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February 1998

# TAX ADMINISTRATION

## IRS' Use of Random Selection in Choosing Tax Returns for Audit



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**United States  
General Accounting Office  
Washington, D.C. 20548**

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**General Government Division**

B-277015

February 5, 1998

The Honorable Paul Coverdell  
United States Senate

Dear Senator Coverdell:

In a letter dated March 25, 1997, you requested that we answer a series of questions about the Internal Revenue Service's (IRS) use of random selection in choosing tax returns for audit (also referred to as "random audits"). On April 14, 1997, we briefed your office on the preliminary results of our work, and in this report, we provide more complete data.

In responding to your questions on IRS' use of random audits during fiscal years 1994 through 1996, our objectives were to provide information on (1) the number of audits selected overall and at random for tax returns filed by all taxpayers and by IRS employees across the nation and in Georgia; (2) the profile of the taxpayers subjected to random audits by state, type of taxpayer return, taxpayer income level, and taxpayer occupation; (3) the results of the random audits in terms of the number of audits for which additional taxes were recommended as well as the amount of these additional taxes and the number of referrals to IRS' Criminal Investigations Division (CID); (4) the known burdens imposed on taxpayers subjected to random audits; and (5) the alternatives that IRS might have used other than random selection to meet its objectives.<sup>1</sup>

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## Results in Brief

Between fiscal years 1994 and 1996, the number of audits nationwide increased from 1.4 million to 2.1 million. Audits done through correspondence with taxpayers on single issues accounted for most of the increase as the number of more complex, face-to-face audits with taxpayers dropped slightly. During this same time, the number of audits done in Georgia also increased (from 45,451 to 55,446), and these were also largely correspondence audits done at the service center. Overall, the increases were due to audits of taxpayers claiming the earned income credit (EIC).

During fiscal years 1994 through 1996, IRS did not randomly select returns for audit from either the population of all taxpayers or all returns. IRS has

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<sup>1</sup>During our work, you also requested that we answer questions about a form of IRS audit project known as Information Gathering Projects (IGP). For fiscal years 1992 through 1994, you asked us to determine the number of IGPs, the IRS controls over their use, and the types and results of IGPs in IRS' Georgia District. We are preparing a separate report, IRS Use of Information Gathering Projects, (GAO/GGD-98-39, Feb. 5, 1998), to answer these questions.

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about 40 audit sources, which are programs and techniques used to select potentially noncompliant returns for audit. IRS' audit sources do not rely on random selection from the population of all returns but rather IRS selects returns having characteristics indicative of potential noncompliance. IRS officials did identify six projects involving subpopulations of taxpayers with indications of noncompliance from which taxpayers were randomly selected for audit. Available IRS data show that no taxpayers outside of these six subpopulations were selected at random for audit.

IRS chose the subpopulations for the six projects nonrandomly on the basis of known or suspected high noncompliance rates and other criteria, including geographic location or business size. Three projects studied the compliance of taxpayers (1) claiming the EIC across the nation,<sup>2</sup> (2) claiming dependent exemptions duplicated on other returns in Florida as well as other locations, and (3) operating certain types of eating and drinking establishments in Ohio. The remaining three projects studied the compliance of self-employed individuals who appeared to be (1) filing questionable Schedule Cs in Illinois, (2) claiming false business losses to be eligible to claim the EIC in Georgia, or (3) not paying self-employment tax in Missouri.<sup>3</sup> Three of the six projects included taxpayers from Georgia. The number of taxpayers in these subpopulations ranged from 2,348 to 15.1 million. By comparison, the population of all taxpayers was more than 100 million. Appendix I summarizes these projects.

The number of audits generated by random selection for these six projects was small compared with the million or more audits done each year. The six projects randomly selected a total of 7,421 taxpayers from the six subpopulations. As of July 1997, IRS had completed audits of 2,961 of the returns filed by 2,629 of the 7,421 taxpayers.<sup>4</sup>

IRS does not randomly audit its 100,000-plus employees; that is, IRS does not randomly select employees for audit from the population of IRS employees. A few IRS employees were audited as part of the six projects that used random selection because they were members of the project

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<sup>2</sup>IRS' CID, together with the Examination Division, reviewed taxpayers' apparently erroneous claims for the EIC, which could lead to erroneous tax refunds. At the conclusion of the CID review, Examination closed the reviews as audits through IRS' service centers.

<sup>3</sup>The Form 1040 Schedule C is used to report profit or loss from a business. IRS describes a "questionable Schedule C" as one in which the taxpayer claims unusual or excessive deductions that appear to be incorrect.

<sup>4</sup>The number of returns audited is greater than the number of taxpayers because some audits led IRS to audit other returns filed by the same taxpayer.

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subpopulation. Of the 2,961 returns audited after random selection from the project subpopulations, 4 involved IRS employees. According to IRS officials, IRS employees were unlikely to be part of the subpopulations being studied, such as the self-employed. IRS officials also said IRS treats its employees the same as other taxpayers for the purposes of audit selection, with one exception: IRS has a special program for auditing returns filed by specific types of employees, such as new hires, executives, and employees in sensitive positions. This special program has not used random selection.

The profile of taxpayers selected randomly for audit in the six projects reflected the location and the nature of the subpopulations under study. Although IRS data show the projects covered taxpayers in almost all states, 16 states had fewer than 10 random audits, and 10 states had more than 100 such audits; these 10 states, generally, had a higher number of audits because an IRS field office for those states ran 1 of the 6 projects.

Most audited individuals in the six projects reported positive income below \$25,000. This is because 2,472, or 84 percent, of the audited returns dealt with the EIC, which is designed to assist lower income individuals. The project involving the EIC studies was a response to a congressional mandate to monitor and improve compliance with the EIC, which IRS' regular audit programs were unlikely to address on a large scale because of the lower incomes reported by EIC recipients.

Audit results for the two projects with more than 200 audited returns showed that the percentage of audits recommending additional taxes was 46 percent for the EIC project and 80 percent for the eating and drinking establishment project. The average amount of additional tax recommended per audit was \$1,653 for the EIC project and \$12,711 for the eating and drinking establishment project.

According to IRS, any audit imposes some level of costs and burdens on taxpayers. IRS has not measured these costs and burdens for any type of audit. As discussed in several of our testimonies, accurately measuring taxpayer costs and burdens is difficult.<sup>5</sup> Even so, IRS has recognized the importance of these measures and has been making efforts to develop them.

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<sup>5</sup>Taxpayer Rights and Burdens During Audits of Their Tax Returns (GAO/T-GGD-97-186, Sept. 26, 1997); 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).

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According to officials, IRS had no alternative data sources that would accomplish the objectives of the six projects other than random audits. Further, they said compliance data that addressed these objectives did not exist outside IRS. We did not evaluate whether the designs of the six projects were adequate to meet the objectives or identify alternative data sources that might have addressed the objectives. However, beyond these six projects, our previous work as well as research by others has pointed to a lack of tax compliance data that IRS could use to guide its compliance efforts. IRS officials said they needed statistically valid data that can be used to test ways to correct tax noncompliance and improve their audit selection methodologies to better target noncompliant taxpayers for audit. Outside these research purposes, IRS officials said they have little incentive to randomly select taxpayers for audit because IRS' regular audit programs generally find more noncompliance at lower costs.

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## Background

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### IRS Audits of Tax Returns

IRS audits tax returns to check compliance in reporting income or deductions and in other tax issues as well as in paying the correct tax liability. IRS auditors check taxpayers' documents in support of data reported on tax returns. Through IRS' 33 district offices, auditors either visit the taxpayers to review the documentation or ask taxpayers to bring it to the IRS office. These district-based audits often focus on two or more tax issues.

Tax examiners in IRS' 10 service centers are to check taxpayers' documentation through correspondence audits. These audits usually involve one tax issue, such as the number of tax exemptions claimed on a return.

Regardless of the type of audit, IRS auditors decide whether to recommend that additional taxes be assessed. If auditors recommend additional tax assessments, the taxpayer can agree with or appeal the change. If the taxpayer wins the appeal, the additional taxes recommended in the audit would not be assessed and collected.

IRS has about 40 audit sources, which are programs and techniques used to select potentially noncompliant returns for audit. The major source is the discriminant function (DIF) formula, a computer-generated score designed

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to predict returns that, if audited, would be most likely to result in additional taxes owed. The other sources prompting audits include (1) referrals from outside or inside IRS, (2) information provided by a third party, (3) indications of fraud or noncompliance from another audit, (4) actions of tax return preparers, and (5) returns filed by IRS employees who hold sensitive positions. Service center processes also identify potential noncompliance, such as apparently improper claims for the EIC on tax returns.

IRS has established procedures to better ensure that auditors promote a fairer tax system by focusing on potentially noncompliant returns. IRS also has established nine audit standards to guide auditors' behavior in areas such as probing for unreported income and developing evidence of noncompliance. After an audit, selected IRS staff across the country are to review a small sample of audits closed by district offices to measure auditors' adherence to these standards.

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## Why Returns May Be Randomly Selected for Audit

In its simplest form, random selection is a process by which all members of a specific population or subpopulation have an equal chance of being selected for study.<sup>6</sup> This process eliminates personal biases and subjectivity from the selection process and allows study results to be generalized to a larger group. On this basis, IRS could study compliance for a specific taxpayer subpopulation by randomly selecting a sample of taxpayer returns from that subpopulation for audit. The results of these audits could be projected to that entire subpopulation. Indications of noncompliance would not be considered in the random selection of returns for audit.

Traditionally, the only IRS program using widespread random selection has been the Taxpayer Compliance Measurement Program (TCMP). Under TCMP, IRS auditors did line-by-line audits of randomly selected tax returns from large taxpayer populations such as individuals, partnerships, or small corporations. TCMP was IRS' program for gathering comprehensive and reliable tax compliance data. IRS used the data for measuring compliance levels, estimating the tax gap, identifying compliance issues, developing DIF formulas for objectively selecting returns for audit, and allocating audit resources. In addition, Congress used TCMP data for policy analysis, revenue estimating, and research. IRS did the last TCMP for individuals who filed returns for tax year 1988; these audits were generally done during

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<sup>6</sup>In more complex types of random selection, every member of a specific subpopulation has a known chance of being selected, but these chances may not be equal since selection depends on statistically derived formulas and weights.

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1990, 1991, and 1992. IRS had planned a TCMP for tax year 1994 but postponed it indefinitely because of concerns about the costs to IRS and the burdens on taxpayers.

Outside TCMP, IRS' Examination Division initiates audit projects at IRS district offices and service centers to improve the selection of the audit workload. Also IRS' Compliance Research function runs research projects at IRS districts and service centers through District Research Offices. IRS occasionally does research projects, such as the ongoing series of EIC studies, through other functions.<sup>7</sup> All of IRS' projects focus on measuring the extent and nature of noncompliance for specific tax issues or specific groups of taxpayers in which compliance problems have occurred. These projects also tend to focus on finding solutions to the compliance problem that use nonenforcement means, such as taxpayer assistance, rather than enforcement means, such as audits. IRS officials said they may choose to randomly select samples of tax returns in these projects for research purposes.

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## Objectives, Scope, and Methodology

You asked 12 questions about IRS audits and IRS' use of random selection for audits closed during fiscal years 1994 through 1996, which were

1. The total number of IRS audits closed nationwide and in Georgia;
2. The number of audits across the nation and in Georgia that were randomly selected (i.e., random audits);
3. The number of IRS closed audits of returns filed by IRS employees;
4. The number of audits of IRS employees that were randomly selected;
5. IRS' plans or efforts to measure taxpayers' burdens and costs from being subjected to random audits;
6. The number of nationwide random audits, by location of the taxpayer;
7. The number of nationwide random audits, by type of taxpayer;
8. The number of nationwide random audits, by taxpayer income levels;

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<sup>7</sup>As of September 1997, IRS had finished an EIC study for filing years 1994 and 1995 and was still completing the EIC study for filing year 1996.



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9. The number of nationwide random audits, by type of taxpayer business;
  10. The number of nationwide random audits that resulted in additional taxes recommended and the amounts of those additional taxes;
  11. The number of nationwide random audits that resulted in referrals for criminal investigation; and
  12. The alternatives other than random audits IRS might have used to meet its objectives.

To answer your questions, we defined random audit as any audit of a taxpayer's return that was randomly selected, including returns randomly selected from subpopulations that were nonrandomly targeted because of suspected or known noncompliance. We used the returns as the basis of our analysis in order to make some comparisons to the overall audit universe. However, when IRS selects one taxpayer's return for audit, through whatever means, it may also audit other returns filed by the taxpayer in that or another tax year. Although the first selection may be random for the subpopulation, the selection of additional returns may not. In reporting the overall number of random audits, we distinguished between the number of taxpayers and number of returns.

Within this context, we responded to your 12 questions through 5 objectives on IRS' use of random audits during fiscal years 1994 through 1996. Our objectives were to provide information on (1) the number of audits selected overall and at random for tax returns filed by all taxpayers and by IRS employees across the nation and in Georgia; (2) the profile of the taxpayers subjected to the random audits by state, type of taxpayer return, taxpayer income level, and taxpayer occupation; (3) the results of the random audits in terms of number of audits for which additional taxes were recommended as well as the amount of these additional taxes and the number of referrals to IRS' CID; (4) the known burdens imposed on taxpayers subjected to random audits; and (5) the alternatives other than random selection that IRS might have used to meet its objectives.

To identify the number of audits done nationwide and in Georgia as well as of returns filed by IRS employees for fiscal years 1994 to 1996, we collected related data from IRS officials in the National Office and Georgia District. We also used data from IRS' database on closed audits—the Audit Information Management System (AIMS)—for each of these fiscal years. We interviewed Examination Division officials in the National and Georgia

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District offices to understand these data as well as IRS' procedures for selecting and doing audits. We collected data on IRS procedures, including those on audits of IRS employees.

To identify the number of audits that used random selection, we first reviewed IRS' audit selection procedures and interviewed Examination Division and Research Division officials in the National Office to discuss the types of audits that may use random selection. These types included audits done for IGPS in the Examination Division, research projects in the District Office Research and Analysis (DORA) unit, and EIC project audits. IRS does not track the use of random selection, so we asked officials to query the district offices and DORAs about projects that may have used it.<sup>8</sup>

We reviewed all the information IRS had available on the projects in the National and Georgia District offices to see whether we could identify other uses of random selection. Some information was unavailable, particularly for projects that started in earlier years. Examination officials explained that IRS is not required to maintain these records. They also said some records were discarded or lost in consolidating from 63 to 33 district offices and in shifting responsibilities for record maintenance during recent reorganization efforts. As a result, we are not sure whether all projects that used random selection have been identified. IRS officials said any omission would be minor because IRS lacks the resources to use random selection extensively.

For one of the six projects that IRS identified as using random selection, the EIC project, our analyses included the first two EIC studies for filing years 1994 and 1995 but not the third, because IRS was still checking the EIC and other claims for filing year 1996. IRS officials would not share the approximately 2,000 taxpayer identification numbers (TIN) associated with the tax year 1995 returns that were randomly selected for the 1996 EIC study, because IRS was still analyzing the audit results and wanted to prevent early release of data on EIC noncompliance. Our having the TINs and AIMS data, however, would not have allowed us to accurately compute the level of noncompliance. IRS provided some summary data on 789 taxpayers whose returns were in the tax year 1995 sample and had been audited, but we did not incorporate those data into our responses to the questions because we could not analyze and verify the data to the extent we could have done with the AIMS data. Appendix II summarizes the data provided by IRS.

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<sup>8</sup>IRS officials explained that they do not track the use of random selection because it is used rarely outside TCMP.

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For any project that we or IRS identified as randomly selecting returns for audit, we asked for the TIN on the audited returns. We used these TINs in two ways. First, we matched them to data on IRS employees in 1994, 1995, and 1996 to identify IRS employees subjected to random audits. Second, we matched the TINs to AIMS data to answer the questions about the profile of the taxpayers (e.g., income level and state location) and audit results (e.g., additional taxes recommended and referrals to Criminal Investigation).<sup>9</sup>

For the taxpayer profile and audit results, we reported the available AIMS data on each random audit. We did not test the reliability of the AIMS data. We did not report estimates that may be developed from the data because we did not evaluate the statistical validity of IRS' random selection; further, most of the random audits were not finished. For these reasons, in combination with the small number of random audits compared with all audits, we did not attempt to draw conclusions about the profile and results. Also, we did not report results of audits involving fewer than three taxpayers because of IRS disclosure rules that protect taxpayer privacy.

To identify IRS' efforts to measure taxpayers' costs and burdens, we talked to Examination officials and collected data on IRS' plans and surveys to define and measure taxpayer burden. We reviewed IRS' ongoing efforts for measuring taxpayer satisfaction with the audit process through a survey. We reviewed IRS' 1992 and 1996 survey results for measuring taxpayer burden and attitudes of large corporations. We did not attempt to evaluate these surveys or plans.<sup>10</sup>

To identify whether IRS had any alternatives to random audits, we first interviewed IRS officials and collected IRS data about the objectives of each project using random selection. Next, we reviewed our prior reports as well as a Price Waterhouse report on compliance data and the trade-offs with alternative sampling strategies.<sup>11</sup> We interviewed IRS officials and researched the literature to see whether we could find any other data sources that would meet IRS objectives. We did not attempt to evaluate the worthiness of IRS objectives.

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<sup>9</sup>For audits done at service centers, AIMS data did not identify the state in which the taxpayer resided. As a result, we used zip code information from AIMS to determine state location. We merged this state information with the state information from AIMS on random audits at IRS districts.

<sup>10</sup>Examination Customer Satisfaction Survey (June 22, 1997) and Measuring Taxpayer Burden and Attitudes for Large Corporations: 1996 and 1992 Survey Results (Mar. 5, 1997).

<sup>11</sup>Tax Administration: Alternative Strategies to Obtain Compliance Data (GAO/GGD-96-89, Apr. 26, 1996); Tax Research: IRS Has Made Progress but Major Challenges Remain (GAO/GGD-96-109, June 5, 1996); and Price Waterhouse, Alternatives to the Taxpayer Compliance Measurement Program (Feb. 28, 1997).

Our work was done at IRS' National Office in Washington, D.C., the Georgia District Office, Atlanta Service Center, and Southeast Regional Office between March and November 1997 in accordance with generally accepted government auditing standards. We requested comments from the IRS Commissioner on a draft of this report and these comments are discussed at the end of this report.

### Overall and Random Audits Done Nationwide and in the Georgia District

Between fiscal years 1994 and 1996, according to IRS data, audits increased nationwide as well as in Georgia. During this period, IRS did not randomly select any taxpayers from the population of all taxpayers for audit. IRS did identify six subpopulations with known or suspected noncompliance from which it randomly selected taxpayers for audit. Compared with the overall number of audits, IRS did very few random audits during this period—both across the nation and in Georgia. Similarly, very few of the audits of IRS employees involved random selection.

### Total Audits Done Nationwide and in Georgia

Table 1 shows that the total number of nationwide audits increased from 1994 to 1996. During that time, the number of audits done in Georgia also increased (from 45,451 to 55,446). Both of these increases resulted from a change in emphasis in the types of audits. IRS increased the number of service center correspondence audits and decreased the number of district office audits; correspondence audits can be done more quickly than audits at a district office.

**Table 1: Total Returns Audited Nationwide and in Georgia, Fiscal Years 1994-1996**

Locality	Returns audited		
	1994	1995	1996
Nationwide	1,426,573	2,100,144	2,136,819
District Office	1,009,163	969,365	948,425
Service Center	417,410	1,130,779	1,188,394
Georgia	45,451	57,617	55,446
Georgia District <sup>a</sup>	37,866	38,220	28,430
Atlanta Service Center <sup>b</sup>	7,585	19,397	27,016

<sup>a</sup>Georgia District Office encompasses the state of Georgia.

<sup>b</sup>Only includes the taxpayers within the Atlanta Service Center who are located in Georgia.

Source: IRS data for fiscal years 1994-1996.

## Random Audits Conducted Nationwide and in the Georgia District

During the 3 years, IRS did not randomly select any taxpayers from the population of all taxpayers for audit. According to IRS data, only those belonging to one of the six project subpopulations were eligible for being randomly selected. IRS chose these six subpopulations nonrandomly on the basis of historically high noncompliance rates or other evidence of suspected high noncompliance rates. These subpopulations represent small segments of the population of taxpayers and include taxpayers in a specific occupation, industry, geographic area, or economic activity; or with specific characteristics, such as being EIC recipients.

Table 2 shows the number of random audits across the six project subpopulations for the nation and Georgia during fiscal years 1994 through 1996. Compared with all its audits, IRS rarely did random audits. For the 3 years, IRS audited 2,961 returns across the nation—including 157 in Georgia—in these six projects. Most of these audits took place at IRS service centers—2,524 nationwide and 133 in Georgia. These IRS data reflect the number of returns audited and not the number of taxpayers audited.

**Table 2: Returns Audited After Using Random Selection From Project Subpopulations, Nationwide and in Georgia, Fiscal Years 1994-1996**

<b>Project</b>	<b>Nationwide</b>	<b>Georgia</b>
EIC studies <sup>a</sup>	2,472	130
Eating and drinking establishments	247	0
Duplicate dependent SSNs	162	14
Questionable Schedule Cs	5	0
EIC Schedule-C loss	13	13
Self-employment tax	62	0
<b>Total</b>	<b>2,961</b>	<b>157</b>

<sup>a</sup>IRS had not completed its work on its filing year 1996 EIC study and would not provide the tax year 1995 sample.

Source: IRS data for fiscal years 1994-1996.

Of the six projects shown in table 2, three included taxpayers from Georgia. The EIC Schedule C project is managed by the Georgia district; the duplicate dependent Social Security number (SSN) project is managed by a neighboring district; and the EIC studies project is national in scope. The EIC studies accounted for the bulk of the random audits both nationwide and in Georgia. The other two projects did not involve more than seven random audits of Georgia taxpayers in any of the 3 years. Additional Georgia taxpayers may be subjected to random audits because the three projects were ongoing in 1997.

As table 3 shows, the 6 projects included 7,421 taxpayers. For fiscal years 1994 through 1996, as of July 1997, IRS had audited only 2,629 taxpayers—largely in the filing year 1994 and 1995 EIC studies. During the audits of these 2,629 taxpayers, IRS audited 2,961 returns because some audits led IRS to audit additional returns from the same taxpayer. The other 4,792 taxpayers had not yet had their audits completed because the projects had recently begun; specifically, 3,702 of these taxpayers were selected for the duplicate dependent SSN project, which started during 1996.

**Table 3: Taxpayers Randomly Selected for Audit, Those Audited, and the Number of Returns Audited by Project, Fiscal Years 1994-1996**

Project	Subpopulation	Taxpayers randomly selected	Taxpayer audits not yet closed	Taxpayers audited	Returns audited
EIC studies <sup>a</sup>					
Filing year 1994 study	4,966,000	1,060	125	935	1,070
Filing year 1995 study	15,100,000	2,048	674	1,374	1,402
Eating and drinking establishments	24,000	118	7	111	247
Duplicate dependent SSNs	3,200,000	3,835	3,702	133	162
Questionable Schedule Cs	2,348	12	7	5	5
EIC Schedule-C loss	9,343	175	165	10	13
Self-employment tax	25,469	173	112	61	62
<b>Total</b>	<sup>b</sup>	<b>7,421</b>	<b>4,792</b>	<b>2,629</b>	<b>2,961</b>

<sup>a</sup>IRS had not completed its work on its filing year 1996 EIC study and would not provide the tax year 1995 sample.

<sup>b</sup>Not applicable, because some taxpayers fit in more than one of the subpopulations.

Source: IRS data for fiscal years 1994-1996.

Table 3 also shows that IRS' use of random selection did not cover the entire population of taxpayers. The subpopulations in the 6 projects accounted for a small portion of the more than 100 million tax returns filed annually. The subpopulations ranged from 2,348 to 15.1 million in any 1 year. IRS randomly selected the 7,421 taxpayers after nonrandomly selecting subpopulations of taxpayers known or suspected to be noncompliant.

**Total and Random Audits of IRS Employees Compared With All Taxpayers**

Table 4 compares all audited taxpayers and IRS employees with returns audited as a result of random selection. It makes two basic points. First, the percentage of returns audited as a result of random selection for both groups was very small compared with the overall number of returns audited. For the 3 fiscal years in total, the percentage of audited returns subjected to random selection was slightly higher for IRS employees than for all taxpayers (0.06 percent compared with 0.05 percent, respectively).

Second, IRS audited four IRS employees' returns after random selection from a subpopulation. According to officials, IRS employees were unlikely candidates for being selected randomly for audit because they generally did not fall into the subpopulations. Four of the six projects involved businesses or self-employed individuals. As a general rule, few IRS employees would also be self-employed. Two of the projects involved the EIC, which is designed to help the working poor. Many full-time IRS employees would be ineligible for the program.

**Table 4: All Returns Audited, IRS Employee Returns Audited, and the Number of Returns Audited as a Result of Random Selection, Fiscal Years 1994-1996**

Returns	1994	1995	1996	Total
<b>All taxpayers</b>				
Audited	1,426,573	2,100,144	2,136,819	<b>5,663,536</b>
Audited as a result of random selection	714	1,101	1,146	<b>2,961</b>
Randomly audited returns as a percentage of all audited returns	0.05%	0.05%	0.05%	<b>0.05%</b>
<b>IRS employees</b>				
Audited	1,135	2,828	3,103	<b>7,066</b>
Audited as a result of random selection	4	0	0	<b>4</b>
Randomly audited returns as a percentage of all IRS employees' audited returns	0.35%	0%	0%	<b>0.06%</b>

Note: The "Audited as a result of random selection" rows do not include any returns from IRS' tax year 1995 sample for its filing year 1996 EIC study.

Source: IRS data for fiscal years 1994-1996.

To provide another perspective on these percentages, we analyzed the overall audit rates for individual taxpayers and IRS employees for fiscal years 1994 through 1996. For all individual taxpayers, IRS audited 1.08 percent, 1.67 percent, and 1.67 percent, respectively, of the returns filed. For IRS employees, IRS audited 1 percent, 2.6 percent, and 2.7 percent,

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respectively, of the roughly 110,000 IRS employees during each of the 3 years. Most of the IRS employees audited were new hires, executives, candidates for executive positions, and employees promoted into sensitive positions; the rest were selected for audit just like any other taxpayer would be.

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## Profile of Taxpayers Selected for the Six Projects

To profile the characteristics of taxpayers audited through the six projects, we analyzed IRS data on the 2,961 audited returns. The characteristics included the taxpayer's state, type of return, income level, and occupation or business. Our results cannot be considered definitive because our analysis only involved completed audits, and most of the projects are ongoing with the audits of 4,405 taxpayers still to be closed.

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## State Location of the Taxpayer

For fiscal years 1994 to 1996, 16 states had fewer than 10 random audits, and 10 states had more than 100 random audits.<sup>12</sup> Most of these audits resulted from the EIC and Ohio's eating and drinking establishment projects. In future years, Florida, Georgia, and Missouri will likely have a higher number of random audits because of three ongoing projects: (1) the duplicate dependent SSN project in Florida; (2) the EIC Schedule-C loss project in Georgia; and (3) the self-employment tax project in Missouri. (See app. III, table III.1.)

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## Type of Taxpayer Return

According to IRS data, the 2,961 returns audited in the 6 projects fell into 3 categories of tax returns—individual, corporate, and employment tax returns—except in 1996, when fewer than 3 partnership returns were audited. Of these 2,961 returns, individual returns accounted for 2,781 of the audits. For example, in fiscal year 1994, all 714 random audits involved individual returns. (See app. III, table III.2.)

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## Taxpayer Income Levels

Of the 2,961 returns audited in the 6 projects, 2,572 returns reported positive income of less than \$25,000. The project on the EIC, which is designed to help lower income individuals, accounted for 2,417 of these returns. This income level accounts for most individual tax returns and most IRS audits overall (See app. III, table III.3.). For fiscal year 1996, these lower income taxpayers filed about 59 million of the 116 million returns.

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<sup>12</sup>The 10 states were Florida, Georgia, Illinois, Louisiana, Mississippi, New York, North Carolina, California, Ohio, and Texas; the last 3 states had between 230 and 301 random audits.



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Further, 1.1 million (most of them with EIC claims) of the 2 million returns audited in fiscal year 1996 also involved taxpayers from this income level.

Few of the random audits involved higher income taxpayers, but this is also true for audits overall. However, IRS usually audits a higher percentage of returns that report higher income. For fiscal year 1996, IRS audited almost 3 percent of the individual returns reporting at least \$100,000 in positive income but less than 2 percent of the returns reporting less than \$25,000 in positive income. Before the recent influx of audits focusing on EIC claims, the audit rates for such lower income returns were well below 1 percent.

Random audits in the eating and drinking establishment project included nonindividual returns, such as corporate, employment, and partnership returns. For this project, 40 percent of the audited nonindividual returns were filed by corporations with total gross receipts under \$250,000. For corporate returns alone, this category represented 69 percent of the audits. In 1994, IRS data showed it did not audit any nonindividual returns as a result of random selection. (See app. III, table III.4.)

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## Taxpayer Occupation or Business

AIMS has limited information on the occupation or business of individual taxpayers. In fact, it does not record an individual's occupation. Instead, the database indicates whether a taxpayer filed a Form 1040 Schedule C (income from an individual business) or Form 1040 Schedule F (income from farming) and may indicate the type of Schedule C business (e.g., retail sales, services). Of the cases we reviewed, AIMS had very little data on the types of businesses; the data that did exist varied greatly, suggesting no discernable pattern. However, one of the six projects identified the type of business by the title—eating and drinking establishments.

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## Audit Results From the Six Projects

We also analyzed data on the reported results of the 2,961 audits in the projects. These results included the percentage of returns with recommended additions to reported taxes, the amount of additional taxes recommended, and the number referred to CID. These results cannot be considered definitive because our analysis only involved returns with completed audits, and most of the projects are ongoing with over 4,000 taxpayer returns still to be completed.

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### Percentage of Recommended Additional Taxes

For the 3 fiscal years, the percentage of completed audits that recommended additional taxes to a return was 80 percent or higher for the projects on eating and drinking establishments and self-employment tax. The percentage recommending additional taxes for the project on EIC studies averaged 46 percent for the 3 years. Each year, the percentage for this project rose—from 12 percent in 1994, to 50 percent in 1995, and to 69 percent in 1996. For the same period, the nationwide average across all audited returns was 67 percent. (See app. III, table III.5.)

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### Amount of Additional Taxes Recommended

The amount of reported additional taxes recommended from audits of individual returns for all 3 years exceeded \$200,000 in three of the six projects. The project on the EIC studies recommended about \$1.9 million in additional tax; the eating and drinking establishment project recommended about \$712,000, and the duplicate dependent SSN project recommended about \$208,000. The amounts recommended in the other three projects fell below \$20,000 during the same period.

Of the 2 projects with more than 200 audited returns, the average amount of additional taxes recommended per individual return audited for the EIC project was \$1,653; and for the eating and drinking establishments project, the average amount of additional taxes recommended was \$12,711—double the national average of \$6,251 for fiscal years 1994 to 1996. (See app. III, table III.6.)

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### Referrals for Criminal Investigation

None of the 2,961 audited returns during fiscal years 1994 to 1996 resulted in criminal referrals to IRS' CID or the Department of Justice. In fact, IRS auditors referred very few cases to CID for criminal fraud. In fiscal year 1996, auditors only referred 783 of more than 2 million audits.

CID relies on various sources of information for initiating its investigations, including information from (1) within IRS, such as from the Examination Division; (2) other government sources, such as U.S. Attorneys; (3) banks and other financial institutions; and (4) the public. In an effort to increase the quality of fraud referrals from other IRS groups to CID, IRS established formal fraud-referral procedures, effective for fiscal year 1996. According to CID officials, the objective of these procedures was to increase coordination between CID and other IRS divisions, particularly Examination.

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## Burden Imposed on Taxpayers Selected for Audit in the Six Projects

According to IRS, any audit—whether randomly selected or otherwise—imposes some level of cost and burden on taxpayers. However, IRS has no system or data to measure the costs and burdens associated with any of its audits. IRS recognizes this situation and, as a result, is trying to develop measures of taxpayer costs and burden as well as data sources.

In considering ways to define and measure the burdens and costs imposed on taxpayers, IRS plans to include all contacts with taxpayers—from telephone calls and correspondence to audits and collection notices—in its measures. With these measures, IRS plans to capture savings from burden reduction initiatives, such as increasing telephone assistor access at Customer Service sites. IRS plans to measure taxpayer burden by dollars, in order to compare the savings and costs of burden reduction initiatives versus tax law enforcement initiatives. IRS also plans to develop alternative methods for measuring taxpayer burden and satisfaction with all IRS products and services.

In the interim, IRS began its current survey for measuring taxpayer satisfaction with the audit process in July 1997. The survey is based on a Price Waterhouse study done in 1991 and a related prior survey conducted by Booz-Allen in 1989. IRS decided to use the Price Waterhouse study as a model for its current survey.

The purpose of the survey is to provide IRS with information from a small sample of taxpayers on (1) their level of satisfaction with recent income tax audits, (2) their suggestions to increase the level of satisfaction and improve the audit process, and (3) recurrent problems and how IRS could correct them. IRS plans to compare taxpayers' perceptions of the quality and efficiency of the audit process with IRS' assessments. IRS plans to conduct the survey through the mail for a 1-year span in four of its district offices. Results of the survey are to be available as early as late 1998; afterward, IRS plans to make decisions about future surveys.

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## IRS Alternatives to Conducting Random Audits

For the six projects, IRS officials said that they could not have met the research objectives through alternatives to random selection. Internally and externally, no statistically valid compliance data addressed the objectives of these projects according to these officials. We did not independently evaluate the designs of the six projects to determine if they would meet their objectives. We have reported on IRS' lack of statistically valid data outside the data from TCMP or specialized research that not only

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measured taxpayer compliance but also offered insights on the nature of and reasons for tax noncompliance.<sup>13</sup> Price Waterhouse has made similar points about IRS' ongoing need for statistical compliance data.<sup>14</sup>

IRS officials said that without such compliance data, IRS has few options to using random audits for compliance research purposes, particularly for statistical precision, data quality, and data collection cost considerations. The officials said they need some source of statistical compliance data to be able to project research results to a larger subpopulation as a way to improve audit selection methodologies to better target noncompliant taxpayers for audit. To the extent that the random selection is adequately designed and properly done, it allows IRS to develop estimates of noncompliance for an entire subpopulation without burdening each taxpayer within that subpopulation.

Outside these research purposes, IRS officials indicated that they would have little incentive to randomly select returns for audit because IRS wants to invest its limited audit resources productively. According to IRS officials, random audits usually generate less additional recommended taxes per audit hour compared with audits selected for ongoing programs. IRS wants to target audit resources on returns selected through the ongoing programs, which attempt to focus on the most noncompliant taxpayers, rather than on returns selected randomly.

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## Agency Comments and Our Evaluation

In a letter dated December 23, 1997, IRS' Acting Chief Compliance Officer commented on a draft of this report (see app. IV). He expressed disagreement with our definition of random audit. He said random audit involves random selection for audit in which every taxpayer in the filing population would have an equal chance of being selected. He also said the six projects discussed in our report are not random audits. He said they are projects where returns were selected using a statistical random return selection technique from a subpopulation of returns that were nonrandomly selected because of suspected or known noncompliance.

We believe our report clearly makes this same distinction between random selection from the population of all taxpayers and random selection from subpopulations picked because of suspected or known noncompliance. And as we noted in the draft report, for the period reviewed, IRS did not randomly select for audit any taxpayer from the population of all

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<sup>13</sup>GAO/GGD-96-89 (Apr. 26, 1996) and GAO/GGD-96-109 (June 5, 1996).

<sup>14</sup>Price Waterhouse (Feb. 28, 1997).

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taxpayers. As a result, we made no changes to the report on the basis of IRS' comments.

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

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

Sincerely yours,

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, prominent initial "J".

James R. White  
Associate Director, Tax Policy and  
Administration Issues

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**Contents**

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**Abbreviations**

AIMS	Audit Information Management System
CID	Criminal Investigations Division
DIF	discriminant function
DORA	District Office of Research and Analysis
EIC	earned income credit
IGP	Information Gathering Project
IRS	Internal Revenue Service
SOI	statistics of income
SSN	Social Security number
TIN	taxpayer identification number
TCMP	Taxpayer Compliance Measurement Program



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# Descriptions of Projects Involving Random Selection

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Earned Income Credit (EIC) studies—A series of nationwide studies conducted on 1993, 1994, and 1995 tax returns to provide broader information on taxpayer understanding of and assess compliance with EIC qualification requirements. The audits done in these studies were unusual in that both Criminal Investigation Division (CID) and Examination were involved. Because of this circumstance, some audits of returns may have been recorded as closed on the Audit Information Management System well after CID's initial contact with the taxpayers.

Eating and drinking establishments—An Information Gathering Project begun in 1993 at Internal Revenue Service's (IRS) Cleveland District, seeking to measure the accuracy of income reported by eating and drinking establishments that had fewer than 25 locations and that were licensed to sell alcoholic beverages in Ohio.

Duplicate dependent Social Security numbers (SSN)—A research effort, managed by IRS' North Florida District, examining those returns filed in tax year 1995 where more than one taxpayer claimed the same dependent (a duplicate dependent SSN). IRS is testing the effectiveness of notices in modifying taxpayer behavior for 1996, securing amended returns for 1995, and learning more about the subpopulation.

Questionable Schedule Cs—A research effort, managed by IRS' Illinois District, to determine the compliance of "questionable" wholesale and retail sole proprietorships. IRS drew two samples from tax year 1993 of Schedule Cs who claimed (1) zero gross receipts, zero other income, and zero cost of goods sold, and (2) gross receipts of \$350 or under, zero cost of goods sold, and total expenses greater than \$1,050.

EIC Schedule-C losses—A research effort, managed by IRS' Georgia District, attempting to determine if sole proprietorships might be using losses from Schedule C to offset other income; such offsets allow a taxpayer that would have been otherwise ineligible to qualify for EIC. IRS selected its sample from tax year 1994 returns including a Schedule C and claiming EIC.

Self-employment tax—A research effort, managed by the IRS' Kansas-Missouri District, testing the impact of an educational letter as a means of improving compliance for taxpayers filing a Schedule C, Schedule F, and/or Other Income but not a Schedule SE with their return. The returns selected for testing were from tax year 1993.

# IRS Summary Data for IRS' Study of EIC Claims for Filing Year 1996

Because it was still drafting a report on EIC compliance during the 1996 filing season, IRS did not wish to share the tax year 1995 taxpayer sample. IRS did provide summary data from the sample, which follows.

**Table II.1: AIMS Summary Data by Audit Class for Returns in IRS' Filing Year 1996 EIC Study**

<b>Audit class<sup>a</sup></b>	<b>Number of returns</b>
1040A, TPI under \$25,000	706
Non-1040A, TPI under \$25,000	57
TPI \$25,000 under \$50,000	4
Schedule C, TGR under \$25,000	16
Schedule C, TGR over \$25,000 under \$100,000	<sup>b</sup>
Schedule C, TGR \$100,000 and over	<sup>b</sup>
Schedule F, TGR under \$100,000	<sup>b</sup>

Legend:

1040A—U.S. individual income tax return  
 TPI—Total positive income  
 TGR—Total gross receipts  
 Schedule C—Business income schedule  
 Schedule F—Farm income schedule

<sup>a</sup>Type and class of return examined.

<sup>b</sup>In accordance with statistics of income (SOI) criteria, the data have been deleted to avoid disclosure for specific taxpayers.

Source: IRS summary of 1996 EIC study data.

**Table II.2: AIMS Summary Data by Return Type for Individual Returns in IRS' Filing Year 1996 EIC Study**

<b>Return type</b>	<b>Number of returns</b>
Nonbusiness	767
Business <sup>a</sup>	22

<sup>a</sup>Form 1040A Schedule C or Schedule F filers.

Source: IRS summary of 1996 EIC study data.

**Appendix II**  
**IRS Summary Data for IRS' Study of EIC**  
**Claims for Filing Year 1996**

**Table II.3: AIMS Summary Data by State of Residence for Returns in IRS' Filing Year 1996 EIC Study**

<b>State</b>	<b>Number of taxpayers</b>
Alabama	12
Alaska	0
Arizona	13
Arkansas	12
California	46
Colorado	5
Connecticut	45
Delaware	<sup>a</sup>
Florida	44
Georgia	14
Hawaii	25
Idaho	0
Illinois	21
Indiana	5
Iowa	4
Kansas	10
Kentucky	4
Louisiana	25
Maine	4
Maryland	15
Massachusetts	0
Michigan	6
Minnesota	11
Mississippi	11
Missouri	17
Montana	<sup>a</sup>
Nebraska	<sup>a</sup>
Nevada	4
New Hampshire	0
New Jersey	14
New Mexico	29
New York	30
North Carolina	28
North Dakota	<sup>a</sup>
Ohio	35
Oklahoma	14
Oregon	6
Pennsylvania	17

(continued)

**Appendix II**  
**IRS Summary Data for IRS' Study of EIC**  
**Claims for Filing Year 1996**

<b>State</b>	<b>Number of taxpayers</b>
Rhode Island	0
South Carolina	8
South Dakota	0
Tennessee	22
Texas	202
Utah	4
Vermont	0
Virginia	6
Washington	6
West Virginia	0
Wisconsin	7
Wyoming	<sup>a</sup>
<b>Total</b>	<b>789</b>

<sup>a</sup>In accordance with SOI criteria, the data have been deleted to avoid disclosure for specific taxpayers. However, deleted data are included in the total.

Source: IRS summary of 1996 EIC study data.

# Characteristics and Results of Random Audits

**Table III.1: All Returns Audited and Number Audited as a Result of Random Selection by State, Fiscal Years 1994-1996**

State	Returns audited	
	All	Random selection
Alabama	67,216	86
Alaska	17,660	0
Arizona	94,266	41
Arkansas	41,764	59
California	1,479,229	234
Colorado	77,195	23
Connecticut	65,110	21
Delaware	16,948	9
District of Columbia	21,024	10
Florida	272,774	140
Georgia	158,187	157
Hawaii	23,092	<sup>b</sup>
Idaho	25,332	8
Illinois	239,084	142
Indiana	88,712	8
Iowa	37,927	21
Kansas	40,809	23
Kentucky	40,525	7
Louisiana	85,554	152
Maine	19,626	9
Maryland	105,704	64
Massachusetts	96,787	39
Michigan	129,373	22
Minnesota	84,430	40
Mississippi	57,078	105
Missouri	77,213	67
Montana	14,338	<sup>b</sup>
Nebraska	26,897	9
Nevada	61,230	13
New Hampshire	19,716	7
New Jersey	153,003	78
New Mexico	31,712	26
New York	366,323	158
North Carolina	97,187	136
North Dakota	12,719	4
Ohio	124,159	263
Oklahoma	67,270	49

(continued)

**Appendix III  
Characteristics and Results of Random  
Audits**

<b>State</b>	<b>Returns audited</b>	
	<b>All</b>	<b>Random selection</b>
Oregon	62,337	20
Pennsylvania	173,918	73
Rhode Island	22,498	11
South Carolina	60,220	62
South Dakota	11,518	5
Tennessee	66,782	95
Texas	453,770	302
Utah	29,245	5
Vermont	9,187	<sup>b</sup>
Virginia	119,737	86
Washington	107,975	21
West Virginia	19,501	<sup>b</sup>
Wisconsin	59,006	38
Wyoming	8,986	5
<b>Total<sup>a</sup></b>	<b>5,641,853</b>	<b>2,961</b>

Note: The "Random selection" column does not include any returns from IRS' tax year 1995 sample for its filing year 1996 EIC study.

<sup>a</sup>Does not include returns from U.S. territories or where the state was unknown.

<sup>b</sup>In accordance with SOI criteria, the data have been deleted to avoid disclosure for specific taxpayers. However, deleted data are included in the total.

Source: IRS AIMS data for fiscal years 1994-1996.

**Appendix III  
Characteristics and Results of Random  
Audits**

**Table III.2: All Returns and Number Audited as a Result of Random Selection by Tax Return Type, Fiscal Years 1994, 1995, and 1996**

Tax type	Returns audited					
	1994		1995		1996	
	All	Random selection	All	Random selection	All	Random selection
Individual	1,225,707	714	1,919,437	1,045	1,941,560	1,022
Corporate	78,014	0	71,233	38	80,087	68
Employment	62,189	0	53,978	18	56,181	{56} <sup>b</sup>
Partnership	8,077	0	7,072	0	7,636	
Excise	33,493	0	29,521	0	31,579	0
Estate	11,077	0	11,419	0	11,794	0
Fiduciary	4,662	0	4,326	0	4,511	0
Gift	1,853	0	1,893	0	1,934	0
Luxury	1,399	0	1,149	0	1,316	0
Other <sup>a</sup>	102	0	116	0	221	0
<b>Total</b>	<b>1,426,573</b>	<b>714</b>	<b>2,100,144</b>	<b>1,101</b>	<b>2,136,819</b>	<b>1,146</b>

Note: The "Random selection" columns do not include any returns from IRS' tax year 1995 sample for its filing year 1996 EIC study.

<sup>a</sup>Includes returns not falling into one of the nine major tax types and any returns where the tax type is not specified in the AIMS database.

<sup>b</sup>In accordance with SOI criteria, the data in adjoining cells have been combined to avoid disclosure for specific taxpayers. However, data are included in appropriate totals.

Source: IRS AIMS data for fiscal years 1994-1996.



**Appendix III  
Characteristics and Results of Random  
Audits**

**Table III.3: All Individual Returns Audited and Those Audited as a Result of Random Selection, by Taxpayer Income Level and by Project, Fiscal Years 1994-1996**

Project	Individual returns								
	Form 1040/1040A				Schedule C (business)			Schedule F (farming)	
	TPI under \$25,000	TPI \$25,000 under \$50,000	TPI \$50,000 under \$100,000	TPI \$100,000 and over	TGR under \$25,000	TGR \$25,000 under \$100,000	TGR \$100,000 and over	TGR under \$100,000	TGR \$100,000 and over
Nationwide	2,759,062	648,020	473,004	353,308	355,273	268,403	187,730	20,552	21,352
EIC studies <sup>a</sup>	2,417	10	0	0	{27} <sup>b</sup>	13	3	{4} <sup>b</sup>	0
Eating and drinking establishments	17	7	8	13		9	{14} <sup>b</sup>		0
Duplicate dependent SSNs	110	22	{13} <sup>b</sup>	4	10	{5} <sup>b</sup>		0	0
Questionable Schedule Cs	0	4		0	0			0	0
EIC Schedule-C loss	4	4	{13} <sup>b</sup>	0	0			0	0
Self-employment tax	24	18		0	8	0	0	0	0
<b>Total</b>	<b>2,572</b>	<b>65</b>	<b>34</b>	<b>17</b>	<b>45</b>	<b>27</b>	<b>17</b>	<b>4</b>	<b>0</b>

Legend:

TPI—Total Positive Income  
TGR—Total Gross Receipts

<sup>a</sup>IRS had not completed its work on its filing year 1996 EIC study and would not provide the tax year 1995 sample.

<sup>b</sup>In accordance with SOI criteria, the data in adjoining cells have been combined to avoid disclosure for specific taxpayers. However, data are included in the appropriate totals.

Source: IRS AIMS data for fiscal years 1994-1996.

**Appendix III  
Characteristics and Results of Random  
Audits**

**Table III.4: All Nonindividual Returns and Those Audited as a Result of Random Selection by Tax Return Type With a Breakdown by Corporate Assets, by Project, Fiscal Years 1995-1996**

Project	Corporate returns									
	Form 1120S (nontaxable)		No balance sheet	Form 1120				All other 1120 related forms	Partnership returns	Employment tax returns
	Under \$200k	\$200k and over		Under \$250k	\$250k under \$1M	\$1M under \$50M	\$50M and over			
Nationwide	16,603	20,649	6,835	28,357	20,735	40,730	14,185	3,226	14,708	110,159
Eating and drinking establishments	21	7	8	52	9	9	0	0	{74} <sup>a</sup>	

Note: In fiscal year 1994, IRS did not audit any nonindividual returns as a result of random selection.

<sup>a</sup>In accordance with SOI criteria, the data in adjoining cells have been combined to avoid disclosure for specific taxpayers.

Source: IRS AIMS data for fiscal years 1995-1996

**Table III.5: Number and Percentage of Returns Audited Overall and as a Result of Random Selection That Had Additional Taxes Recommended by Project, Fiscal Years 1994-1996**

Projects	Audited returns	Audited returns with recommended taxes	Percentage
<b>Nationwide</b>	5,663,536	3,820,467	67%
EIC studies <sup>a</sup>	2,472	1,129	46%
Eating and drinking establishments	247	198	80%
Duplicate dependent SSNs	162	100	62%
Questionable Schedule C	5	0	0
EIC Schedule-C loss	13	9	69%
Self-employment tax	62	51	82%
<b>Total</b>	<b>2,961</b>	<b>1,487</b>	<b>50%</b>

<sup>a</sup>IRS had not completed its work on its filing year 1996 EIC study and would not provide the tax year 1995 sample.

Source: IRS AIMS data for fiscal years 1994-1996.

**Appendix III  
Characteristics and Results of Random  
Audits**

**Table III.6: Additional Taxes Recommended per Audited Individual Returns Overall, and per Audited Individual Returns Resulting From Random Selection, by Project for Fiscal Years 1994-1996**

<b>Project</b>	<b>Amount of recommended taxes</b>	<b>Recommended taxes per return</b>
Nationwide (individual returns)	\$21,524,190,486	\$6,251
EIC studies <sup>a</sup>	\$1,866,252	\$1,653
Eating and drinking establishments	\$711,835	\$12,711
Duplicate dependant SSNs	\$207,952	\$2,080
Questionable Schedule Cs	0 <sup>b</sup>	0 <sup>b</sup>
EIC Schedule-C loss	\$18,889	\$2,099
Self-employment tax	\$17,495	\$343

<sup>a</sup>IRS had not completed its work on its filing year 1996 EIC study and would not provide the tax year 1995 sample.

<sup>b</sup>Of the five returns audited for this project, none resulted in any recommended taxes.

Note: For nonindividual returns audited, such as corporate returns, the recommended taxes per audited return may be skewed by several large recommended assessments that exceeded the range for the majority of the recommended assessments. For example, the 1996 recommended taxes per return for nationwide nonindividual audited returns, which included some high recommended assessments against very large corporations, was \$200,164 per return; for eating and drinking establishments, it was \$8,199.

Source: IRS AIMS data for fiscal years 1994-1996.

# Comments From the Internal Revenue Service



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

CHIEF COMPLIANCE OFFICER

December 23, 1997

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

Dear Ms. Willis:

Thank you for the opportunity to review your recent draft report titled "Tax Administration: IRS' Use of Random Selection in Choosing Tax Returns for Audit". The opportunity to provide additional clarifying information was appreciated. We also appreciate that the report does recognize the need for statistically random return selection techniques to gauge the level of noncompliance both within the filing population and within certain defined filing subpopulations. We would, however, like to take this opportunity to express some disagreement with the report's definition of the term "random audit".

In your report you define a "random audit as any audit of a taxpayer's return that was randomly selected, including returns randomly selected from subpopulations that were non-randomly targeted because of suspected or known noncompliance." The definition of a random selection of audits is the random selection of taxpayers for audit in the filing population. That is, all taxpayers in the filing population have an equal chance of getting selected. This is a statistically valid method to determine compliance levels. The IRS has only one such program - Taxpayer Compliance Measurement Program (TCMP).

Non-randomly selected subpopulations start with a defined area of noncompliance. Only that limited number of taxpayers in the filing population whose returns meet the criteria established for that subpopulation would be subject to audit. Thus, they do not meet the definition of a random audit.

-2-

Ms. Lynda D. Willis

The six individual projects that are discussed in the report are not random audits. They are projects where returns were selected using a statistical random return selection technique from a subpopulation of returns that were *nonrandomly selected* because of "suspected or known noncompliance." It is not material that once the area of noncompliance was identified then there could be a randomness to identifying returns in that area of noncompliance.

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

Sincerely,

  
John M. Dalrymple  
Acting Chief Compliance Officer/  
Acting Chief Taxpayer Service

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**United States  
General Accounting Office  
Washington, D.C. 20548-0001**

**Bulk Rate  
Postage & Fees Paid  
GAO  
Permit No. G100**

**Official Business  
Penalty for Private Use \$300**

**Address Correction Requested**

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