statistical division then determines a statistically valid sample for each income class and makes a random selection based on ending digits of social security or employee identification numbers. A statistically accepted technique is used to insure a random selection of returns by class. The returns identified are then assigned to qualified examiners for auditing. These examiners perform intensive probes for unreported income and verify all deductions. Furthermore, all related returns such as partnership returns are also examined to insure that the correct income has been determined and allocated to each return identified in the T.C.M.P. sample.

Usually a T.C.M.P. sample of individual returns involves a sample of 50,000 returns out of more than 80,000,000 that are filed nationally. To date, we have made five such surveys and are now conducting one on returns filed in 1977. From April 1, 1977, through March 31, 1979, the Omaha district will examine approximately 650 "1040 forms" and an undetermined number of related returns. What this means to you and your client is that the IRS will be asking for supporting evidence of all income and expenses related to that taxpayer.

A survey of small corporations samples approximately 20,000 returns out of a little more than a million filed. To date, the IRS has conducted two surveys on small corporations and plans to conduct another for returns filed in 1978. In addition to surveying individuals and small corporations, the IRS has conducted one survey on estate tax returns and another on fiduciary returns.

The data gathered on these surveys can be used to represent the results the IRS could expect to find if every return in that particular class were audited. These surveys also provide the IRS with estimated levels of voluntary compliance—the amount of tax that actually was self-assessed stated as a percentage of the amount that should have been self-assessed. For example, from the most recent T.C.M.P. data for all individual taxpayers involving returns filed in 1974, it is estimated that the individual taxpayer reported approximately 92.8% of his taxes to the government. However, the compliance by class varied widely. Those nonbusiness returns with $10,000 to $50,000 AGI showed a compliance rate of 96.1% while individual businesses with AGI under $10,000 showed compliance of only 57.2%

In addition to providing overall compliance information, the T.C.M.P. examination furnishes the basic data for the return selection system. In selecting returns for audit, it is critical that the IRS use procedures designed to insure that each taxpayer's return is handled in an objective, impartial manner. To achieve this objectivity and to improve selection, so that the IRS could get closer to its goal of auditing those returns most in need of audit, the IRS began using the Discriminate Function System which it refers to as D.I.F. to select individual and corporate returns for audit in 1969.

The D.I.F. system consists of a mathematical formula developed from the T.C.M.P. data for each audit class. After a return is filed and categorized into a particular audit class, a computer assigns weights to certain significant tax return line items and to certain relationships between those items that are characteristic of returns with substantial tax error. These relationships are determined by a comparison of what taxpayers reported on their returns with the T.C.M.P. sample and the tax errors discovered during the audit. These individual weights are summed into an index score for each return. This score indicates the audit potential of a return and, generally, the higher the score the greater the probability of significant tax error. The D.I.F. formula is applied uniformly to all returns in a particular audit class. This scoring allows the IRS to determine the number of examiners each district will need in order to examine the highest scored returns in each audit class on a nation-wide basis.

Since the D.I.F. scoring system is not perfect, each high-scored D.I.F. return is manually screened by an experienced examiner to eliminate those returns not warranting examination. For example, where the taxpayer has attached an explanation for a questionable item, a manual screening of the return allows the IRS to determine whether an examination is warranted and the scope and type of examination to be conducted.

Approximately three-fourths of the over 2,000,000 individual income tax returns audited in 1976 were selected for audit by D.I.F. system or because they related to the D.I.F.-selected returns. The D.I.F. system has enabled the IRS to reduce the number of audits resulting in no change. This has helped to improve taxpayer relationships and to make better use of limited resources. The IRS is continuing to do research and to implement procedures designed to reduce further the number of no change audits.

Some returns are also selected for audit under other established selection methods. For example, all corporate returns not subject to the D.I.F. system are manually screened. Refund claims for previously paid taxes are also manually screened. Information documents such as W2's, 1099's, and 1087's are matched to identify under-reporters of income, and returns are selected at random under T.C.M.P.

In addition to identifying and selecting returns for examination, the IRS also conducts return correction programs at the service centers which are located nation-wide. These programs involve the identification of returns having simple errors which are normally apparent on the face of the return. When an error is identified, a notice is sent to the taxpayer proposing an adjustment. No examination of books or records is necessary. For example, the service centers handle cases where the taxpayer has filed more than one return or where taxpayers should have filed a self-employment tax and did not.

PROBLEM AREAS

With T.C.M.P. and the selection process program as background, there are some areas of continuing concern to the IRS that I would now like to discuss. For example, the IRS is planning to increase its emphasis on partnership examination in 1978. The IRS is convinced that the tax shelter type of partnership returns are in definite need of examination. Therefore, the 1978 audit plan has been doubled in this particular area. The plan coverage in 1977 to date is going from 1.5% to 3% of returns filed. Specifically, partnership returns reflecting losses over $25,000 will receive highest audit coverage. The IRS intends to examine twenty-four percent of the returns meeting that criteria and anticipates that the most abusive tax shelter partnerships will fall into this category. The decision to increase audit coverage of tax shelter partnership was based on two factors: first, the evidence that many of these returns were overstating losses and therefore would produce significant direct audit yields and; second, extreme abuse of tax shelters tends to erode the nation's confidence in the tax system and could eventually destroy the voluntary compliance system.

The IRS program to check abuses in this area includes increased efforts to identify questionable devices early and to issue revenue rulings promptly to give guidance both to potential investors and to examining agents. It is also hoped that this program will increase taxpayer confidence in the fairness of the tax system and in the ability of the IRS to respond effectively to tax avoidance schemes. In keeping with this goal, the Omaha office will audit 328 returns, which is more than a 100% percent increase.

In the corporate area, the IRS audit plan for 1978 shows audit coverage ranging from 3.8% for corporations with assets under $50,000 to 100% for the largest corporations. Our most recent T.C.M.P. data for small corporate returns indicate that under-reporting has increased for all asset classes. The most marked declined in reporting has occurred in the lowest asset class of corporations—that is, those with assets of less than $50,000. In 1969, the measured level of voluntary compliance on corporations with assets of less than $50,000 was sixty percent. In 1973, the level had fallen to 52.6% The overall compliance level for the entire range of corporations with assets of less than $1,000,000 was 80.5% for 1973. This was down by more than three percent from 1969. In 1975, the IRS began to audit more taxpayers in the lower business classes in order to increase the compliance level to an acceptable range. This effort will continue during 1978.

The 1976 Tax Reform Act opens another interesting area—the preparers' penalty program. The Act imposes a $100 penalty for the negligent or intentional disregard of rules or regulations resulting in an understatement of tax liability and a $500 penalty for the willful attempt to understate tax.

Negligent or intentional disregard of the rules and regulations will occur when a preparer does not exercise due diligence regarding the information submitted by the taxpayer to determine the correct tax liability. Rules and regulations include the provisions of the Internal Revenue Code, the IRS regulations, and IRS revenue rulings. What constitutes due diligence will depend on the facts and circumstances of the particular case. However, a preparer will not be guilty of intentional disregard of a rule or regulation if he believes in good faith and with a reasonable basis that the rule or regulation does not accurately reflect the Code. This test is being applied in the same manner as that under section 6653 relating to disregard of rules and regulations by a taxpayer. However, if a preparer believes that a rule or regulation is accurate but yields to the taxpayer's belief that it is not and prepares the return in conflict with the rule or regulation, that prepaper may be held liable.

The IRS has already imposed the penalty on a few preparers. The $100 penalty is imposed only upon the individual preparer who actually participates in the violation. The preparer's employer will not also be liable unless the employer or one or more of the principal officers also participates in the violation. However, each preparer who participates in a violation will be liable. Thus, numerous preparers may be subject to the $100 penalty for the same return if they all participate, even if they all participated on the same item. However, the preparer is subject to only one $100 penalty per return.

A willful attempt to understate tax liability includes situations where the preparer disregards information furnished to him by the taxpayer or others in an attempt to reduce wrongfully the taxpayer's tax. This situation would occur, for example, when a preparer disregards certain information as to income or takes larger deductions than the information would justify. Thus, when a preparer, after being informed that the taxpayer has two dependents, takes four on the return, he has willfully understated liability as has a preparer who adds miscellaneous charitable contributions to the information given to him by the taxpayer. If the taxpayer tells the preparer that he paid $4,000 in travel and entertainment (T.&E.) expense, the preparer must ask the taxpayer what records or other evidence he has to substantiate the $4,000 deduction. Although the preparer need not see evidence of the claim, he must reasonably satisfy himself that the evidence as represented would meet the requirements of section 274 of the Code and the accompanying regulations.

Before section 274 was enacted in 1962, a taxpayer who had occasion to entertain customers might keep few if any records, relying on the *Cohan* rule to give him a deduction. George M. Cohan, an entertainer, had claimed a rather large sum for entertainment expenses with no records at all to support the amount claimed. The IRS disallowed the deduction, The tax court said, in effect, that where the taxpayer could establish that entertainment was an ordinary and necessary expense in his business and that he did in fact entertain, it was incumbent upon the IRS to allow some reasonable amount. This rule led to a game between the IRS and the taxpayer. The taxpayer might claim a generous sum for T.&E. because he believed that the IRS would disallow some but not all of the claimed expense. Often, the amount of the disallowance would be determined by the extent of the taxpayer's protest. Of course, if the case was not audited, the taxpayer was home free.

Section 274 disallows entertainment expenses which would otherwise be deductible under section 162 unless these expenses qualify under the rules of section 274 including, in many cases, a requirement for substantiation by adequate records or by other sufficient evidence. At the time section 274 was enacted, the IRS hoped that it would end a growing abuse. Lately, however, there have been disturbing reports of tax negotiations characteristic of audits under the old game system. The IRS has issued new instructions for examining T.&E. which it hopes will stem that practice.

That rather lengthy discussion brings me to an important point about preparer's liability. Because T.&E. items are subject to a substantiation requirement, the preparer's responsibility is not limited to entering the taxpayer's figures on a return or a schedule. Although the preparer need not make himself the auditor or visually inspect the evidence supporting a deduction, he does have an obligation to satisfy himself that the evidence as represented would meet the requirement of section 274 and the regulations.

Because the audit coverage of the IRS is small, the taxpayer may well be playing what has come to be called the "audit lottery" by burying questionable items in his return. Commissioner Kurtz suggested in a speech shortly after taking office that there should be greater reporting of questionable positions. Some of you who may have read that speech may also remember that things got out of hand shortly thereafter. The Commissioner intended to say that sometimes taxpayers take positions for which there is little or no legal support and which are directly contrary to revenue rulings or cases. These taxpayers will rely in a large measure on sustaining their positions through the IRS' failure to select the return for audit or to discover the item when it does audit. When this happens, the integrity of the tax system suffers. Moreover, it also encourages taxpayers to push harder and harder in the lottery direction and to take positions which are supported only by the most tortured reasoning. The IRS believes that the audit lottery presents a dilemma to the ethical tax practitioners and that more precise guidelines in this area would curtail its use as a tax evasion tool.

Another area where many practitioners have had problems in the past is with the repetitive audit of individual and nonbusiness returns. A repetitive audit occurs when a taxpayer is notified that his return will be audited and the problem issue or issues identified are the same ones that were audited in previous years. The IRS is now attempting to identify those returns that had a "no change" the prior year. If it is the same issue as was audited previously, then the IRS will not reaudit that return. However, should a taxpayer become a victim of a repetitive audit, he should advise the IRS by calling the office or by bringing the prior year's return in as evidence that this year's audit would be a repetitive audit. The latter approach will undoubtedly obtain more immediate results. Without the prior year's return as evidence, the IRS must secure the return from the federal record center to make the determination not to audit.

During the past nine months, you have probably heard a lot about disclosure. Prior to the Tax Reform Act of 1976, returns were readily available to other government agencies for inspection under section 6103 of the Code with only limited restrictions. Under the Reform Act, other government agencies can inspect a taxpayer's return only after showing it has a "material interest" in that return. The Tax Reform Act of 1976 has also elevated disclosure violations to felony status and has increased the fine for abuse of disclosure to approximately $5,000.

The most profound change in the disclosure rules concerns the release of information to the Department of Justice and United States attorneys for the administration of federal nontax crimes. While the Commissioner can release to the Attorney General any return information that the IRS has gathered from sources other than the taxpayer, he cannot authorize the release of tax returns or information submitted by the taxpayer. Furthermore, current law requires that tax return and taxpayer return information shall be released to another agency only upon a federal district court order.

CONCLUSION

The IRS is striving to develop audit plans that will encourage voluntary compliance, treat taxpayers equally, and make the most effective use of audit resources. The IRS realizes that these objectives are difficult to achieve as well as to define under the budget process. However, it is easier to justify additional resources based solely on comparing money spent against revenue collected. Despite its problems, this tax system is the best in the world, and the nation must have confidence in it in order to make the voluntary compliance system operative. If confidence fails, we will be in very serious trouble.