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TAX ADMINISTRATION

Taxpayer Rights and  
Burdens During Audits of  
Their Tax Returns

Statement of James White, Associate Director, Tax Policy  
and Administration Issues, General Government Division



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# Tax Administration: Taxpayer Rights and Burdens During Audits of Their Tax Returns

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Taxpayers and Congress have expressed concerns with how the Internal Revenue Service (IRS) treats taxpayers in audits and whether audits are too burdensome. Based on its ongoing and previous work, GAO makes the following points on these issues:

- IRS has limited data on both the treatment of taxpayers and the burdens imposed on them during audits. IRS recently created a system to track taxpayers' complaints about improper treatment but IRS does not solicit input on all improper treatment. Similarly, IRS has no comprehensive definition of, and little data on, the burden its audits impose on taxpayers. IRS has recently developed a survey that will ask individual taxpayers about their satisfaction with various parts of the audit process but results will not be available until 1998.
- IRS has various indicators and standards on audit performance. One measure of audit performance is how much additional tax is recommended. IRS does not have a corresponding measure on how much of the recommended tax is ultimately collected after taxpayer appeals. Without an indicator to balance taxes recommended against those collected, IRS auditors could have an incentive to recommend taxes that would be unlikely to withstand a taxpayer challenge. IRS has nine audit standards. The standards focus on the efficient use of auditors' time and not on when they should use particular audit techniques. To ensure adherence to the standards, IRS relies on oversight by the auditors' managers. However, their workload limits their time for doing oversight.
- GAO's work on one set of IRS audit techniques—those used in analyzing taxpayers' financial status to identify unreported income—showed that IRS used these techniques in less than a quarter of the audits completed in the time periods covered by GAO's review. In about one-quarter of the audits in which financial status techniques were used, IRS did not have to contact the taxpayer to obtain information on the taxpayer's financial status beyond what was reported on the tax return. GAO also found that IRS' use of financial status techniques has not increased in recent years. Regarding revenue impact, GAO found that in about 16 percent of the cases where they were used, these techniques did help to identify significant amounts of unreported income—\$10,000 or more. However, in over three-quarters of the total audits in which these techniques were used, no changes resulting from the use of these techniques were made to the income reported. Most of the audits did result in some tax change for other reasons. Data are not available to permit GAO or IRS to determine the additional burden imposed on taxpayers from the use of the techniques in audits.

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**Summary**  
**Tax Administration: Taxpayer Rights and**  
**Burdens During Audits of Their Tax Returns**

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- IRS is concerned that its ability to target the potentially most noncompliant taxpayers for audits is deteriorating. IRS' concern arises because it has not been able to rely on its past approach for developing statistically valid research data that allowed IRS to create and periodically update formulas to target the returns with the most potential for noncompliance. IRS last collected these data through audits of a random sample of taxpayers for tax year 1988. IRS subsequently abandoned that approach due to concerns about its costs and to concerns from the public and Congress about the taxpayer burden involved with those audits.

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# Tax Administration: Taxpayer Rights and Burdens During Audits of Their Tax Returns

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Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its inquiry into the rights of taxpayers and their treatment during audits of their tax returns by the Internal Revenue Service (IRS). Recently, taxpayers, tax professionals, and Congress have expressed concerns about how IRS treats taxpayers during audits and whether audits are overly burdensome. You asked us to discuss IRS' data on taxpayer complaints and the burden imposed on taxpayers as well as IRS' indicators for measuring audit performance. You also asked us to discuss our ongoing work for the Chairman of the House Committee on Ways and Means on IRS' use of a particular audit technique—reviews of taxpayers' financial status (i.e., their flow of income and expenses)—and IRS' methodology for selecting tax returns for audit.

Today, I would like to make four points taken from this ongoing work as well as from previous reports and testimonies.

- First, IRS has limited data on both the treatment of taxpayers and the burdens imposed on them during audits. IRS recently created a system to track taxpayers' complaints about improper treatment but IRS does not solicit input on all improper treatment. Similarly, IRS has no comprehensive definition of, and little data on, the burden its audits impose on taxpayers. IRS has recently developed a survey that will ask individual taxpayers about their satisfaction with various parts of the audit process but results will not be available until 1998. While recognizing the difficulties in collecting data from taxpayers about treatment and burden, we believe that this survey may have the potential to provide better information than presently exists.
- Second, IRS' Examination Division has various indicators and standards on audit performance. One measure IRS uses for audit performance is how much additional tax is recommended. IRS does not have a corresponding measure on how much of the recommended tax is ultimately collected after taxpayer appeals. Without an indicator to balance taxes recommended against those collected, IRS auditors could have an incentive to recommend taxes that would be unlikely to withstand a taxpayer challenge. IRS has nine audit standards. The standards focus on the efficient use of auditors' time and not on when they should use particular audit techniques. To ensure adherence to the standards, IRS relies on oversight by the auditors' managers. However, their workload limits their time for doing oversight.

- Third, our work on one set of audit techniques—those used in analyzing taxpayers’ financial status to identify any unreported income—provided several interesting statistics. We estimated that IRS auditors used these techniques in less than a quarter of the audits completed in the time periods covered by our review. When used, financial status techniques were always part of an audit that included other techniques or methodologies. In about one-quarter of the audits in which financial status techniques were used, IRS did not have to contact the taxpayer to obtain information on the taxpayer’s financial status beyond what was reported on the tax return. We also found that the use of financial status techniques has not increased in recent years. Regarding revenue impact, we found that in about 16 percent of the cases where they were used, these techniques did help to identify significant amounts of unreported income—\$10,000 or more. However, of the total audits in which these techniques were used, in over three-quarters no changes resulting from the use of these techniques were made to the income reported, although most of the audits resulted in some tax change for other reasons. Data are not available to permit either us or IRS to determine the additional burden imposed on taxpayers from the use of financial status techniques in audits.
- Fourth, IRS is concerned that its ability to target the potentially most noncompliant taxpayers for audits is deteriorating. IRS’ concern arises because it has not been able to rely on its past approach for developing statistically valid research data that allowed IRS to create and periodically update formulas to target the returns with the most potential for noncompliance. IRS last collected these data through audits of a random sample of taxpayers for tax year 1988. IRS subsequently abandoned that approach due to concerns about its costs and to concerns from the public and Congress about the taxpayer burden involved with those audits. For context, we note that from the 1960s, when IRS first created its research-based audit formulas until it stopped gathering that research data after 1988, it had reduced the rate to which its audits made no recommended tax change from more than 40 percent to around 10 to 15 percent, depending on the type of return and the year of the audit.

I would like to discuss each of these points in more detail after providing an overview on why IRS audits tax returns and how IRS is supposed to do the audits.

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## Overview of IRS Audits of Tax Returns

IRS’ Examination Division audits tax returns to ensure that taxpayers report and pay the amount of tax they owe. Because our tax system is

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based on self-assessment, IRS also does audits to induce taxpayer compliance and promote public confidence in the tax system.<sup>1</sup>

The income tax gap—the difference between taxes owed and taxes paid voluntarily and on time—is one reason why IRS seeks to provide an audit presence. Under IRS' most recent estimate, the 1992 income tax gap for individuals exceeds \$90 billion, of which about two-thirds can be attributed to individuals not reporting income on their tax returns.

In recent years, IRS has been auditing about one to two percent of the 100-million plus income tax returns filed annually by individual taxpayers.<sup>2</sup> IRS' policies and procedures are generally directed at selecting returns that appear to be most noncompliant. After selecting the returns, IRS audits them either (1) through 1 of its 33 district offices by meeting with taxpayers or their representatives or (2) through 1 of its 10 service centers by corresponding with the taxpayers. Since fiscal year 1992, these audits have been recommending between \$5 billion to \$8 billion in additional taxes each year. Appendix I of my statement summarizes selected audit statistics since fiscal year 1992.

IRS auditors are instructed to not only verify the eligibility and amounts for various types of tax deductions, credits, and exemptions, but to also look for any indications of unreported income. If auditors find such indications, they are to exercise their judgment in deciding whether to do further probes in an effort to determine whether the taxpayer underreported income.

To guide auditors, IRS manuals and publications have identified the rights of taxpayers during audits and the manner in which auditors should treat taxpayers. For example, IRS documents say that taxpayers have the right, among others, to know why IRS is asking for information about the tax return and to authorize another person to represent them during the audit. Through its documents and training programs, IRS instructs its audit staff to explain these rights to the audited taxpayer and to protect those rights. In addition, audit staff are instructed to protect taxpayers' privacy as well as treat them with professionalism and courtesy.

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<sup>1</sup>IRS also induces compliance through taxpayer assistance, third-party reporting to IRS of payments (such as wages and interest) made to taxpayers, computer matching of tax returns to third-party data, income tax withholding, and penalties for noncompliance.

<sup>2</sup>IRS also annually audits tens of thousands of income tax returns filed by corporations and partnerships as well as thousands of other types of returns such as those filed to report estate tax, gift tax, employment tax, and excise tax.

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## **IRS Data on Audit Burden and Taxpayer Complaints About Treatment**

Recently, taxpayers, tax professionals, and Congress have criticized IRS for treating taxpayers improperly and imposing unnecessary burdens during audits. At a general level, these criticisms have asserted that auditors lacked sufficient experience, training, motivation, or competence. Specific criticisms have focused on a range of asserted IRS behaviors, including:

- subjecting compliant taxpayers to unnecessary audits, resulting in no change to the tax liability reported on the tax returns;
- wasting taxpayers' time during the audit by asking for irrelevant documentation or by delving into issues that are minor or personal; and
- treating taxpayers unprofessionally or abusively, regardless of whether they underpaid their taxes, by lying, making threats, applying pressure, and the like.

IRS has limited data for use in responding to such assertions. With respect to unprofessional or improper treatment, in 1994 and 1996, we reported that IRS lacked comprehensive data on the nature and magnitude of the complaints as well as their resolutions.<sup>3</sup> Nor did IRS have clear definitions that allowed it to determine whether these complaints indicated auditor behaviors that were "abusive" or "unnecessary."

Since our 1996 report, IRS has developed a definition and tracking system for complaints about improper treatment. IRS defines a complaint as an allegation by taxpayers or their representatives that an IRS employee violated the law, regulation, or IRS rules of conduct or used inappropriate behavior (e.g., rude, overzealous, discriminatory, intimidating) or that an IRS system failed to function properly or within the prescribed time frame.

IRS' complaint tracking system does not systematically solicit input from taxpayers on their treatment during audits; rather, it records only those complaints initiated by taxpayers. As a result, neither we nor IRS have representative data on the extent to which auditors treat taxpayers improperly across the roughly 2 million audits.

Nevertheless, IRS does report the data the system collects on taxpayer complaints. For the first quarter of fiscal year 1997, IRS reported that taxpayers initiated 1,203 complaints, of which 290 (25 percent) involved audit staff. Of the 290 audit-related complaints, almost half involved assertions of inappropriate behavior by an auditor and about one-quarter of these complaints were addressed through counseling or administrative

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<sup>3</sup>Tax Administration: IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly (GAO/GGD-95-14, Oct. 26, 1994), and Tax Administration: IRS Is Improving Its Controls for Ensuring That Taxpayers Are Treated Properly (GAO/GGD-96-176, Aug. 30, 1996).



action or through the employee leaving IRS; for the remaining three-quarters of the complaints, IRS concluded that the employee's behavior was appropriate or that information provided by the taxpayer was not complete enough to take disciplinary action against the employee.

With respect to taxpayer burden, IRS has limited data on the burden—whether necessary or not—imposed by audits. For example, in fiscal year 1996, IRS tax auditors made no changes to 14 percent of the individual tax returns. However, IRS does not know the amount of burden imposed by these or other audits.

Data on burden can be difficult to collect for various reasons. Neither IRS nor its stakeholders have clear definitions or agreement on what constitutes audit burden as well as unnecessary burden. Further, our work has shown that taxpayers do not keep records on the amount of audit burden in terms of time or money.<sup>4</sup>

IRS has recently developed a survey that will ask individual taxpayers about their satisfaction with the audit process. Results will not be available until 1998. Recognizing the difficulties in collecting data about treatment and burden, we believe that this survey may begin to provide better information about taxpayer treatment and burden but its usefulness will need to be evaluated.

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## **IRS' Indicators to Measure the Impacts of Audits**

IRS has established some indicators for measuring its audit performance. However, existing indicators primarily focus on interim results without also considering final results from the audits. Similarly, IRS has established nine audit standards to guide its auditors. However, the standards do not provide objective criteria on when to use particular audit techniques.

IRS' Examination Division has used additional tax recommended as an important indicator of audit performance (see app. II for the fiscal year 1997 indicators).<sup>5</sup> We expressed concerns in previous work that overreliance on additional taxes recommended as an indicator of performance could create undesirable incentives for auditors (and other Examination staff) to recommend taxes that would be unlikely to

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<sup>4</sup>Tax System: Issues in Tax Compliance Burden, (GAO/T-GGD-96-100, Apr. 3, 1996) and Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers, (GAO/T-GGD-95-42, Dec. 9, 1994).

<sup>5</sup>Taxpayers do not necessarily have to pay the recommended taxes. Taxpayers may challenge them through administrative channels within IRS or the courts. If they win the challenge, the recommended taxes will not be assessed as owed. If they lose or raise no challenge, the recommended taxes are assessed.

withstand a taxpayer challenge.<sup>6</sup> While we recognize the complexity of the Internal Revenue Code and the difficulties faced by both IRS and the taxpayer in determining the “correct tax,” the fact remains that audit recommendations that do not withstand such a challenge may have imposed an unnecessary burden on the taxpayer. For this reason, in our previous work, we supported the need to measure taxes recommended but advocated balancing that indicator with others such as taxes ultimately collected.

Our work also pointed out that developing an indicator of taxes ultimately collected from audits would be challenging. For example, the time lag between an audit and the ultimate tax collected makes linking the two problematic. IRS is working on developing a way of determining the ultimate taxes collected.

In addition to indicators of audit performance, IRS also has nine audit standards to provide guidance to auditors on minimizing the time spent on an audit, checking large and unusual claims on tax returns, probing for unreported income, and preparing adequate audit workpapers (see app. III for all nine standards). These nine standards do not address the proper treatment of taxpayers. Further, although the standards provide guidance on the proper depth and breadth of audits given the time available, they provide little objective guidance to auditors on when to use particular audit techniques such as those related to an analysis of a taxpayer’s financial status.

To ensure adherence to the standards, IRS relies on managers’ oversight of auditors. However, according to IRS officials, these managers cannot review all audits because their workloads limit the time available for review. As audits close throughout the year, separate groups of IRS staff supplement the managerial review process by reviewing a small sample of audits to measure adherence to the nine standards (see appendix III for measurement results in fiscal years 1992 through 1996).

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## **IRS’ Use of Financial Status Techniques**

Given recent complaints about the asserted burdens and intrusions associated with IRS’ financial status audit techniques, the Chairman of the House Committee on Ways and Means asked us to report on the frequency and results of IRS’ use of these techniques. IRS uses these techniques to identify unreported income. During our analyses of audits done in 1992-93

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<sup>6</sup>Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement (GAO/GGD-94-70, Sept. 1, 1994) and Tax Administration: Factors Affecting Results From Audits of Large Corporations (GAO/GGD 97-62, Apr. 17, 1997).

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and 1995-96, we found that IRS relied primarily on two financial status techniques:<sup>7</sup>

1) Cash transaction analysis (or cash-T), in which the auditor uses the tax return and other sources to ensure that adequate income has been reported on the return to cover expenses. In deciding to use this technique, auditors may first do a preliminary cash-T. It differs from the regular cash-T in that the auditor does it before meeting with taxpayers, relying on information reported on tax returns.

2) Bank deposit analysis, in which the auditor verifies that the taxpayer's bank deposits are consistent with the income reported on the tax return.

To do our work, we randomly sampled from the universe of audits closed in IRS districts in which IRS scheduled meetings with taxpayers to review their records. These samples covered 1992-93 and 1995-96 and were both projectable to universes of about a half million audits.

On the basis of our analysis of these two samples, we estimate that the use of financial status techniques had not increased over the time frames we reviewed—the techniques were used in about one-quarter of the audits in each of our two universes. Financial status techniques were never used alone; they were always part of audits that included other audit techniques to explore issues other than unreported income, such as overstated deductions.

These techniques imposed no or little additional burden on taxpayers in some of the audits where they were used. For example, IRS auditors used just the preliminary cash-T in 23 percent of the 1995-96 audits that used financial status techniques. The preliminary cash-T technique imposes no additional burden on the taxpayer because the auditor relies on the information on the tax return and does not have to contact the taxpayer to obtain additional information or explanations to complete this technique.

We found that use of the financial status techniques in some cases helped to identify significant amounts of unreported income—\$10,000 or more—that IRS would not have otherwise found. However, over three-quarters of the audits in which these techniques were used resulted in no changes that were directly attributable to the use of these

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<sup>7</sup>Other techniques include an analysis of (1) a taxpayer's net worth and (2) a business taxpayer's reported cost of goods sold and data on average markups within the specific business to estimate gross receipts generated by that taxpayer.

techniques, even though IRS did find noncompliance in most of these audits through other techniques.

While neither we nor IRS know the actual burden imposed on taxpayers, our review of IRS' workpapers illustrated some conditions under which use of certain techniques may impose additional burdens. For example, a bank deposit analysis can be very burdensome if the auditor asks for records on many bank accounts and asks many questions about the deposits in those accounts. A regular cash-T may or may not be very burdensome, depending on the number of contacts with taxpayers to request information and the amount of information requested.

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## Barriers to Selecting the Most Noncompliant Tax Returns for Audit

As discussed in previous reports, IRS is concerned about its ability to objectively select tax returns so that it focuses on the most noncompliant taxpayers.<sup>8</sup> IRS' concerns arise because it has not been able to rely on its past approach for developing statistically valid research data that allowed IRS to create and periodically update formulas to target the returns with the most potential for noncompliance. IRS refers to these as discriminant function (DIF) formulas, which have served as the major method for selecting returns for audit.<sup>9</sup> IRS fears that its DIF formulas have become imprecise because the formulas use outdated statistical data.

In past years, IRS collected the statistically valid research data under its Taxpayer Compliance Measurement Program (TCMP). TCMP involved full-scale audits of a random sample of tax returns—usually for about 50,000 individual taxpayers every 3 years. In 1995, IRS abandoned this approach due to concerns about its costs and to concerns from the public and Congress about the taxpayer burden involved with those audits. As a result, IRS' last TCMP covered tax year 1988.

In a 1996 report, we discussed IRS' need for compliance data that are statistically valid and more current.<sup>10</sup> IRS needs the data not only to update

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<sup>8</sup>Tax Research: IRS Has Made Progress But Major Challenges Remain, (GAO/GGD-96-109, June 5, 1996); Tax Administration: Alternative Strategies to Obtain Compliance Data (GAO/GGD-96-89, Apr. 26, 1996); Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994); and Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993).

<sup>9</sup>Tax Administration: Audit Trends and Results for Individual Taxpayers (GAO/GGD-96-91, Apr. 26, 1996). IRS has up to 40 methods for identifying returns to audit. Appendix IV summarizes the number of audits selected by the major methods for fiscal years 1992 through 1996.

<sup>10</sup>Tax Administration: Alternative Strategies to Obtain Compliance Data (GAO/GGD-96-89, Apr. 26, 1996).

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its DIF formulas but also to support most of its compliance programs. Accordingly, we recommended that IRS develop a cost-effective, long-term strategy to ensure the continued availability of such compliance data.

Since IRS started to use DIF in the 1960s to better target its audits through fiscal year 1996, IRS has reduced the rate at which its auditors made no tax changes from more than 40 percent of the audited returns to around 10 to 15 percent, depending on the type of return and the year of the audit. IRS is concerned that as time passes, DIF's precision in identifying noncompliant returns may decrease unless IRS updates the formulas with valid data, and that as a result, more and more compliant taxpayers will be unnecessarily burdened with an audit. We are now designing a study of this issue at the request of the Chairman of the House Committee on Ways and Means.

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Madam Chairman, this concludes my testimony. I would be pleased to answer any questions you or other members of the Subcommittee may have.

# Selected Information About the Returns Filed and Examined and Recommended Additional Taxes (Fiscal Years 1992-96)

Description	1992	1993	1994	1995	1996
Number of returns					
Filed	152,031,900	153,453,600	152,732,800	154,293,700	155,279,600
Examined	1,452,009	1,300,230	1,426,573	2,100,144	2,136,819
Percent coverage	.96	.85	.93	1.36	1.38
Recommended additional tax and penalties (in billions)					
Individual returns	6.3	5.7	6.2	7.8	\$7.6
Corporate returns	18.1	14.7	15.1	17.7	\$18.0
All other <sup>a</sup>	2.5	2.7	2.6	2.3	\$2.5
Average tax and penalty per return examined by					
Revenue agent for non-CEP <sup>b</sup>	\$25,161	\$24,704	\$18,177	\$21,237	\$24,407
Revenue agent for CEP	3,940,148	2,700,352	3,279,298	4,032,528	3,998,409
Tax auditor	2,280	2,625	3,113	3,497	3,051
Service center	2,541	2,934	1,945	1,427	1,733

<sup>a</sup>Other includes fiduciary, estate, gift, employment, excise, windfall profit, and miscellaneous taxes.

<sup>b</sup>CEP = Coordinated Examination Program, under which IRS audits the largest corporations.

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# IRS Examination Division Measures for 1997

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Basic measures across Examination activities include

- 1.Amount of additional tax and penalties recommended.
- 2.Percentage of additional recommended amounts plus interest amounts that were collected before IRS issued the second notice on the amounts that were assessed.
- 3.Average number of days that an audit case remains open.
- 4.Amount of additional tax and penalty recommended as well as the amount of tax protected in audits divided by the total full-time-equivalent staffing invested.

For the Coordinated Examination Program (CEP), additional measures include

- 1.Average number of tax years for tax returns filed by a CEP taxpayer that have not yet been audited.
- 2.Amount of additional tax and penalty recommendations that CEP taxpayers agreed to pay minus amount overassessed divided by the total full-time-equivalent staffing invested.
- 3.Amount of total adjusted revenues divided by the total full-time-equivalent staffing invested.

# IRS' Examination Quality Measurement System

The Office of Compliance Specialization, within IRS' Examination Division, has responsibility for Quality Measurement Staff operations and the Examination Quality Measurement System (EQMS). Among other uses, EQMS measures the quality of closed audits against nine IRS audit standards. The standards address the scope, audit techniques, technical conclusions, workpaper preparation, reports, and time management of an audit. Each standard includes additional key elements describing specific components of a quality audit. Table III.1 summarizes the standards and the associated key elements.

**Table III.1: Summary of IRS' Examination Quality Measurement System (EQMS) Auditing Standards (as of October 1996)**

No.	Standard	Key elements	Purpose	Overview
1	Considered large, unusual, or questionable items	A. Balance sheet and Schedule M considered B. Income, deduction, and credit items considered C. Scope of examination was appropriate	Measures whether consideration was given to the large, unusual, or questionable items in both the precontact stage and during the course of the examination.	This standard encompasses, but is not limited to, the following fundamental considerations: absolute dollar value, relative dollar value, multiyear comparisons, intent to mislead, industry/business practices, compliance impact, and so forth.
2	Probes for unreported income	A. Consideration of internal controls for all business returns B. Consideration of books and records C. Consideration of financial status D. Appropriate use of indirect methods	Measures whether the steps taken verified that the proper amount of income was reported.	Gross receipts were probed during the course of examination, regardless of whether the taxpayer maintained a double entry set of books. Consideration was given to responses to interview questions, the financial status analysis, tax return information, and the books and records in probing for unreported income.
3	Required filing checks	A. Consideration of prior and subsequent year tax returns B. Consideration of related returns C. Compliance items considered	Measures whether consideration was given to filing and examination potential of all returns required by the taxpayer, including those entities in taxpayer's sphere of influence/responsibility.	Required filing checks consist of the analysis of return information and, when warranted, the pick-up of related, prior, and subsequent year returns. In accordance with Internal Revenue Manual 4034, examinations should include checks for filing information returns.

(continued)



**Appendix III  
IRS' Examination Quality Measurement  
System**

No.	Standard	Key elements	Purpose	Overview
4	Examination depth and records examined	A.Adequate interviews conducted B.Adequate exam techniques used C.Fraud adequately considered and developed D.Issues sufficiently developed	Measures whether the issues examined were completed to the extent necessary to provide sufficient information to determine substantially correct tax.	The depth of the examination was determined through inspection, inquiry, interviews, observation, and analysis of appropriate documents, ledgers, journals, oral testimony, third-party records, etc., to ensure full development of relevant facts concerning the issues of merit. Interviews provided information not available from documents to obtain an understanding of the taxpayer's financial history, business operations, and accounting records in order to evaluate the accuracy of books or records. Specialists provided expertise to ensure proper development of unique or complex issues.
5	Findings supported by law	A.Correct technical or factual conclusions reached	Measures whether the conclusions reached were based on a correct application of tax law.	This standard includes consideration of applicable law, regulations, court cases, revenue rulings, etc., to support technical or factual conclusions.
6	Penalties properly considered	A.Recognized, considered, and applied correctly B.Penalties computed correctly	Measures whether applicable penalties were considered and applied correctly.	Consideration of the application of appropriate penalties during all examination is required.
7	Workpapers support conclusions	A.Fully disclose audit trail and techniques B.Legible and organized C.Adjustments in workpapers agree with 4318, 4700, and reports D.Activity record adequately documents exam activities E.Disclosure	Measures the documentation of the examination's audit trail and techniques used.	Workpapers provided the principal support for the examiner's report and documented the procedures applied, tests performed, information obtained, and the conclusions reached in the examination.
8	Report writing procedures followed	A.Applicable report writing procedures followed B.Correct tax computation	Measures the presentation of the audit findings in terms of content, format, and accuracy.	Addresses the written presentation of audit findings in terms of content, format, and accuracy. All necessary information is contained in the report, so that there is a clear understanding of the adjustments made and the reasons for those adjustments.

(continued)

**Appendix III  
IRS' Examination Quality Measurement  
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No.	Standard	Key elements	Purpose	Overview
9	Time span or time charged	A.Examination time commensurate B.Exam initiation C.Examination activities D.Case closing	Measures the utilization of time as it relates to the complete audit process.	Time is an essential element of the auditing standards and is a proper consideration in analyses of the examination process. The process is considered as a whole and at examination initiation, examination activities, and case-closing stages.

Source: IRS data.

## Standard Success Rate

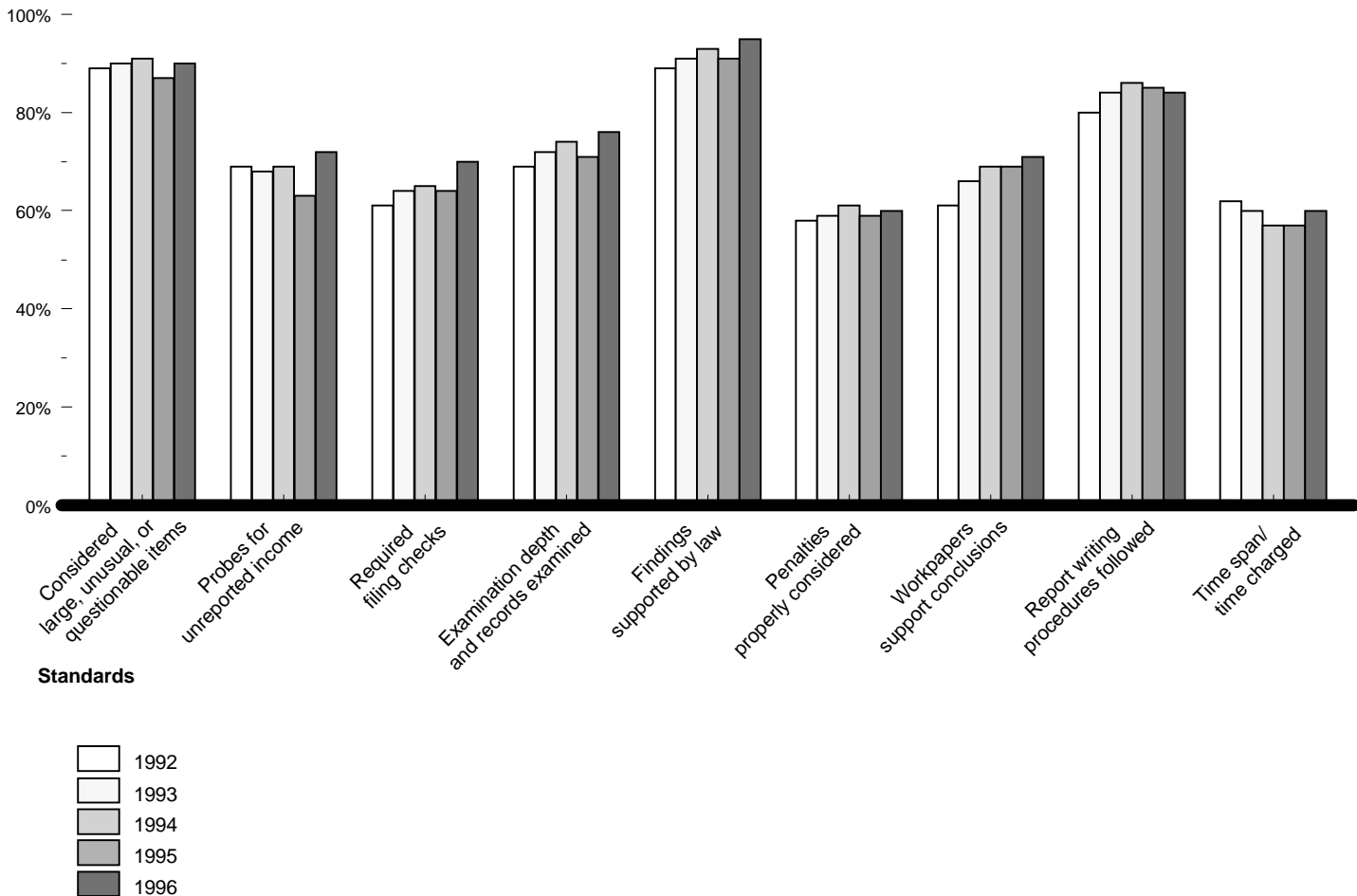
EQMS quality reviewers use the key element definitions to determine whether an audit adhered to the standard. Thus, adherence to audit quality is measured by the presence or absence of associated key elements. For a standard to be rated as having been met, each of the associated key elements must also be rated as met or not applicable. If the audit does not demonstrate the characteristics described by one of the key elements, then the standard is rated as not met.

One measure that IRS uses to evaluate the audit quality is the standard success rate. It measures the percentage of cases for which all the underlying key elements of each standard are rated as having been met. According to IRS, this measure is useful for determining whether a case is flawed and in what area. Figures III.1 and III.2 show the standard success rates for each of the standards for fiscal years 1992-96 for office and field audits, respectively.

**Appendix III  
IRS' Examination Quality Measurement  
System**

**Figure III.1: Standard Success Rates for Office Audits** (Fiscal Years 1992-96)

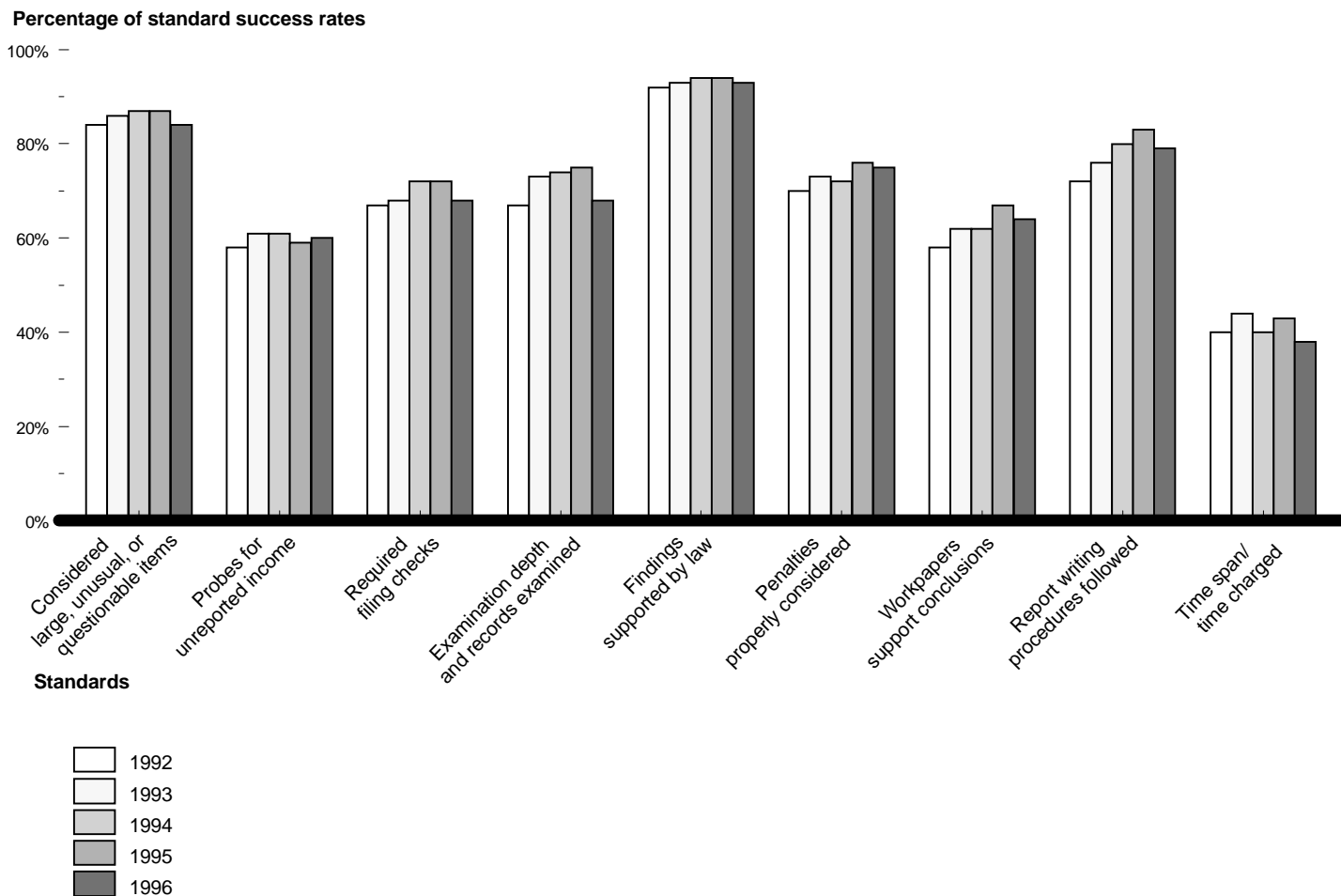
Percentage of standard success rates



Source: IRS data.

**Appendix III  
IRS' Examination Quality Measurement  
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**Figure III.2: Standard Success Rates for Field Audits (Fiscal Years 1992-96)**



Source: IRS data.

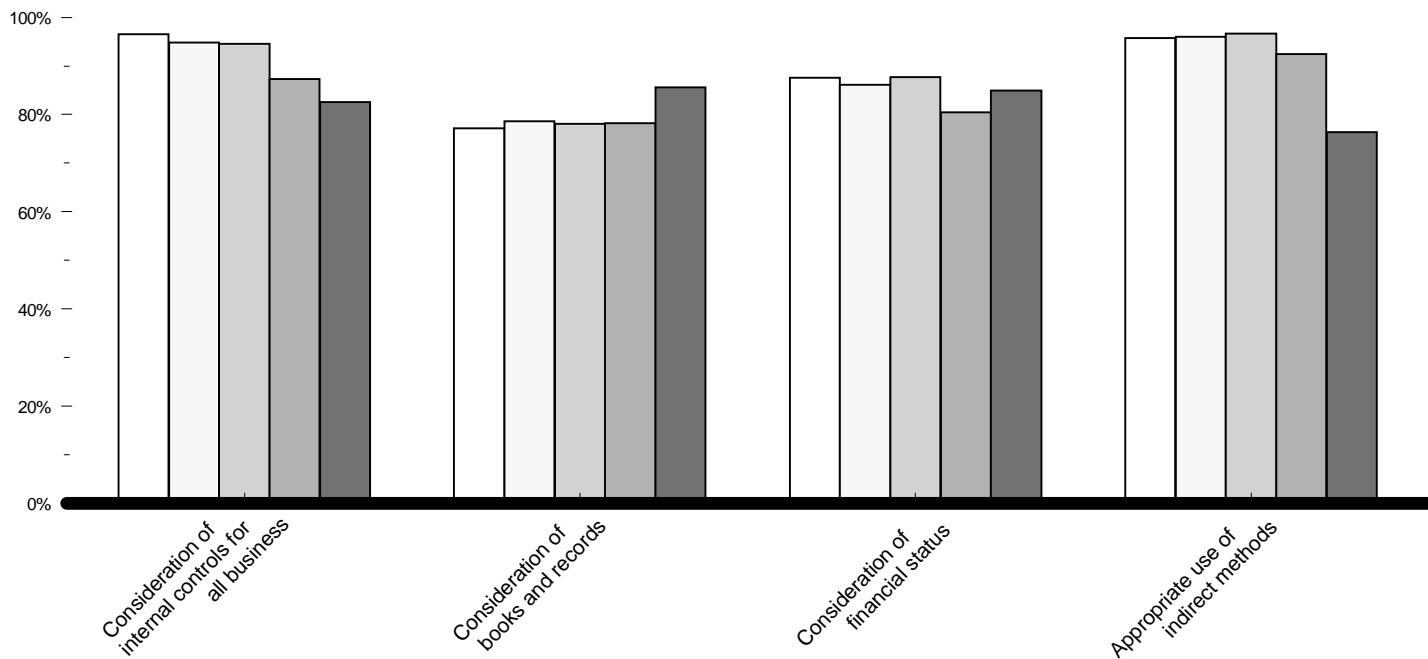
**Key Element Pass Rate**

IRS also uses the key element pass rate as a measure of audit quality. This measure computes the percentage of audits demonstrating the characteristics defined by the key element. According to IRS, the key element pass rate is the most sensitive measurement and is useful when describing how an audit is flawed, establishing a baseline for improvement, and identifying systemic changes. Figures III.3 and III.4 show the pass rates for the key elements of standard 2 for fiscal years 1992 through 1996 for office and field audits, respectively.

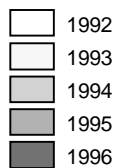
**Appendix III  
IRS' Examination Quality Measurement  
System**

**Figure III.3: Key Element Pass Rates for Key Elements of Standard 2 for Office Audits (Fiscal Years 1992-96)**

Percentages of key element pass rates



**Key Elements of Standard 2, Probes for unreported income**

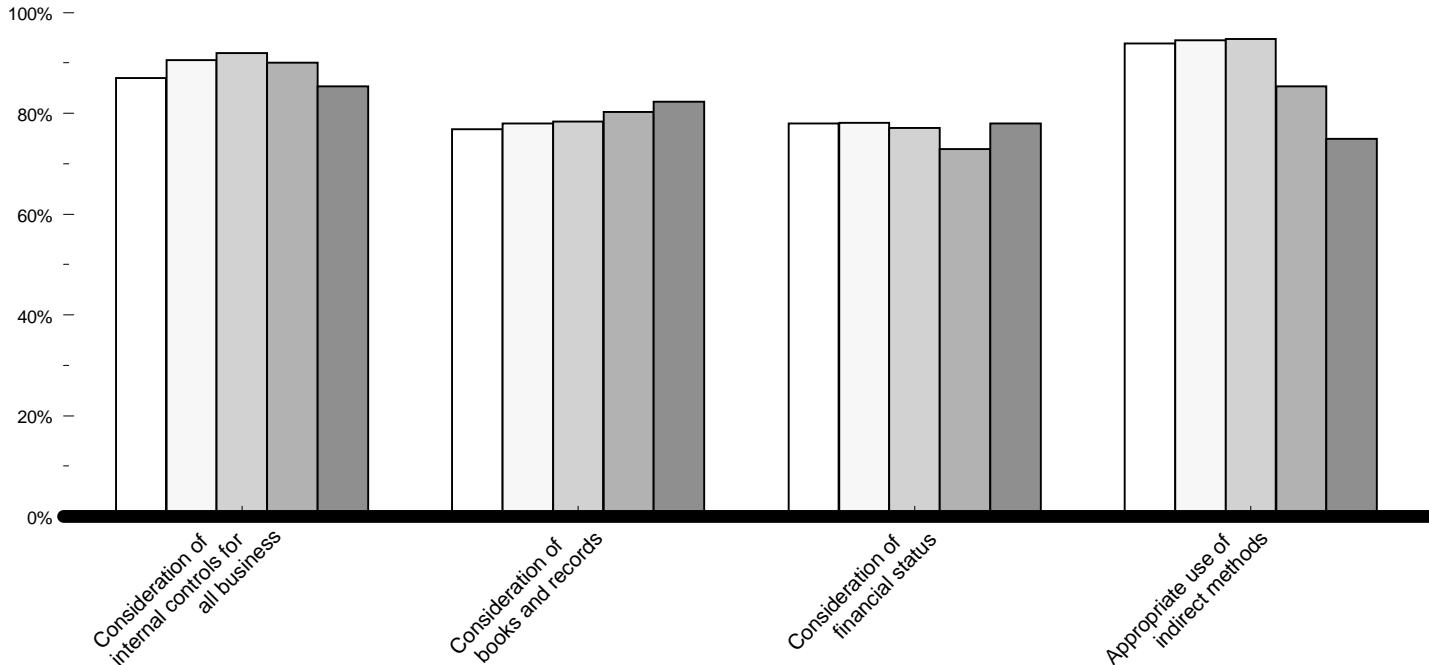


Source: IRS data.

**Appendix III  
IRS' Examination Quality Measurement  
System**

**Figure III.4: Key Element Pass Rates for Key Elements of Standard 2 for Field Audits (Fiscal Years 1992-96)**

Percentages of key element pass rates



**Key Elements of Standard 2, Probes for unreported income**

- 1992
- 1993
- 1994
- 1995
- 1996

IRS data.

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# Number and Percent of Individual Returns Audited by Audit Source (Fiscal Years 1992-96)

Audit sources	Fiscal year 1992	
	Number	Percent
DIF/DIF related	452,445	38%
Nonfilers	119,865	10
Tax shelter related	101,453	8
Self-employment tax	71,126	6
Regular classification	52,528	4
State information	48,418	4
Service center studies and tests	43,333	4
Compliance projects	40,403	3
Claims for refund	33,163	3
Return preparers	27,706	2
Non-DIF multiyear	26,866	2
Unallowable items	13,117	1
Other sources	175,596	15
<b>Total</b>	<b>1,206,019</b>	<b>100%</b>



**Appendix IV  
Number and Percent of Individual Returns  
Audited by Audit Source (Fiscal Years  
1992-96)**

Fiscal year 1993		Fiscal year 1994		Fiscal year 1995		Fiscal year 1996	
Number	Percent	Number	Percent	Number	Percent	Number	Percent
372,116	35%	239,557	20%	263,200	14%	351,867	18%
190,809	18	402,435	33	410,612	21	212,226	11
48,070	5	29,687	2	27,473	1	20,300	1
46,310	4	43,032	4	48,578	3	40,601	2
50,709	5	47,170	4	46,637	2	48,534	3
3,564	0	4,573	0	3,210	0	71,582	4
20,059	2	22,825	2	25,026	1	18,684	1
44,267	4	41,959	3	38,624	2	45,680	2
37,203	4	26,412	2	23,175	1	31,495	2
28,231	3	27,708	2	26,542	1	33,637	2
29,373	3	26,742	2	24,926	1	29,927	2
12,099	1	134,007	11	761,886	40	824,721	42
176,156	16	179,600	15	219,548	11	212,306	11
<b>1,058,966</b>	<b>100%</b>	<b>1,225,707</b>	<b>100%</b>	<b>1,919,437</b>	<b>100%</b>	<b>1,941,560</b>	<b>100%</b>

Note 1: For this table, we used the format from our 1996 report on audit trends (GAO/GGD-96-91, Apr. 1996). That format listed the top 10 sources for each of the fiscal years 1992 through 1994. Using that format, we updated the numbers and percentages for those categories for fiscal years 1995 and 1996.

Note 2: See next page for definitions of terms used in this table.

Note 3: Percentages are the percent of total audits for the year and have been rounded to the nearest whole percent.

Source: GAO analysis of IRS data.

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# Definitions of Audit Sources

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Claims for Refund	Ammended returns audited because of taxpayers' claims for refunds.
Compliance Projects	Returns identified through IRS' information gathering projects.
DIF/DIF Related	Returns selected on the basis of a computer-generated score (the scoring is based on an analysis technique known as discriminant function). Also included are related returns identified during an audit of a DIF-source return and related returns from prior or subsequent years for the same taxpayer.
Non-DIF Multiyear	Related returns from prior or subsequent years for the same taxpayer, when the initial source was other than a DIF-source return.
Nonfilers	Audits initiated against known taxpayers who did not file a return with IRS.
Other Sources	Over 25 other audit sources, such as referrals from other IRS Divisions, which were not one of the 10 largest sources during the period of our review.
Regular Classification	Manually selected returns for audit that do not result from other specified audit sources.
Return Preparers	Returns identified for audit due to questionable tax preparers.
Self-Employment Tax	Returns involving self-employment tax issues identified by IRS service center examination staff.
Service Center Studies and Tests	Returns identified through service center projects initiated by the IRS National Office.
State Information	Returns identified from various state sources, generally under exchange agreements between IRS and the states.

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**Appendix V**  
**Definitions of Audit Sources**

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<b>Tax Shelter Related</b>	Related returns of partners, grantors, beneficiaries, and shareholders identified during audits of either partnerships, fiduciaries, or Subchapter S corporations involving potential tax shelter issues.
<b>Unallowable Items</b>	Returns involving refundable credits and dependency exemptions, such as the Earned Income Tax Credit, identified by service center examination staff.

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