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TAX ADMINISTRATION

IRS' Return Selection Process

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The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives

The Honorable Amo Houghton
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

For 1992, according to the most recent estimate of the Internal Revenue Service (IRS), individual taxpayers, at the time they submitted their tax returns, did not pay about $100 billion in income tax liabilities. An audit is one of the enforcement tools IRS uses to try to reduce this figure.

Recently, Congress has voiced concerns about the methods IRS uses to select returns for audit and the techniques used to conduct audits. These concerns contributed to the passage of the IRS Restructuring and Reform Act of 1998 (Public Law 105-206, July 22, 1998). Among other things, this act limits IRS' ability to use certain audit techniques and requires that IRS include in information it sends to taxpayers an explanation of the reasons why it selects returns for audit.

IRS has many sources from which to select tax returns for audit. IRS' intent is to select returns with audit potential—returns for which an audit is most likely to find errors and recommend changes to the reported tax. One source is the discrimnant function (DIF), an automated system for scoring individual tax returns according to their audit potential. IRS' policy also allows returns to be selected through non-DIF sources (e.g., referrals from other federal and state government agencies) if these returns can be shown to have a greater audit potential than a DIF-selected return.

In an April 1996 letter, the committee asked that, among other things, we explore how effectively IRS selects individual income tax returns for audit.[1] However, IRS does not have information on all aspects of audit effectiveness. Consequently, we agreed, on the basis of discussions with your office, to focus on audits in which auditors in IRS district offices hold

[1]This is the third in a series of reports you requested on IRS' audit process. The other two were: Tax Administration: More Criteria Needed on IRS' Use of Financial Status Audit Techniques, (GAO/GGD-98-38, December 30, 1997); and IRS Audits: Workpapers Lack Documentation of Supervisory Review, (GAO/GGD-98-98, April 15, 1998).

face-to-face meetings with individual taxpayers to review their books and records.[2] For these books and records audits, we agreed to (1) determine the extent to which IRS district offices have used various sources to select these individual returns for audit; and (2) compare the results of audits selected using these sources in terms of the rate at which audits recommended no-change to the tax reported (no-change audits), amount of additional taxes recommended per return audited, and rates at which IRS assessed and collected such recommended taxes after the audit.[3] For our analyses, we examined books and records audits of returns received by IRS in 1992, 1993, and 1994 that were closed within a 4-year period.[4]

Results in Brief

Of the 1.1 million closed books and records audits of returns received in 1992, 1993, and 1994, our analysis showed that IRS selected 59 percent of the returns using its DIF source. The other 41 percent were selected using non-DIF sources.

When we compared the results from DIF and non-DIF audits of returns received in 1992, 1993, and 1994, the non-DIF audits generally resulted in lower no-change rates and higher recommended additional taxes than DIF audits. These results are consistent with IRS' policy to use non-DIF sources if the audit potential appears to be higher than it would be from a DIF audit.

In contrast, we estimated that IRS collected a greater proportion of the additional taxes recommended in DIF audits than for non-DIF audits, based on a sample of returns received in 1992. An estimated 57 percent of the recommended additional taxes were collected for DIF audits versus 35 percent for non-DIF. Several IRS operations affect collections and we were unable to determine from IRS' data which of these caused the non-DIF collection rate to be lower.

Caution is needed if one uses the three results we analyzed to compare the effectiveness of DIF and non-DIF sources. The no-change rate, the recommended additional tax amounts, and the collection rate on these recommended amounts do not present a complete picture of audit

[2]As discussed in the Scope and Methodology section and appendix I of this report, we excluded some audits because they are not typical books and records audits.

[3]In this report, when we refer to the recommended additional tax, this includes refunds and penalty amounts, if applicable. IRS combines tax and penalties into one figure reported as "audit results." This figure cannot be separated in IRS' data files.

[4]Between 2 and 5 percent of the returns selected for audit remained open at the end of our study period. See the scope and methodology section for a discussion of these open audits.

effectiveness. For example, data are not readily available on how audits affect voluntary compliance and taxpayer burden. Nor are data readily available on how other factors, such as the quality of the audits, affected the results across the selection sources.

Background

IRS conducts various compliance checks to determine whether taxpayers reported the correct tax liability on their returns. Initially, taxpayers may be contacted as IRS processes their filed returns if IRS identifies a math error or missing information on the return. IRS also uses computers to match information on the tax return with information obtained from third parties, such as employers and financial institutions, that report payments such as salaries and interest paid to individuals. During fiscal year 1996, IRS used computer matching to identify about 3.2 million taxpayers who may have underreported income on returns or not filed required returns. Additionally, IRS audited about 2.1 million tax returns to determine whether taxpayers reported the correct tax liability.

Audits are performed at IRS' 10 service centers and 33 district offices. Service centers and district offices perform different types of audits on the basis of complexity of the audit, training and pay grade of auditors, and audit techniques used. Service centers conduct correspondence audits, generally of a single issue such as earned income credit claims. These audits rely on correspondence to ask taxpayers to provide information about an item on the tax return. Face-to-face audits with taxpayers to review their books and records occur in IRS' 33 district offices. District office audits are more complex, with multiple issues and often more than 1 tax year being audited.

IRS has developed many sources, or reasons, for selecting returns for audit, which can be segregated into those using DIF sources and those using non-DIF sources.[5] DIF scores are automatically calculated for all filed individual tax returns. This DIF calculation is based on a series of formulas developed by IRS that are designed to indicate the returns that have the highest probability of a tax change if audited. The higher the DIF score the greater this probability.

Before implementing DIF, IRS had no systematic way to evaluate which among all filed returns had the greatest potential for changes to the reported tax if audited. Instead, IRS relied on its auditors across the

[5]The exact number of source codes used varies by year because IRS periodically combines some and develops new ones. See appendix I for list of all source codes used by IRS during the years covered in this review.

country to identify which returns to audit by using their experience and judgment in reviewing returns. This process was time consuming and required large amounts of resources.

Starting in 1969, IRS began using DIF as part of a multistage process to narrow down the number of returns to be reviewed by the auditors. This process change was intended not only to improve the effectiveness of return selection, but also to reduce the amount of judgment involved in selecting returns for audit. Calculating the DIF score for all filed returns is the first stage of this process. Then, returns with DIF scores above a national cutoff are to be placed in the DIF inventory, from which they may be selected for audit by a district office.

In the next stage, the district offices are to indicate how many DIF-scored returns will be needed by their various suboffices. Returns with the highest DIF scores are to be pulled from the DIF inventory and reviewed by experienced auditors to determine whether the return will be accepted as filed or sent to the district for audit. In this process, known as classification, reviewers also are to indicate which portions of the return should be audited. Once in the district, returns are generally reviewed at multiple levels before being sent to an audit group for distribution to the auditors.

Districts also use numerous non-DIF sources for identifying specific returns for audit. As with DIF returns, these non-DIF returns are to be reviewed in the district office at multiple levels and either accepted as filed or forwarded to audit groups. Unlike audits selected using DIF, these returns need not be selected by DIF score or solely from the DIF inventory. For the non-DIF sources we include in our review, we grouped these into five categories.[6]

- IRS projects, which include audits that focus on specific types of issues, such as unreported income, or types of taxpayers, such as those operating cash businesses, whose returns have specific characteristics that indicate potential noncompliance;
- referrals of potentially noncompliant returns that come from both inside and outside IRS; for example, returns are referred by IRS' Collection Division and by state tax agencies;

[6]In this report we use the term "non-DIF sources" when referring to the five categories. IRS has many other non-DIF sources for audit selection at the district office. Because this review focused on the sources associated with the selection process for audits of taxpayers' books and records, we did not analyze these other non-DIF sources. A complete list of source codes and the reasons for excluding them can be found in appendix I.

- individuals whose returns were completed by a preparer that IRS has identified as questionable;
- regular classification that is a catchall group for various kinds of audits that had to be manually selected, such as those involving bankruptcy; and
- all other reasons for selecting a return for books and records audits, such as those involving income from illegal narcotics, tax fraud, or abusive tax shelters.

The DIF formulas, together with the multiple levels of review in the selection process, are designed to ensure that returns having the greatest potential for a change to the reported tax are most likely to be audited. If this audit potential can be justified, IRS districts can use non-DIF sources to select returns for audit. Specifically, the districts should show that using a non-DIF source would generally offer more potential for changing the reported tax than continuing to audit returns identified by DIF.[7] The steps for selecting DIF and non-DIF returns for audit are shown graphically in appendix II.

Scope and Methodology

To determine the extent to which IRS district offices have used various sources to select returns for audit, we first reviewed return selection procedures and sources as outlined in the Internal Revenue Manual (IRM) and in attachments to the instructions for IRS' Audit Information Management System (AIMS). We collected data on these sources from IRS' closed case data files. We talked to IRS' Examination and Research Division staffs in the National Office as well as Examination staff in the Northern California District and Western Regional offices to understand the information about the procedures and sources. Finally, we collected data from the AIMS data files on closed audits on the extent to which IRS used each source in accordance with the criteria outlined below.

To compare the no-change rate and additional tax recommended per audited return for the various audit selection sources, we used data from AIMS files on closed audits. Our primary interest was books and records audits of individual returns. We focused on such audits at district offices because service center audits were being evaluated in another assignment. We eliminated audits such as those coded as claims for refund, nonfilers, research and reference, and taxpayer requests because these are generally not books and records audits. In addition, we eliminated audits of related

[7]Certain types of returns, such as those claiming large refunds, are considered mandatory and may or may not be selected for audit solely because of the potential for a tax change.

and multiyear returns because of the difficulty of associating these audits to 1 of the 3 years we analyzed.[8]

We analyzed returns received by IRS in 1992, 1993, and 1994. Because the criteria for selecting returns may change from year to year, we wanted to organize our data in a manner that would reflect the selection source. We discussed this with IRS officials and concluded that our analysis would be based on the year IRS received the return (filing year) rather than on the year the audit was closed (as presented in the AIMS files). Using the closed case data files for fiscal years 1992 through 1997, we collected data for audits of returns

- received in 1992 with audits closed during 1992 through 1995,
- received in 1993 with audits closed during 1993 through 1996, and
- received in 1994 with audits closed during 1994 through 1997.

We used these years because they were the most recent filing years for which IRS had 4 years of audit closures. Tracking 4 years allowed us to account for almost all of the returns selected for audit. Even so, some audits of returns received in 1992, 1993, and 1994 remained opened at the end of our 4 year test period. Using the AIMS files, we determined that

- 4 percent of the audits for 1992 returns were open at the end of fiscal year 1995,
- 5 percent of the audits for 1993 returns were open at the end of fiscal year 1996, and
- 2 percent of the audits for 1994 returns were open at the end of fiscal year 1997.

To compare how much of the additional tax recommended was assessed and collected for DIF and non-DIF audits, we selected a sample of audits from the 1992 study population. We selected 1992 instead of 1993 or 1994 to allow as much time as possible for collection activities. This sample was divided into 4 strata: (1) audits selected using the DIF scores and closed with the taxpayer agreeing to the additional tax recommended (agreed audits), (2) audits selected using the DIF scores and closed without the taxpayer agreeing to all of the additional tax recommended (unagreed audits), (3) agreed audits selected using non-DIF sources, and (4) unagreed audits selected using non-DIF sources. We used transcripts from IRS' master file to compare the amount actually collected with the

[8]See appendix I for a more complete description of the source codes eliminated and those used in the study population.

amounts recommended. A more complete explanation of our sample selection strategy and sampling errors can be found in appendix III.

There are some limitations on our data analysis. We did not validate AIMS data files on the closed audits. During our analysis of the master file transcripts for a selected sample, however, we noted some data inconsistencies between the master file and the AIMS files. We found source codes on the AIMS files that differed from those on the master file. According to IRS, the source code recorded on the AIMS files is correct, and there is no mechanism to make these changes on the master file accounts. We also found substitute for return (SFR) audits even though we had removed SFR source codes from our analysis.[9] IRS officials indicated that it was not possible to identify all SFRs by source code. We excluded only those SFRs that could be identified using the AIMS coding. Moreover, we did not adjust the dollar amounts for inflation, thus the dollars reported may be conservative.

We performed our audit at IRS headquarters offices in Washington, D.C.; the Western Region; the Northern California District Office; and IRS' Fresno Service Center. Our work was done between January 1998 and September 1998 in accordance with generally accepted government auditing standards.

Sources of IRS Audits

DIF-selected returns accounted for 59 percent of the books and records audits conducted at IRS' district offices of returns received in 1992, 1993, and 1994.[10] The remaining 41 percent of the audits were selected from the 5 non-DIF sources. Table 1 shows the number of books and records audits conducted for each of the six sources for returns received by IRS between 1992 and 1994.

[9]IRS files a substitute return for certain individuals who do not appear to have filed required tax returns. These returns are prepared from information documents provided by third parties, such as banks and employers. According to IRS officials, these SFRs may have been selected for other audit purposes and thus were not coded as SFRs.

[10]Audits of taxpayer books and records averaged less than one-half of 1 percent of the returns received in 1992, 1993, and 1994. During this same period, staffing and other workload limited all district office audits to only about 1 percent of returns received.

Table 1: Number of Books and Records Audits Conducted for Returns Received Between 1992 and 1994

Category[a]	1992	1993	1994	Total
DIF	178,419	142,142	310,557	631,118
Non-DIF-selected sources	135,564	128,993	174,490	439,047
Projects	41,173	40,804	50,797	132,774
Referrals	40,353	31,173	32,102	103,628
Preparers	26,578	25,799	37,561	89,938
Regular classification	16,563	20,008	24,795	61,366
Other sources	10,897	11,209	29,235	51,341
Total	**313,983**	**271,135**	**485,047**	**1,070,165**

[a]See appendix I for a summary of the specific source codes included in each of the categories.

Source: Summarized from IRS' closed case data files for fiscal years 1992 through 1997.

Most returns are selected for audit using DIF because, according to IRS officials, it is IRS' primary indicator of noncompliance and enables them to select returns that have the greatest probability of error on a nationwide basis. In addition, IRS officials also told us that districts might be unable to identify any additional returns with a higher audit potential through non-DIF sources than through those selected by DIF. Moreover, it may be easier to obtain large numbers of returns with potential noncompliance through DIF than through non-DIF sources. For DIF, districts simply request that service centers send them a certain number of returns. The service center selects the highest DIF-scored returns meeting the district's geographic requirements. For non-DIF, selection is more complex. District office officials must identify specific returns that appear to have a greater potential for tax change than DIF-selected returns. These returns must then be ordered individually by taxpayer name and Social Security number.

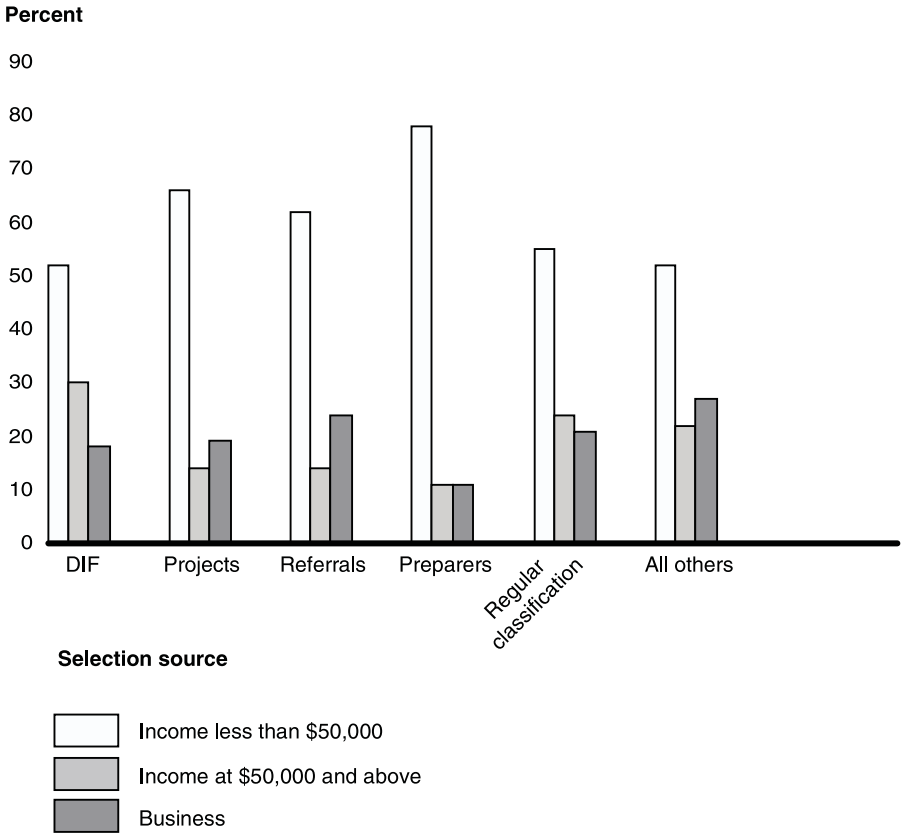
As part of our analysis of IRS' audit selection sources, we separated the audits into returns filed by nonbusiness individuals with income under $50,000; nonbusiness individuals with income of $50,000 and above; and individual taxpayers whose primary source of income was from self-employment (labeled as business).[11] To look at how IRS distributed audits by sources and these types of individual taxpayers, we combined the 3 years covered in this review.

Figure 1 shows that IRS conducted a larger percentage of audits of nonbusiness individuals with income under $50,000 than of individuals with higher incomes or business income, regardless of the selection

[11]Individuals report business income on the Schedule C of Form 1040. Business income cannot be broken out the same way nonbusiness income is because IRS does not organize the income data in the same manner. For example, business income is grouped in three categories as below $25,000, $25,000 but less than $100,000, and over $100,000. Nonbusiness income is grouped into five categories that are not comparable.

source. For example, over half the audits with DIF as the source were of individuals with income under $50,000; 30 percent were of higher income individuals; and less than 20 percent were of individuals with business income. It is important to recognize, however, that over 75 percent of the returns received by IRS during 1992, 1993, and 1994 reported income under $50,000. Although a higher absolute number of audits are done on individuals with nonbusiness income under $50,000, IRS audits a greater percentage of individuals with business income and individuals with nonbusiness income over $50,000.

Figure 1: Percent of Audits by Type of Taxpayer and Source of Audit



Source: GAO analysis of IRS data for 1992, 1993, and 1994.

Comparison of DIF and Non-DIF Audits

For audits of returns that were received in 1992, 1993, and 1994, the no-change rates were generally lower and recommended tax amounts were generally higher for the five non-DIF sources compared to the results from DIF sources. This is consistent with IRS' policy to use non-DIF sources if the audit potential appears to be higher than for DIF sources. However, on the basis of a sample of audits of returns received in 1992, we found that IRS collected a greater proportion of the recommended tax amount from audits selected using DIF than from those using non-DIF sources.

The no-change rate varied depending on the selection source and the type of taxpayer being audited. Overall, for the 3 years of audits covered in our analysis, the no-change rate was 22 percent.[12] For the six sources we identified as being books and records audits, the overall no-change rate varied from about 15 percent for audits selected due to a questionable preparer to about 28 percent for audits selected using regular classification. Returns selected using DIF were closed with no change in about 26 percent of the audits. Detailed information on the no-change rate by source and year can be found in appendix IV. Table 2 shows the no-change rate by year and audit selection source.

Table 1: No-change Rate by Filing Year and Selection Source

	Percent of audits closed with no change to tax			
Selection source	**1992**	**1993**	**1994**	**All years**
DIF	27	27	25	26
Projects	19	19	20	19
Referrals	14	17	17	16
Preparers	15	17	14	15
Regular classification	24	28	30	28
Other sources	22	19	12	16

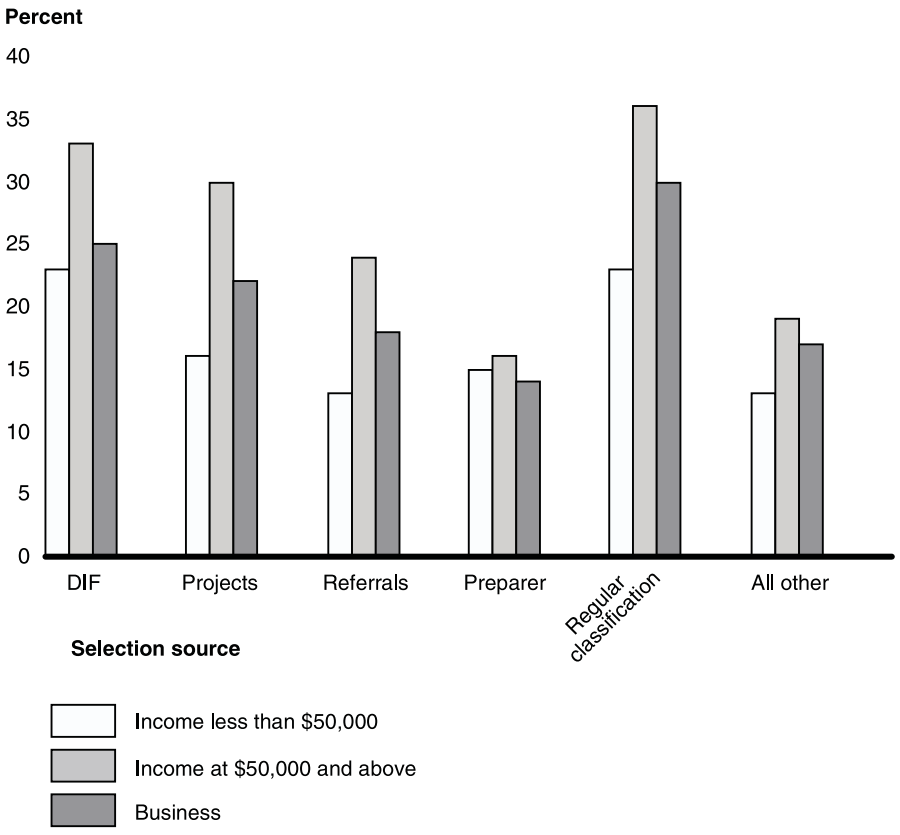
Source: GAO analysis of IRS data for 1992, 1993, and 1994.

For all sources, audits of nonbusiness individuals with income of over $50,000 had the highest no-change rate.[13] Figure 2 summarizes these results for each source and type of taxpayer.

[12]IRS reported no-change rates of 15 percent, 12 percent, and 8 percent for all district office audits of individual returns closed in fiscal years 1992, 1993, and 1994, respectively. IRS' no-change rates are lower than ours because our calculation includes only audits of taxpayer books and records. IRS' rates include other kinds of audits, such as claims and nonfilers, that often have very low no-change rates.

[13]Regardless of source, the lowest no-change rate occurred in the group of taxpayers with the lowest income and the highest no-change rate occurred in audits of taxpayers with the highest income. Appendix IV describes these results in more detail.

Figure 2: No-change Rate by Type of Taxpayer and Source of Audit



Source: GAO analysis of IRS data for 1992, 1993, and 1994.

The average amount of additional tax recommended per audit covered in our analysis declined from over $4,000 for closed audits of returns received in 1992 to about $3,300 for closed audits of returns received in 1994 (a decrease of about 18 percent). By audit selection source, our analysis of 1992 compared to 1994 showed that the recommended additional tax increased only in audits of returns selected using DIF and preparer sources. The average additional tax recommended in DIF audits increased from about $2,500 in 1992 to almost $3,100 in 1994 (an increase of about 24 percent). The average additional tax recommended in audits selected due to a questionable preparer increased from about $1,950 in 1992 to almost $2,100 in 1994 (an increase of about 7 percent).

Our analysis by selection source also showed that the average amount of additional taxes recommended per audit over the 3 years varied. The

average amounts ranged from less than $2,000 for returns selected because of questionable tax preparers to over $10,000 for referrals. However, the average recommended additional tax for referrals was always at least double the averages for other selection sources. Table 3 shows the average additional tax recommended by selection source for each of the years in our analysis.

Table 2: Average Additional Recommended Tax by Filing Year and Selection Source

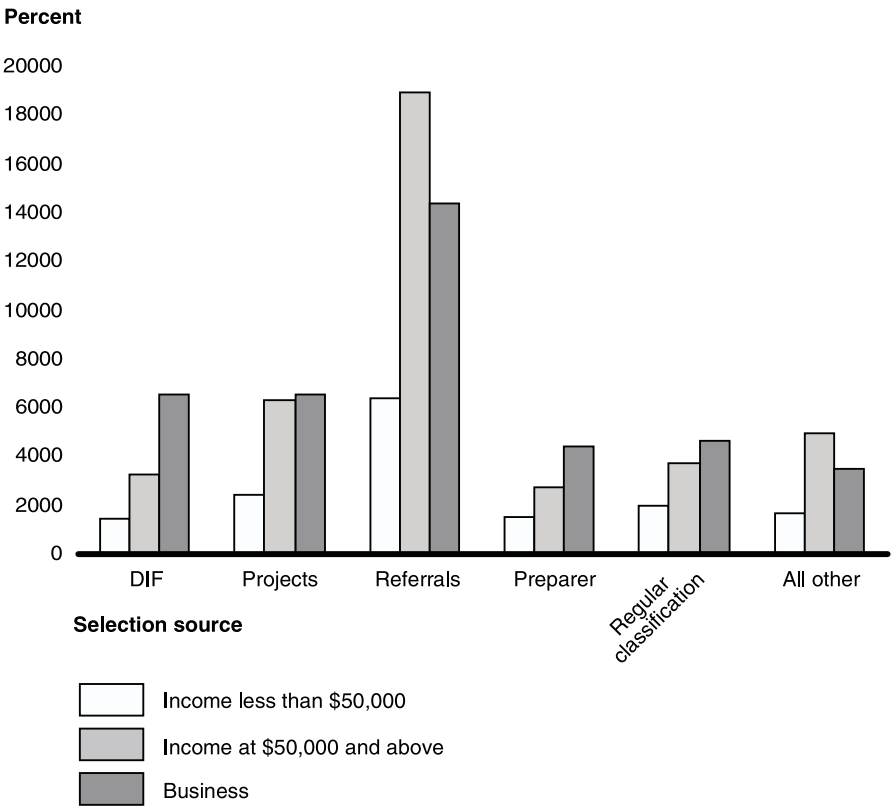
	Average additional recommended tax			
Selection source	**1992**	**1993**	**1994**	**Overall**
DIF	$2,487	$2,945	$3,082	$2,883
Projects	4,286	3,771	3,357	3,772
Referrals	12,542	8,804	8,329	10,091
Preparers	1,949	1,912	2,094	1,999
Regular classification	3,358	2,507	2,969	2,924
Other sources	3,974	3,373	2,218	2,843

Source: GAO analysis of IRS data for 1992, 1993, and 1994.

As figure 3 shows, the average amount of additional tax recommended per audit varied by type of taxpayer and source.[14] It shows lower average tax amounts in audits of nonbusiness individuals with income under $50,000 compared to the remaining two groups for all sources. It also shows higher average amounts in audits of business individuals compared to audits of nonbusiness individuals—except for referrals and other sources.

[14]Regardless of the source, the averages ranged from $2,100 for lower income taxpayers to almost $7,100 for individuals with business returns.

Figure 3: Average Additional Tax Recommended by Taxpayer Type and Source of Audit



Source: GAO analysis of IRS data for 1992, 1993, and 1994.

IRS does not have a system that allows it to readily track taxes assessed and collected from audits by the source of the audit. IRS can track collections through its Enforcement Revenue Information System (ERIS). However, IRS has not analyzed the information in ERIS to determine the collection rate by audit source. Although an analysis by source is possible using information from ERIS, it would be difficult.

To obtain information on the amount of recommended additional tax that is assessed and collected, we selected a sample of audits of returns received in 1992 that were included in our earlier analyses. Using information from these sampled audits and IRS' master file, we estimated assessments and collections for audited returns in this population.

We found no statistically significant difference in the proportion of recommended tax assessed between audits selected using DIF and audits selected using non-DIF sources. However, we found a statistically significant difference in the proportion collected. We estimated that IRS collected about 57 percent of the recommended tax for DIF returns and about 35 percent for non-DIF returns as of April 1998.[15] It was not clear from the data we had why collections were greater for DIF-selected returns.

Our estimated 57 percent collection rate for DIF sources is high compared to the collection rate for all individual taxpayer audits conducted at district offices. In a June 1998 report to the House Ways and Means Committee, we found that for all types of district office audits closed in 1992, IRS had collected about 31 percent of the amounts recommended.[16]

Caution Is Needed When Comparing the Results of DIF and Non-DIF Audits

Caution is needed if one uses the three results we analyzed to compare the effectiveness of DIF and non-DIF sources. The no-change rate, the recommended additional tax amounts, and the collection rate on these recommended amounts do not present a complete picture of audit effectiveness. Nor is it easy to control for other factors that may influence the three types of results we analyzed.

To evaluate the overall effectiveness of selection sources, these audit results are not the only ones that could be used. As noted in our June 1998 report, the impacts of audits on voluntary compliance and taxpayer burden are other results that could help IRS develop a more balanced picture of audit effectiveness, but IRS does not collect such data.[17] That report recognized that gathering such data was difficult because of limitations in data sources and research methods. Beyond these possible results, we concluded that IRS could do more to collect data on its direct and indirect costs to do audits and then assess or collect any additional taxes. We recommended that IRS begin to collect such data, and IRS agreed to do so.

In addition, IRS does not have data available that would allow it to control for other factors that may affect the three audit results we analyzed. For example, data on whether the results across the selection sources vary by

[15]Because of the sample size and variability of the data, we were unable to make statistically valid estimates of the assessments or collections for specific selection sources. Point estimates and sampling errors can be found in appendix III.

[16]Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs (GAO/GGD 98-128, June 23, 1998).

[17]GAO/GGD 98-128, June 23, 1998.

the type of tax issue being audited are not available. Nor does IRS have data on how the quality of the audit affects the results across the selection sources.

Even with these cautions, comparing DIF and non-DIF audit sources by the audit results we analyzed can be useful. For example, the comparisons we did by source and selection year could provide a baseline that would allow IRS to gauge some of the impacts of changes to the audit selection process over time.

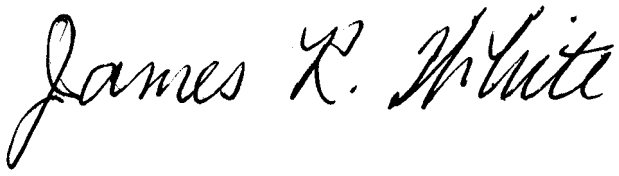
Agency Comments

We requested comments on a draft of this report from the Commissioner of Internal Revenue. Officials representing the Assistant Commissioners for the Examination and Research Divisions, as well as a representative from the Commissioner's Office of Legislative Affairs, provided IRS' comments in a January 13, 1999, meeting. IRS also provided written comments in a January 20, 1999, letter, which is reprinted in appendix V.

IRS was in overall agreement with the draft report and said it fairly describes IRS' return selection program. IRS also provided some additional information to elaborate on issues we raised and technical comments; where appropriate, we made changes to this report on the basis of these technical comments.

We are sending copies of this report to the Committee's Ranking Minority Member, the Chairman and Ranking Minority Member of the Senate Committee on Finance, various other congressional committees, the Director of the Office of Management and Budget, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties.

The major contributors to this report are listed in appendix VI. If you or your staffs have any questions concerning this report, please contact me or Thomas D. Short, Assistant Director, on (202) 512-9110.



James R. White
Director, Tax Policy and
Administration Issues

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Abbreviations

AIMS	Audit Information Management System
DCI	data collection instrument
DIF	discriminant function
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SFR	substitute for return

Definition of Source Codes for IRS Audits

This appendix shows the types of audits included in our study population. We included sources that appeared to be for audits of taxpayer books and records conducted at one of the Internal Revenue Service's (IRS) district offices.

We excluded audits for two reasons:

- Reason 1: We excluded audits that did not deal with the taxpayers' books and records or that were not conducted at an IRS' district office. These audits included claims for refund, nonfilers, substitute for return, service center correspondence audits, and research studies.
- Reason 2: We excluded related and multiyear audits because we were unable to relate them to specific returns in one of our target years. Also, some of these returns were selected on the basis of audits of partnership or corporation returns

Table I.1 shows the total number of audits closed by IRS for the 3-year period of our analysis and the number included in the analysis. Table I.2 shows the individual source codes and indicates which are included in the study population and which are not. This table also provides the reason a source was excluded or the source code group for those included.

Table I.1: Number of Audits by Year the Return Was Received

Description	Year return was received by IRS[a]		
Type of audit	1992	1993	1994
Total recorded audits	806,344	1,129,956	1,593,912
Less (excluded audits)			
Service center audits[b]	246,602	305,711	688,441
Nonfilers	115,108	434,238	296,527
Multiple returns	70,826	61,467	60,144
Related returns	47,046	41,148	50,600
Claims	10,309	11,529	10,175
Other excluded returns	2,470	4,728	2,978
Total audits excluded from analysis	**492,361**	**858,821**	**1,108,865**
Returns included in the analysis			
DIF-selected returns	178,419	142,142	310,557
IRS projects	41,173	40,804	50,797
Referrals	40,353	31,173	32,102
Preparers	26,578	25,799	37,561
Regular classification	16,563	20,008	24,795
All other selection reasons	10,897	11,209	29,235
Total audits included in analysis	**313,983**	**271,135**	**485,047**

[a]Each of the years contains audit information from 4 years of IRS' Audit Information Management System (AIMS) closed case database.

[b]Service center audits are those with an organization code of 5000 or above on the AIMS database.

Source: IRS' AIMS database.

Table I.2: Source Code Table—Inclusions and Exclusions

Source code	Definition	Status	Reason excluded/group
01	Tax shelters and automatics	Included	Other
02	DIF source returns	Included	DIF
03	Unallowable items	Included	Other
04	Multiple filers	Included	Other
05	DIF-related pickup	Excluded	Reason 2
06	Correspondence examination	Included	Other
07[a]	Claim—medium examination potential	Excluded	Reason 1
08	Self-employment examination	Included	Other
09[a]	All other claims for refund	Excluded	Reason 1
10	DIF multiyear	Excluded	Reason 2
11	Studies, tests, and research programs	Excluded	Reason 1
12	DIF related delinquent return	Excluded	Reason 2
13[a]	Married taxpayers filing separately	Included	Other
14	Information Return Program—high underreporter	Included	Other
15[a]	Math/clerical error abatement	Excluded	Reason 1
16[a]	Returns with an illegal narcotics issue	Included	Other
17	Tax shelter program	Included	Other
20	Regular classification	Included	Reg. Class.
23	IRA recovery	Included	Other
24	Nonfiler/refusal to file Tax Delinquency Investigation	Excluded	Reason 1
25[b]	Substitute for return	Excluded	Reason 1
26	Alternative minimum tax program	Included	Other
30	Claims for refund	Excluded	Reason 1
31[b]	Paid claims for refund	Excluded	Reason 1
32	Carry-back refund	Excluded	Reason 1
35[b]	Administrative adjustment request (claim)	Excluded	Reason 1
37[a]	Stockholder returns	Included	Other
39	Tax shelter—related pickup	Excluded	Reason 2
40	Multiyear examination—non-DIF-related	Excluded	Reason 2
44	Delinquent return—non-DIF-related	Excluded	Reason 1
45	Reference and research	Excluded	Reason 1
46	IRS employee returns	Included	preparer
48	Service center—unallowable related	Excluded	Reason 2
49	Return preparer program	Included	Preparer
50	Related pickup—non-DIF	Excluded	Reason 2
60	Information reports	Included	Referral
62	Compliance projects—national office	Included	IRS projects
63[a]	Referrals from appeals	Included	Referral
64	Pickup related to form 1065 (partnership), 1041 (estate), or 1120S (S-Corp).	Excluded	Reason 2
65	Collection referral	Included	Referral
66[a]	Referrals from criminal investigation	Included	Referral
67[a]	Compliance projects—regional office	Included	IRS projects
68[a]	Underreported income program—DIF	Included	DIF
70	Referrals	Included	Referrals
71[a]	Referrals from Social Security	Included	Referral
73	Taxpayer request and reconsideration	Excluded	Reason 2
75[a]	Referrals from Justice	Included	Referral
76[a]	Referrals from other U.S. agencies	Included	Referral
77	Referrals from state tax agencies	Included	Referral

Source code	Definition	Status	Reason excluded/group
80	Taxpayer Compliance Measurement Program	Included	Other
85	Information return program match	Included	Referral
86[a]	All other information return program methods	Included	Referral
88	Special enforcement	Included	Referral
90	Fraud	Included	Referral
91	TCMP related returns	Excluded	Reason 2
95[a]	IRS racketeer	Included	Referral
96[a]	Strike force	Included	Referral
97[a]	Wagering	Included	Referral
98[a]	Illegal income	Included	Referral

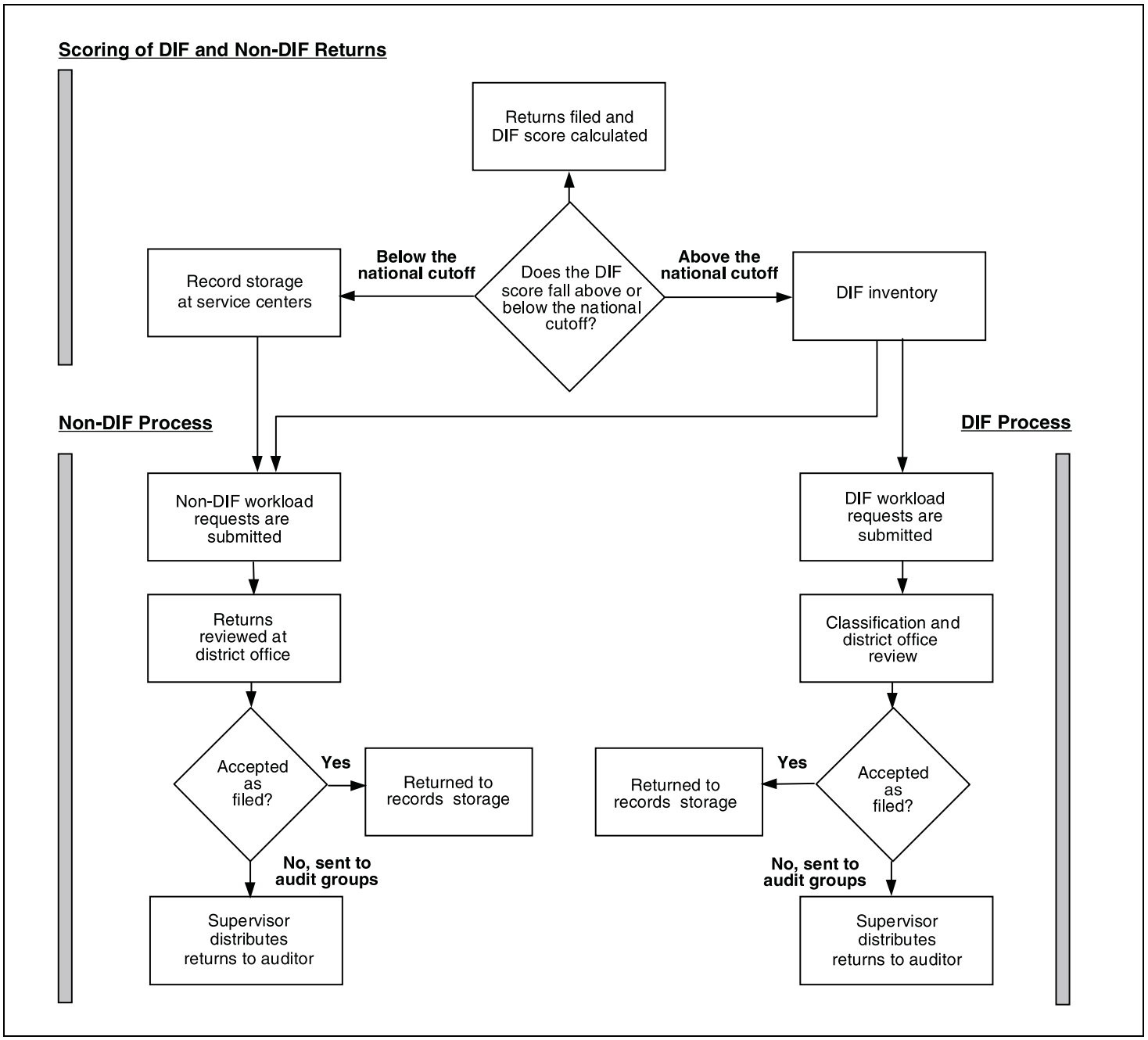
[a]These codes used for returns received in 1992 and 1993 only.

[b]These source codes effective for posting years 1994 and after only.

Source: IRS' AIMS closed case data files and AIMS Coding Manual.

Flow Chart of IRS' Audit Selection Process

Figure II.1: Summary of IRS' process for selecting returns to audit.



Source: Review of IRS' written procedures and discussions with IRS officials.

Statistical Methodology for Analyzing Assessments and Collections of Recommended Tax

This appendix describes the methodology we used to determine how much of the recommended additional tax the IRS actually assesses and collects. We used information from IRS' master file and a sample of audits of returns received in 1992 that were audited during the period 1992 through 1995. We used this sample to compare the amount of assessment and collection for audits selected using the DIF score and those where the DIF score was not the primary reason the return was selected for audit.

Study Population

IRS does not maintain information on the source for selecting a return for audit, the additional tax recommended, and the amount assessed and collected in the same database. To determine what proportion of additional tax was assessed and collected, we looked at information on IRS' individual master file for amount assessed and collected and the AIMS closed audit database for the selection source and the amount of additional tax recommended in the audit.

As noted in our report, we limited our study population to audits of books and records done at IRS' district offices. To compare how much of the additional tax recommended was assessed and collected for DIF and non-DIF audits, we selected a sample of audits from our 1992 study population. We selected 1992 instead of 1993 or 1994 to allow as much time as possible for collection activities. We also eliminated audits where the AIMS database indicated that a refund had been made or no additional tax had been recommended during the audit. This sample population contained records of 229,550 audits.

Sample Selection and Weighting

To obtain the sample of books and records audits, we selected a stratified probability sample of 1,083 audits of taxpayer books and records. The sample was stratified by whether or not the taxpayer agreed or disagreed with the adjustments to tax that IRS recommended and whether or not the audit was selected because of its DIF score or for some non-DIF reason. The number of audits sampled in each stratum was based on the number of returns in the population and the total additional taxes recommended in the audits. The division of the population and sample of audits between different strata is shown in table III.1.

Table III.1: Distribution of Audits in the AIMS Database by Sample Strata

Strata	Audits in population	Results of examination	Audits in sample
Agreed DIF-selected	112,512	$330,957,253	332
Agreed non-DIF-selected	100,254	586,909,138	250
Unagreed DIF-selected	9,583	128,733,806	251
Unagreed non-DIF-selected	7,201	258,077,075	250
Total	**229,550**	**$1,304,677,272**	**1,083**

Source: IRS AIMS database and GAO sampling data.

We obtained copies of the master file transcript for 1,082 of the audits we selected. IRS could find no record for one of the taxpayers. For each of the sample audits, we obtained information on the amount of additional tax recommended (from the AIMS database) and the amount assessed and the amount collected (from the master file transcript).

Sampling Errors and Confidence Intervals of Estimates

The results of how much of recommended taxes was assessed and collected shown in this report are estimates because they are based on the sample of audits drawn from the total population of all eligible audits of returns received in 1992. The accuracy of these estimates is quantified by their sampling errors, expressed as 95 percent confidence intervals. In table III.2 for example, we estimate that the difference between DIF and non-DIF collections is 22 percent. This estimate is surrounded by a confidence interval of ± 13 percentage points, indicating that we are 95-percent confident that the actual percentage difference in the population of all audits of returns received in 1992 lies between 8 percent and 36 percent.

Table III.2: Confidence Interval for Estimate of difference in Assessments and Collections for DIF-Selected and Non-DIF-Selected Audits

Description	Percent of audit results assessed	Percent of audit results collected
Point estimate DIF-selected returns	76%	57%
Confidence interval DIF-selected returns	± 8%	± 9%
Point estimate non-DIF-selected returns	83%	35%
Confidence interval non-DIF-selected returns	± 7%	± 9%
Percentage difference	7%	22%
Confidence interval at the 95 percent confidence level for the percentage difference	± 11%	± 13%

Source: GAO analysis of sampled data for 1992.

Controlling for Nonsampling Errors

In addition to the reported sampling errors, various obstacles can occur when conducting this type of review and may cause other types of errors, commonly referred to as nonsampling errors. For example, differences in how questions are interpreted and errors in entering data could affect the results. We included steps in both the data collection and data analysis stages for the purpose of minimizing such nonsampling errors. These steps involved the 100-percent review of completed data collection instruments (DCI) and data entry of those DCIs. We also had a second analyst check all computer analyses and programming.

Tables of Audit Results for Filing Years 1992, 1993, and 1994

We grouped the audit results of our analyses by IRS' activity codes. These are codes IRS uses to categorize individual tax returns relative to the various tax forms filed and the taxpayer's income level. The following are definitions of the activity codes:

- 530 - Form 1040A with total positive income less than $25,000;
- 531 - Non-1040A with total positive income less than $25,000;
- 532 - Total positive income of $25,000 or more but less than $50,000;
- 533 - Total positive income of $50,000 or more but less than $100,000;
- 534 - Total positive income of $100,000 or more;
- 535 - Form 1040C with total gross receipts under $25,000;
- 536 - Form 1040C with total gross receipts of $25,000 or more but less than $100,000;
- 537 - Form 1040C with total gross receipts of $100,000 or more;
- 538 - Form 1040F with total gross receipts under $100,000; and
- 539 - Form 1040F with total gross receipts of $100,000 or more.

For the grouping of IRS audits included in our analyses, the following sets of tables present the results of these audits by source of audit and activity codes for each of the 3 years reviewed—1992, 1993, and 1994. The first set of tables shows the total number of audits, the second set shows the no-change rate, and the third set shows the average audit results. Each of the tables summarizes information from IRS' AIMS closed case data files for fiscal years 1992 through 1997. Also, a description of the source codes included in each of the source categories we used can be found in table I.2.

Table IV.1: Number of Returns by Activity Code and Source Group—Returns Received in 1992

	Number of Audits by Source[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Total
530	27,712	6,413	10,950	16,191	11,955	482	73,703
531	23,800	1,151	3,940	6,196	5,584	1,629	42,300
532	37,987	2,067	5,456	6,094	6,459	2,294	60,357
533	36,298	1,921	2,470	3,380	3,171	2,385	49,625
534	20,557	1,441	290	1,694	2,652	1,592	28,226
535	8,414	502	1,078	1,972	3,349	506	15,821
536	9,845	1,394	1,656	2,880	3,614	1,177	20,566
537	10,757	1,388	644	2,347	3,124	715	18,975
538	2,177	101	59	161	249	77	2,824
539	872	185	35	258	196	40	1,586
Total	**178,419**	**16,563**	**26,578**	**41,173**	**40,353**	**10,897**	**313,983**

Table IV.2: Number of Returns by Activity Code and Source Group—Returns Received in 1993

	Number of audits by source[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Total
530	20,871	6,789	11,523	18,143	12,292	2,658	72,276
531	18,107	1,273	3,425	5,195	3,287	1,228	32,515
532	38,913	3,224	5,200	5,370	4,315	1,542	58,564
533	25,533	2,780	2,418	3,125	2,184	1,860	37,900
534	13,643	1,894	274	2,002	2,062	1,083	20,958
535	6,610	445	1,340	1,294	1,638	770	12,097
536	8,501	1,362	1,106	2,138	2,380	1,248	16,735
537	7,752	1,775	434	2,847	2,492	645	15,945
538	1,548	111	59	209	208	94	2,229
539	664	355	20	481	315	81	1,916
Total	**142,142**	**20,008**	**25,799**	**40,804**	**31,173**	**11,209**	**271,135**

Table IV.3: Number of Returns by Activity Code and Source Group—Returns Received in 1994

	Number of audits by source[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Total
530	39,557	7,688	16,136	19,928	12,061	2,077	97,447
531	37,258	1,758	4,981	5,100	3,298	9,817	62,212
532	84,521	3,453	8,167	6,027	4,689	4,857	111,714
533	62,866	3,686	4,290	5,000	2,733	2,822	81,397
534	30,526	2,967	413	3,755	2,078	1,346	41,085
535	14,264	714	1,578	1,571	1,682	3,383	23,192
536	19,358	1,812	1,329	3,390	2,208	3,095	31,192
537	19,488	2,467	538	4,694	2,950	1,311	31,448
538	1,497	94	97	363	179	443	2,673
539	1,222	156	32	969	224	84	2,687
Total	**310,557**	**24,795**	**37,561**	**50,797**	**32,102**	**29,235**	**485,047**

Table IV.4: No-change Rate by Source of Audit and Activity Code—Returns Received in 1992

	Percent by source of audit[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Total
530	17	17	16	15	10	14	15
531	27	30	12	18	12	18	22
532	24	22	12	22	14	22	21
533	31	22	15	26	20	20	28
534	37	32	31	27	23	29	35
535	27	30	14	12	9	15	20
536	20	29	15	14	14	20	18
537	26	32	14	23	20	22	24
538	39	32	23	28	37	32	38
539	38	29	14	27	34	25	34
Total	**27**	**23**	**15**	**18**	**14**	**21**	**22**

Table IV.5 No-change Rate by Source of Audit and Activity Code—Returns Received in 1993

	Percent by source of audit[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Total
530	16	17	20	12	11	26	15
531	27	31	13	20	18	15	23
532	26	33	13	23	17	14	24
533	27	35	17	27	24	11	26
534	43	40	31	29	26	18	38
535	26	25	12	13	14	16	21
536	21	24	13	22	17	18	20
537	31	34	16	27	21	21	28
538	41	36	20	32	38	38	39
539	36	31	25	22	38	25	31
Total	**27**	**28**	**16**	**18**	**16**	**18**	**23**

Table IV.6: No-change Rate by Source of Audit and Activity Code—Returns Received in 1994

Activity code	Percent by source of audit[a]						
	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Total
530	16	20	18	12	11	16	15
531	25	34	10	17	20	5	20
532	23	28	10	21	15	13	21
533	25	36	12	27	21	15	25
534	43	42	24	37	28	24	41
535	23	27	14	23	17	9	20
536	16	29	10	22	17	15	17
537	27	32	17	28	19	19	26
538	38	38	15	23	30	37	35
539	35	30	9	18	29	41	28
Total	**25**	**29**	**14**	**20**	**16**	**12**	**22**

Table IV.7 Average Audit Results by Source of Audit and Activity Code—Returns Received in 1992

	Average audit results by source of audit[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Average audit result—all audits
530	$1,269	$1,976	$1,278	$2,637	$7,409	$5,717	$2,657
531	1,079	2,280	1,504	2,663	8,122	1,719	2,338
532	1,511	2,341	1,878	2,826	8,160	2,116	2,440
533	2,176	2,806	2,444	4,882	11,921	3,298	3,075
534	4,252	8,100	(1,900)	15,839	39,384	7,001	8,537
535	1,705	2,421	2,193	3,599	6,491	2,531	3,037
536	3,300	4,246	4,410	6,382	11,958	3,698	5,429
537	9,823	7,522	9,347	12,180	34,479	8,225	13,929
538	917	6,538	2,226	5,664	6,700	2,094	1,958
539	5,197	1,009	9,282	6,770	14,701	5,214	7,490
Total	**$2,487**	**$3,358**	**$1,949**	**$4,286**	**$12,542**	**$3,974**	**$4,067**

Table IV.8: Average Audit Results by Source of Audit and Activity Code—Returns Received in 1993

	Average audit results by source of audit[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Average audit results—all audits
530	$1,430	$2,280	$1,319	$2,157	$5,754	$1,697	$2,420
531	1,143	1,679	1,569	2,755	7,941	1,851	2,181
532	1,515	1,505	1,892	3,008	6,439	2,710	2,079
533	2,236	2,268	2,397	3,287	12,355	4,364	3,023
534	5,773	3,090	4,718	10,011	20,144	6,984	7,398
535	1,757	2,892	2,256	5,528	5,483	1,976	2,776
536	4,235	3,626	4,523	6,817	8,394	3,325	5,058
537	15,269	4,439	8,229	10,628	19,726	7,113	13,410
538	1,116	2,129	2,749	3,363	2,542	4,815	1,709
539	8,297	3,383	2,980	2,596	8,498	5,559	5,817
Total	**2,945**	**2,507**	**1,912**	**3,771**	**8,804**	**3,373**	**3,630**

Table IV.9: Average Audit Results by Source of Audit and Activity Code—Returns Received in 1994

	Average audit results by source of audit[a]						
Activity code	DIF	Regular classification	Preparers	Compliance projects	Referrals	All other	Average audit results—all audits
530	$1,422	$1,810	$1,466	$1,810	$4,343	$2,085	$1,915
531	1,155	1,885	1,615	3,182	6,412	1,189	1,663
532	1,616	1,678	1,938	2,458	5,067	1,346	1,820
533	2,058	2,146	2,840	3,223	8,398	2,612	2,407
534	6,144	5,851	6,509	8,134	23,286	9,236	7,277
535	2,157	3,254	2,108	3,015	5,815	1,271	2,382
536	5,077	3,424	4,840	4,172	9,156	2,546	4,910
537	13,077	6,323	11,375	7,344	21,767	7,458	12,243
538	1,599	2,141	2,477	1,402	7,984	835	1,924
539	14,738	6,406	4,021	3,003	13,851	2,168	9,428
Total	**3,082**	**2,969**	**2,094**	**3,357**	**8,329**	**2,218**	**3,324**

Comments From the Internal Revenue Service

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

CHIEF OPERATIONS OFFICER

January 20, 1999

Mr. James R. White
Director, Tax Policy and Administration
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. White:

Thank you for the opportunity to review and comment on your recent draft report entitled "Tax Administration: IRS' Return Selection Process." Overall, we are in agreement with the report. We believe it fairly describes our return selection process placing appropriate emphasis on the Discriminant Function (DIF) return selection program. The opportunity to provide additional information was appreciated. We would also like to provide some additional comments.

As your report states, the DIF return selection program is our primary indicator of noncompliance and enables our auditors to select returns with the greatest probability for error on a nationwide basis. With respect to returns selected by this program, the IRS statistics indicate some locations have more returns as a percentage of returns filed, with a higher potential for error. This return "fallout" is a major factor in allocating audit resources. Therefore, in locations with greater noncompliance, there will be more staffing and more DIF returns suitable for audit.

We would also emphasize that it is the type of noncompliance identified that determines the types of audit programs that are worked in a given location. Over the years, we have developed a number of programs to supplement DIF that address certain types of noncompliance more effectively. For example, our return preparer program seeks to identify unscrupulous preparers and correct the returns they have prepared. Local projects are used to identify particular types of noncompliance that are generally limited by location or market segment. Our nonfiler program seeks to bring into compliance taxpayers who have unlawfully ceased filing. We are also engaging in outreach programs with industry organizations, legal, accountant and preparer associations, and others to actively foster compliance even before returns are filed.

The differences in the no change rates and dollars per return between DIF and other audit programs that you compare in the report are not surprising. The results from our various audit programs will vary from year to year reflecting such factors as the underlying noncompliance and our program emphasis. We do monitor such data closely and consider these and other factors in determining the scope and effectiveness of an audit program.

Your report also makes some comparisons between dollars recommended and dollars assessed and collected. We would like to point out, as we did in our response to your report -- "Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs" -- that there are very significant differences between recommended dollars and what they imply as opposed to what is implied by assessed and collected dollars. The reporting of recommended tax provides a measure of what the audit process alone produces. It must be distinguished from the assessment and collection data which are the results of a number of different operations including examination, appeals, litigation, and collection. These actions affect not only the amount of tax assessed but also the tax ultimately collected. As such, the tax that is actually collected may well be substantially different from that which was originally recommended. Therefore, before any valid comparisons of program viability based on collected dollars can be determined, we would counsel careful consideration of the impact of the intervening processes.

Again, we would like to thank you for considering our comments as you finalize your report. Our technical comments are included in the enclosure.

We will continue to work to assure that our audit enforcement efforts strive to achieve compliance not only through the best combination of audit programs once a return is filed but also through outreach to the taxpayers even before a return is filed.

Sincerely,

John M. Dalrymple

Enclosure

Enclosure

Technical Comments on Draft GAO Report
Tax Administration: IRS' Return Selection Process

p. 3, footnote 3
Clarify the sentence: "This figure also includes any refund recommended as a result of audits." The reader may incorrectly believe this data was used in other statistical data in the report.

p. 3, 8, 24, 29
Change all references from "IRS' closed case database" to IRS' closed case data files" This is the correct nomenclature for the data files provided to you.

p. 11
Your statement that districts had not recorded source code changes on master file is misleading. There is no mechanism to change a source code on master file accounts. The source code on AIMS may be different in the case of nonfilers because Collection can post a substitute for return to master file. Some time later, Examination may secure the return for audit under a different source code from that posted on master file.

p. 19
Your statement, "IRS does not yet have a system that allows it to readily track taxes assessed and collected from audits by the source of the audits," is somewhat misleading. We currently have in operation a system -- the Enforcement Revenue Information System (ERIS) -- that does track taxes assessed and collected from audits. While ERIS does not currently report this type of information by source code, that information is accessible. For example, if certain return identifying data is provided (e.g., return type, tax year, taxpayer identification number), ERIS can provide the associated assessments and collections on those returns through special production runs.

p. 24
Change sentence to read " IRS has developed over 40 sources, or reasons, for selecting returns for audit . . ."

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