

GAO

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INTERNAL REVENUE
SERVICE

Challenges Remain in
Combating Abusive Tax
Shelters

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Highlights of [GAO-04-104T](#), a testimony to the Committee on Finance, U.S. Senate

INTERNAL REVENUE SERVICE

Challenges Remain in Combating Abusive Tax Shelters

Why GAO Did This Study

Recent scandals involving corporations, company executives, and accounting, law, and investment banking firms heightened awareness of abusive tax shelters and highlighted the importance of the Department of the Treasury and the Internal Revenue Service (IRS) addressing them. During 1999, Treasury issued a report indicating that abusive shelters were a large and growing problem, involving billions of dollars of tax reductions. Treasury was concerned that abusive shelters could ultimately undermine the integrity of the voluntary compliance tax system.

GAO's statement today is based on work done at the request of the Chairman and the Ranking Minority Member of the Senate Committee on Finance to examine IRS's strategy for dealing with abusive tax shelters. In reporting on abusive shelters, GAO is describing

- their nature and scope,
- IRS's strategy and enforcement mechanisms to combat them and the performance goals and measures IRS uses to track its major effort in that area, and
- the decision-making process IRS used and the plans it has to devote more resources to addressing abusive shelters.

www.gao.gov/cgi-bin/getrpt?GAO-04-104T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

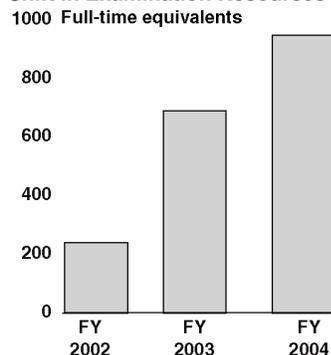
By their nature, abusive tax shelters are varied, complex, and difficult to detect and measure. Abusive shelters manipulate many parts of the tax code or regulations and may involve steps to hide the transaction within a tax return. In recent years, IRS has been accumulating information about them and, although it does not have a reliable measure of the size of the abusive shelter problem, has come to believe that abusive shelters deserve substantially increased attention. IRS continues to gather more information to better define the scope of the problem and has data sources, all with their own limitations, that suggest abusive tax shelters total tens of billions of dollars of potential tax losses over about a decade.

IRS's broad-based strategy for addressing abusive shelters included:

- targeting promoters to head off the proliferation of shelters;
- making efforts to deter, detect, and resolve abuse;
- offering inducements to individuals and businesses to disclose their use of questionable tax practices; and
- using performance indicators to measure outputs and some outcomes and intending to go down the path it has started and develop long-term performance goals and measures linked to those goals. Without these latter elements, Congress would find gauging IRS's progress difficult.

In allocating resources to shelters, IRS used a systematic decision-making process that relied on admittedly limited information. It planned to shift significant resources in fiscal years 2003 and 2004 to address abusive shelters but faces challenges, especially in the near term, in addressing abusive shelters due to a growing workload and limited information on how long it takes to examine shelter cases. IRS's understanding of how many staff will be needed to address the problem over what period will continue to evolve as it gains a better understanding of the problem's scope.

Shift in Examination Resources Allocated to Abusive Tax Shelters



Source: IRS.

Note: Fiscal year 2002 full-time equivalents include actual time spent on the entire returns containing shelters, not on the shelter issues alone. Fiscal year 2003 and 2004 full-time equivalents are planned amounts that are focused more on the shelter issues themselves.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to testify on the Internal Revenue Service's (IRS) efforts to deal with abusive tax shelters. I am using the term "abusive shelters" to describe very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits. Recent scandals involving corporations, company executives, and accounting, law, and investment banking firms heightened awareness of abusive shelters and highlighted the importance of the Department of the Treasury and IRS addressing the problem. During 1999, Treasury issued a report indicating that abusive shelters were a large and growing problem, involving billions of dollars of tax reductions.¹ Treasury was concerned that abusive shelters could ultimately undermine voluntary compliance by eroding the integrity of the tax system. In response to information pointing to the rapid growth of abusive shelters, IRS formalized a strategic initiative in fiscal year 2000 to strengthen its capacity to deal with abusive corporate shelters. One element of IRS's initiative involved creating a central office within the Large and Mid-Size Business (LMSB) Division to coordinate and guide efforts to curb the growth of abusive shelters.

My statement today is based on work we have done at the request of the Chairman and the Ranking Minority Member. In examining abusive shelters, we focused on (1) their nature and scope, (2) IRS's strategy and enforcement mechanisms to combat them and the performance goals and measures IRS uses to track its major effort in that area, and (3) the decision-making process IRS used to allocate resources to abusive shelters and the plans it has to devote more resources to addressing abusive shelters. We were also asked to provide information on IRS's Schedule K-1 document matching program, which we are including in appendix I.

To do our work, we

¹Department of the Treasury, *The Problem of Corporate Tax Shelters* (Washington, D.C.: July 1999).

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- analyzed IRS's and other shelter reports, publications, data, and other documentation providing insight into the characteristics, complexity, size, and type of the problem;²
 - reviewed IRS's planning documents with information on its strategies, measures, and resources;
 - compared the contents of IRS's planning documents to Government Performance and Results Act of 1993 (GPRA)³ criteria for what elements strategic planning should include; and
 - interviewed agency officials about their views on, among other things, the problem's nature and scope and IRS's strategy.

We did our work from September 2002 through August 2003 in accordance with generally accepted government auditing standards. As agreed, we are also discussing the related problem of abusive tax schemes in a report to be released in the near future. Abusive tax schemes are used more by individuals than by large businesses and encompass such distortions of the tax system as falsely describing the law (saying, for example, that the income tax is unconstitutional), misrepresenting facts (for instance, promoting the deduction of personal expenses as business expenses), and using trusts or offshore bank accounts to hide income. The boundary between what we are calling an abusive tax shelter and an abusive scheme is not always clear. Organizationally, although IRS's LMSB Division has lead responsibility for combating abusive shelters, abusive shelters are pursued by IRS's Small Business/Self-Employed Division when they are used by businesses with assets of less than \$10 million or by high-wealth individuals with complicated tax returns.

My statement today will make the following points:

²As part of this work, we tested the tax shelter database maintained by the Office of Tax Shelter Analysis (OTSA) by reviewing related documentation, interviewing knowledgeable agency officials, and doing electronic testing, finding that the required data elements were sufficiently reliable for the purposes of our work. This finding does not mean, however, that the database contains all the information that would be needed to estimate the full size of the abusive shelter problem.

³Pub. L. No.103-62.

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- By their nature, abusive shelters are varied, complex, and difficult to detect and measure. Abusive shelters manipulate many parts of the tax code or regulations and may involve steps to hide the transaction within a tax return. In recent years, IRS has been accumulating information about abusive shelters and the extent that they were promoted, and it has come to believe that abusive shelters deserve substantially increased attention. Suffice it to say, although they do not have a reliable measure of the size of the abusive shelter problem, Treasury and IRS believe that tens of billions of dollars of taxes are being improperly avoided and the potential for the proliferation of abusive shelters is strong. IRS continues to gather more information to better define the scope of the problem and has several data sources, each with certain limitations, that point to billions in tax losses. As of September 30, 2003, a database on shelter transactions that IRS has publicly declared to be tax avoidance transactions suggested the potential tax loss to be about \$33 billion, the majority of which was concentrated from tax year 1993 through the present. This database included only transactions disclosed to or discovered by IRS. In addition, an IRS contractor estimating annual tax gaps resulting from abusive shelters estimated that the annual average of foregone taxes between 1993 and 1999 could have been as small as about \$11.6 billion or as large as about \$15.1 billion. However, Treasury, IRS, the contractor, and we all have concerns about the reliability of the contractor's estimates because of methodological and data constraints that the contractor faced.
 - The broad-based strategy reflected in IRS planning documents included various features as well as elements of strategic planning:
 - targeting promoters to head off the proliferation of shelters;
 - making efforts to deter, detect, and resolve abuse;
 - coordinating efforts throughout IRS;
 - offering inducements to individuals and businesses to disclose their use of questionable tax practices; and
 - using performance indicators to measure outputs and some outcomes and intending to continue down the path it has started and develop long-term performance goals and measures linked to those goals. Without these latter elements, Congress would find gauging IRS's progress difficult.

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- In developing this strategy, IRS has had to make decisions about staffing allocations and what can be accomplished on the basis of admittedly limited information. After using a systematic process to determine staffing priorities, IRS planned a significant shift in resources to address abusive shelters in fiscal years 2003 and 2004. However, it faces challenges, especially in the near term, in addressing abusive shelters due to a growing workload and limited information on how long it takes to examine shelter cases. IRS's understanding of how many staff will be needed to address the problem over what period will continue to evolve as IRS gains a better understanding of the problem's scope.

Background

Although IRS has no single, authoritative definition of abusive shelters, IRS generally characterizes abusive shelters as very complicated transactions that sophisticated tax professionals promote to corporations and wealthy individuals, exploiting tax loopholes and reaping large and unintended tax benefits. As the Joint Committee on Taxation has said, "taxpayers and tax administrators have struggled in determining the line between legitimate 'tax planning' and unacceptable 'tax shelters.'" Even though, it continued, "there is no uniform standard as to what constitutes a tax shelter ... there are statutory provisions, judicial doctrines, and administrative guidance that attempt to limit or identify transactions in which a significant purpose is the avoidance or evasion of income tax."⁴

Abusive shelters have been promoted by some accounting firms, law firms, and investment banks. Investors in these abusive shelters range from large and small corporations to wealthy individuals. IRS approaches the tax shelter enforcement problem from both the promoter and investor perspectives. IRS promoter investigations are designed to learn (1) what abusive shelters have been promoted, if the shelters are registered,⁵ and possibly how much they cost investors, (2) who purchased the shelters and what tax savings the investors expect, and (3) whether promoters should pay penalties for their activities. IRS examines investor and other tax

⁴Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters*, JCX-19-02 (Washington, D.C.: Mar. 19, 2002).

⁵A promoter or other tax shelter organizer must register a tax shelter with the Secretary of the Treasury by describing it and its tax benefits. The Secretary assigns the shelter an identification number.

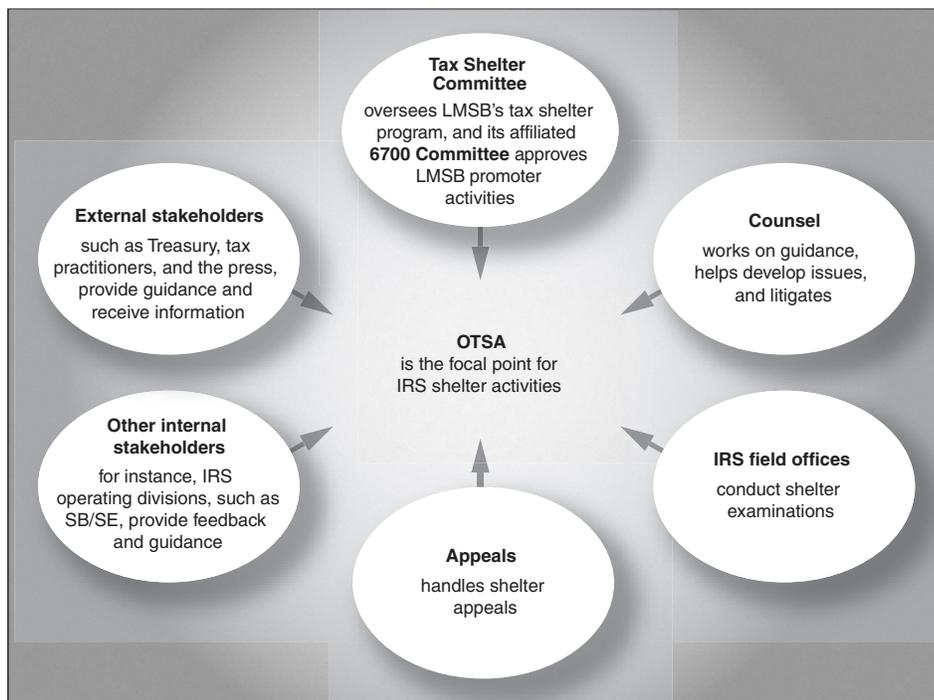
returns to see if income, expenses, taxes, and credits are accurately reported.

In a June 2002 letter, Treasury responded to congressional questions about whether Treasury had a comprehensive strategy for combating tax avoidance. In his letter to the then Ranking Member of the Committee on Finance, then Secretary of the Treasury O'Neill addressed the actions being taken to combat abusive shelters, referring to Treasury's March 20, 2002, enforcement proposals on the topic. The proposals said that IRS had made significant organizational improvements to coordinate its response to ongoing abusive tax shelters. Treasury, all of IRS's operating divisions, and IRS's Office of Chief Counsel are involved in combating abusive shelter activity.

Within IRS, LMSB has primary responsibility for combating abusive tax shelter activity. LMSB's OTSA was created in February 2000 to centralize and coordinate the IRS response nationwide. As shown in figure 1, OTSA is the focal point for IRS shelter activities, overseeing promoter tax shelter registrations; taxpayer disclosures of tax shelters; hotline tip analysis and referral; and issue coordination and interface between the Office of Chief Counsel, Treasury, the Tax Shelter Committee, the 6700 Committee (referring to section 6700 of the Internal Revenue Code), and external stakeholders.⁶ The Tax Shelter Committee oversees LMSB's tax shelter program. The committee is composed of the Commissioner and Deputy Commissioner of LMSB, the Director of Pre-Filing and Technical Guidance, LMSB Division Counsel, five Industry Directors, the Director of International, and the Directors of Field Specialists and Research and Program Planning. The 6700 Committee serves under the Tax Shelter Committee and approves all LMSB tax shelter promoter activities. The financial services' industry director chairs this committee. IRS's appeals function receives and evaluates taxpayer objections to IRS examination determinations and may agree with those determinations or reduce or eliminate changes to tax returns resulting from them. The Office of Chief Counsel plays an integral role in combating shelters through summons enforcement and targeted litigation. By litigating, IRS establishes case law supporting IRS enforcement programs and aims to diminish the incentives taxpayers find for investing in tax avoidance transactions by increasing the risks and costs of IRS discovery.

⁶Section 6700 covers penalties for promoters of abusive shelters.

Figure 1: OTSA's Role in Coordinating IRS Work on Abusive Shelters



Source: Compiled by GAO from IRS information.

Nature of Abusive Shelters Is Varied and Complex

Abusive shelters are complex transactions that manipulate many parts of the tax code or regulations and are typically buried among "legitimate" transactions reported on tax returns. Because these transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters are promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. They may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult.

When a transaction has certain abusive characteristics defined by section 6111 of the Internal Revenue Code, the promoter or other tax shelter

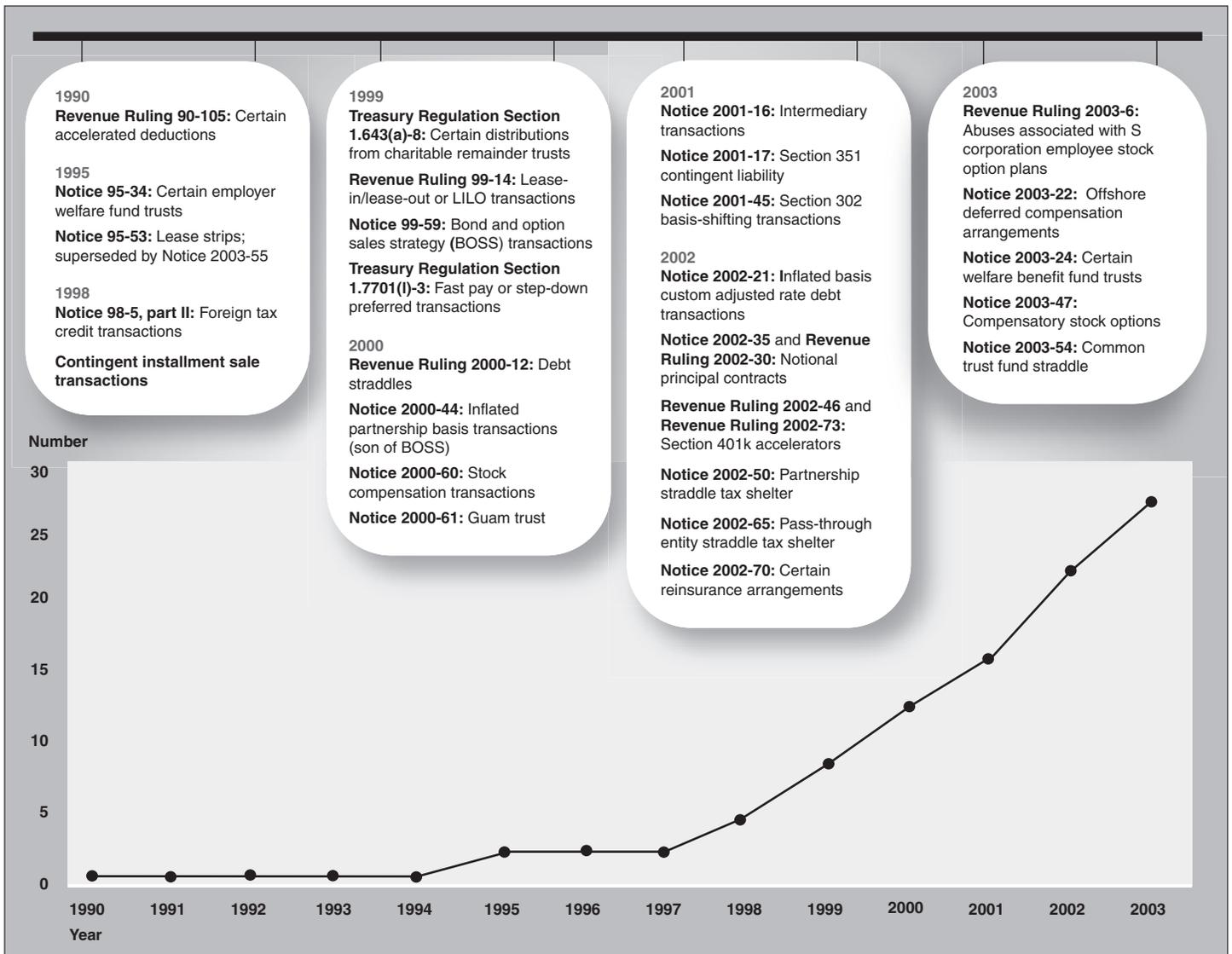
organizer is required to register it, describing the transaction and its tax benefits to the Secretary of the Treasury. This registration requirement enables Treasury and IRS to identify and evaluate questionable transactions. Under recently issued Treasury regulations,⁷ effective February 28, 2003, there are six categories of transactions for which promoters must maintain lists of investors who have entered into the transactions, and investors must disclose the transactions into which they have entered. The rules are designed to allow IRS to use information from investors to identify promoters who do not register transactions and to use promoter registrations and investor lists to identify investors who fail to disclose transactions. The six categories are

- transactions offered under conditions of confidentiality,
- transactions including contractual protections to the investor,
- transactions resulting in specific amounts of tax losses,
- transactions generating a tax benefit when the underlying asset is held only briefly,
- transactions generating differences between financial accounts and tax accounts greater than \$10 million, and
- “listed transactions.”

A “listed transaction” is a transaction that is the same as or similar to one of the types of transactions IRS has determined to be a tax avoidance transaction. For a transaction to be a listed transaction, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. As of mid-August 2003, IRS had listed 27 kinds of abusive tax shelter transactions, a number that, as figure 2 shows, has grown more quickly in recent years than it had grown earlier.

⁷Treas. Reg. Sec. 301.6112-1 and Treas. Reg. Sec. 1.6011-4.

Figure 2: Cumulative Number of Listed Transactions over Time, 1990–mid-August 2003, and Transaction Descriptions



Source: Compiled by GAO from IRS information.

Disputes between IRS and taxpayers about the abusive nature of a transaction may be litigated. In some, but not all, cases, the courts have upheld the government position. The following cases illustrate features of abusive shelters:

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- In 1993, a corporation began a company-owned life insurance (COLI) program in which the company purchased whole-life insurance on 36,000 employees for which the company was the sole beneficiary. The company then borrowed money against the policies at interest rates that averaged 11 percent and deducted the interest expense and administrative fees from income on its tax returns. Over 60 years, the interest costs and administrative fees would have exceeded the cash surrender value of the policies and benefits paid by several billion dollars. IRS disallowed the deductions and the case was litigated. Despite the fact that the money the company made on this arrangement may have been used to fund the company's benefits program, or for other business purposes, the court found that the function of the program itself was only to generate tax deductions. As a result, the Tax Court sustained the IRS disallowance of deductions and concluded that the COLI program was a sham.⁸ The Eleventh Circuit Court of Appeals affirmed the Tax Court's decision.
 - A company had a sizable gain from the sale of a subsidiary and wanted to avoid or minimize paying tax on the gain. An investment bank proposed forming an offshore partnership with a foreign corporation (a tax-indifferent party) for the express purpose of sheltering the capital gains of its corporate client. The partnership purchased and quickly resold notes in a contingent installment sale transaction. The partnership earned a large capital gain, most of which it allocated to the foreign corporate partner. Later, related losses were allocated to the U.S. corporation, generating an approximate \$100 million capital loss for the investment bank's client. The corporation used this capital loss to shelter its U.S.-based capital gains. Both the Tax Court and the Third Circuit Court of Appeals ruled that the transaction lacked economic substance.⁹ The Third Circuit, in addition to requiring economic substance, held that a transaction must have a subjective nontax business motive to be respected for tax purposes.¹⁰ For this transaction, the investment bank was to earn a fee of \$2 million. This was one of 11

⁸*Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

⁹*ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g*, 73 T.C.M. 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).

¹⁰*Id.* at 248.

such partnerships formed over a 1-year period from 1989 to 1990 by the investment bank.

Several Sources Indicate That the Scope of Abusive Shelters Is in the Tens of Billions of Dollars, Though All Are Based on Limited Data

IRS has information that suggests the scope of abusive shelters totaled tens of billions of dollars over about a decade,¹¹ but those estimates are based on limited data. This information comes from an OTSA database, examinations of large corporations, and a contractor study. Information contained in the OTSA database includes transactions disclosed to or discovered by IRS and estimates of potential tax losses. The tax loss estimates vary from being IRS officials' recommended taxes based on examining some transactions to taxpayer judgments regarding potential losses in cases where examinations have not been done. In addition to being based on judgments, the database does not include any reductions resulting from examination, appeal, litigation, or other sources. Information from examinations of the largest corporations, which may overlap information in the OTSA database, shows proposed income adjustments in the tens of billions of dollars before reductions, but data were not available from IRS on the results of examinations of smaller corporations, partnerships, trusts, S corporations, or individuals. Information from IRS's contractor study estimates an annual tax gap due to abusive shelters but has data and methodological limitations.

OTSA Database

As shown in table 1, as of September 30, 2003, an OTSA database included estimated potential tax losses of about \$33 billion from investments in listed transactions, before considering any reductions resulting from examination, appeal, litigation, or other sources and another \$52 billion in potential tax losses from nonlisted transactions with some characteristics of abusive shelters. This database contains information on promoters and investors and the amount of potential tax savings resulting from listed and nonlisted transactions. Nonlisted transactions are transactions that needed to be registered because they have some characteristics of abusive shelters but were not, at least yet, determined to be abusive. According to an IRS official, IRS was studying nonlisted transactions with about \$12 billion in potential tax losses for possible listing. The database only

¹¹For the decade from 1993 through 2002, corporations paid almost \$2 trillion in income taxes.

includes information on abusive or possibly abusive transactions that had been disclosed to or discovered by IRS.

Table 1: IRS's Compilation of Tax Shelter Amounts as of January 14, 2003, and September 30, 2003

Category of transaction	Number of transactions as of		Potential tax loss (billions) ^a as of	
	January 14, 2003	September 30, 2003	January 14, 2003 ^b	September 30, 2003
Listed	3,423	5,185	\$29.3	\$33.0
Nonlisted	1,334	1,582	44.7	52.0
Total	4,757	6,767	\$73.9	\$85.0

Source: IRS OTSA database.

^aThe potential tax loss covers a multiyear period and does not consider reductions that may result from examination, appeal, litigation, or other sources.

^bThe numbers do not add to the total due to rounding.

The estimated tax losses contained in the OTSA database cover a wide range of years from at least as far back as tax year 1989 and extending even to future tax years since, for instance, improperly claimed deductions may be used in some cases to reduce future taxes. For the \$29 billion in estimated tax losses associated with listed transactions contained in the January 14, 2003, database, about 82 percent of the potential tax losses were concentrated in the period from 1993 through 2002.

According to data IRS provided in mid-October 2003, OTSA had information on almost 300 firms that had possibly promoted abusive shelters as well as other tax planning products that contain at least some features of abusive transactions. It was also aware of about 6,400 investors, including individuals and corporations that bought abusive shelters and other aggressive tax planning products.

Examinations of Large Corporations

IRS has proposed shelter-related adjustments to large corporations' income in examinations it has closed and in examinations still open as of early May 2003. In cases closed between October 1, 2001, and May 6, 2003, IRS proposed about \$10.6 billion in abusive shelter-related adjustments to the income of 42 large corporations for tax years 1992-2000. These proposed adjustments would result in about \$3.5 billion in tax revenue if the adjustments were not reduced. The corporations were in what is known as the Coordinated Industry Case (CIC) program, which includes the nation's

largest corporations.¹² They agreed with about \$1.2 billion of the \$10.6 billion in proposed adjustments to income.¹³ As of early August 2003, Appeals research showed that few of the issues comprising the \$9.4 billion unagreed amount had been resolved yet by Appeals or through a settlement initiative, although the database did not track all of them.¹⁴ For the 141 large corporations with cases still open in early May 2003, the amount of proposed shelter-related income adjustments was \$47.6 billion, translating to about \$16 billion in tax if not reduced. IRS did not have similar information for smaller corporations. Also, since one of the sources of information in the OTSA database is shelter-related adjustments proposed in examinations, the proposed adjustments in the CIC program may overlap the information in the OTSA database.

Contractor Study

In July 2003, an IRS contractor estimated the tax gap resulting from abusive shelters for different years. For 1993 through 1999, based on the contractor's estimates, the average annual tax gap could have been as small as about \$11.6 billion or as large as about \$15.1 billion of forgone tax. However, the reliability of the contractor's estimates is questionable because of methodological and data constraints the contractor faced when developing them.

The estimates followed a September 2001 recommendation by the Treasury Inspector General for Tax Administration (TIGTA) that LMSB obtain a more precise estimate of the shelter problem to lay a better foundation for its strategy for addressing abusive shelters.¹⁵ In response, IRS contracted for models to predict the likelihood of finding abusive shelters within

¹²Under the CIC program, IRS continually audits about 1,100 of the nation's largest corporations, all of which have assets of more than \$250 million.

¹³IRS did not track the additional tax payments these corporations actually made related just to the shelter-related adjustment. However, according to data provided by IRS, they paid about an additional \$552 million in taxes related to all issues raised by IRS, including the abusive shelter issues.

¹⁴In mid-August 2003, IRS gave us information showing that for the 14 abusive shelter transactions Appeals had closed in fiscal year 2003 for CIC and other cases, Appeals sustained about 71 percent of the dollar amounts proposed as adjustments to income. Similar information was not available for earlier years.

¹⁵TIGTA, *Management Advisory Report: The Strategy for Curbing Abusive Corporate Tax Shelter Growth Shows Promise but Could Be Enhanced by Performance Measures*, Report Number 2001-30-159 (Washington, D.C.: Sept. 13, 2001).

certain tax returns and to estimate the annual “tax gap” due to abusive shelters. Both IRS and contractor officials believe the contract results are more useful to predict returns with abusive shelters than they are to value the size of the abusive shelter problem.

Nevertheless, as table 2 shows, the contractor produced estimates of the size of the problem for each year from 1993 through 1999. Yearly low-end estimates ranged from \$9.0 billion of foregone tax in 1993 to \$14.5 billion in 1999. On the other hand, the high-end estimates ranged from \$12.1 billion in 1993 to \$18.4 billion in 1999.¹⁶ Averaging the estimates over time results in the \$11.6 billion to \$15.1 billion range cited earlier.

Table 2: Contractor Estimates of the Size of the Abusive Shelter Problem (Dollars in Billions)

Year	Lower bound	Upper bound
1993	\$ 9.0	\$12.1
1994	9.5	12.7
1995	10.3	13.6
1996	11.4	14.9
1997	12.7	16.4
1998	13.6	17.3
1999	14.5	18.4
1993-1999 average	11.6	15.1

Source: Report provided by IRS.

Note: As computed by the contractor, the lower and upper bounds are the boundaries of 90 percent confidence intervals associated with the estimates.

The tax gap model used three different kinds of data: (1) IRS’s Statistics of Income data for the largest U.S. companies, those with assets over \$250 million falling within the CIC program, (2) Standard and Poor’s Compustat financial data, and (3) surveys of IRS field offices. IRS conducted surveys from 1999 through 2001 that asked field managers to identify abusive tax shelters in their open inventory of examinations--

¹⁶Because the contractor found that estimating the problem’s size was difficult and problematic, it applied a statistical technique to the estimates and produced other estimates for each year. However, because it did not believe the statistical technique improved the original estimates, we are not including the second set of estimates here.

relying on each manager's understanding of what an abusive tax shelter is. Since survey data are included in the OTSA database, some of the same information used by the contractor appears in the OTSA information cited earlier.

Treasury, IRS, the contractor, and we have concerns about the contractor estimates. First, it is difficult to determine whether these estimates might be overstating or understating the true extent of the tax gap because of the uncertainties in the underlying data and the elusive nature of the problem. In identifying abusive shelters in the IRS surveys, field managers might have anticipated that some abusive shelters existed where there were none or where the assertion of abuse might not be sustained. On the other hand, they might not have identified all the abusive shelters in their open inventory of examinations because their definitions of abusive shelters might have differed from each other. Finally, the data might not be representative of all transactions, especially those that closed, because survey responses were only to include open cases.

Second, the Statistics of Income data only included U.S. corporations with assets of over \$250 million falling within the CIC program. Many shelters may be reflected in tax returns of smaller corporations, partnerships, Subchapter S corporations, and wealthy individuals and were not included in this study. Since these transactions were not included in the contractor's estimate, the resulting tax gap estimate is incomplete.

Third, the estimates are based on known shelters. They were developed using 1990s' ideas of what constituted abusive shelters. Since then, more shelters have been disclosed or identified by IRS and still others are under consideration for listing. Since the definition of an abusive shelter can change over time, and the data cannot reflect unknown or unidentified shelters, the operational definition of abusive shelters was a conservative one.

While the last two concerns argue that the contractor's estimates understate the true level of abusive shelters for recent years, the contractor's estimates and other indicators of the problem's size based on past data may also be of limited use as guides to current and future activity for other reasons. According to Treasury and IRS officials, the legal and economic environment has changed since the data for this study were developed. First, they said, IRS has taken many administrative actions to address abusive shelters. For instance, it is their belief that nothing puts more of a damper on taxpayer participation in a particular type of

transaction than IRS listing it. Similarly, although corporate-owned life insurance transactions may heavily influence the contractor's estimates, legislation addressed the problem in 1996 and 1997, and therefore current and future estimates would not reflect that problem—although they could reflect problems not identified in the period covered by the contractor's study. Second, court cases have largely supported IRS's assertions about the need for business purpose requirements and about requirements for economic substance in transactions. Third, today's economy is not as robust as the economy in the late 1990s, generating less profit to protect. Finally, the publicity surrounding numerous corporate scandals may create a chilling effect in the market for aggressive transactions. Countering these points, however, are other opinions appearing in the press that (1) the courts could uphold some tax shelters and (2) IRS's capacity to stem abusive shelters is limited.

IRS Strategy to Combat Abusive Shelters Is Broad-Based but Generally Has No Long-Term Performance Goals or Measures Linked to Goals

IRS developed a broad-based strategy for combating abusive shelters that included various features as well as elements of strategic planning. Deeming it a strategic initiative, IRS is executing a strategy incorporating four principal elements: (1) an emphasis on promoters, (2) efforts to deter, detect, and resolve abuse, (3) coordination of efforts throughout IRS, and (4) inducements provided for taxpayers to come forward and expedite case resolution. IRS is implementing a variety of initiatives designed to reduce taxpayer incentives to participate in abusive transactions and discourage promoters from marketing these transactions. Although IRS documents outline an overall strategy for combating abusive shelters, IRS has generally not yet defined long-term performance goals for the effort and the measures it would use to track progress in achieving those goals.¹⁷ However, IRS is planning to establish such goals and measures when it has more information on the abusive shelter activities it is currently tracking.

IRS Is Actively Pursuing Promoters

IRS is actively pursuing abusive promoters to ensure (1) that tax strategies containing characteristics of potentially abusive shelters are registered, (2) that information about transactions is disclosed to IRS as required by

¹⁷Although GPRA is generally applied to agencywide strategic plans, its framework is useful to guide any type of planning. GPRA requires long-term strategic and annual performance goals and associated measures, preferring measures relating to outcomes (results) versus outputs (activities). The Office of Management and Budget says that strategic plans set out long-term goals, outlining planned accomplishments and their implementation schedule.

sections 6111 and 6112 of the Internal Revenue Code, and (3) that, according to IRS's OTSA manager, those who generate noncompliance change their behavior or go out of business. With 98 abusive shelter promoters approved for investigation as of June 30, 2003, IRS uses investigations to gain access to lists of the clients who buy promoters' products and devise a roadmap to audit shelters included in the tax returns of the investors. IRS is also using promoter investigations to enforce the transaction registration requirements, which, in turn, assist in its efforts to understand, track, and close abusive shelters. IRS announced the completion of three large promoter investigations in 2001 through July 2003. They resulted in, among other things, three substantial payments and promoter promises to work with IRS to ensure ongoing compliance with shelter registration and list maintenance requirements.

IRS Efforts Are to Deter, Detect, and Resolve

IRS focuses its efforts on deterring future marketing and sales of abusive tax shelters and on detecting and resolving existing shelters. TIGTA described IRS's abusive shelter approach along the lines of deter, detect, and resolve in September 2001.¹⁸ IRS considers its efforts to provide guidance as early as possible to taxpayers and promoters in the form of recently proliferating IRS and Treasury determinations, notices, and rulings on abusive transactions and of registration, list maintenance, disclosure, and other requirements to be a key deterrent. (See fig. 2.) Also designed to deter abusive tax shelters, accuracy-related penalties aim at investors who use abusive shelters to substantially undervalue true tax liability. Other penalties are for promoters who market shelters that aid and abet the understatement of tax liability or who fail to register shelters. IRS's Examination Returns Control System showed IRS assessing 21 investor penalties totaling about \$73 million between July 1, 2002, and May 1, 2003, which taxpayers had not necessarily agreed to pay. During our review, Treasury included proposed legislation in the Administration's revenue proposals to strengthen the penalties that could be used in abusive shelter situations.

IRS's ability to detect abusive shelters increased in the last 3 years due to OTSA's hotline, through which callers provide tips about transactions or investors; disclosure, registration, and list maintenance requirements; increased attention by IRS management; and increased use of IRS

¹⁸TIGTA, Report Number 2001-30-159.

examination resources to look for shelter irregularities. For instance, between May 31, 2000, and July 30, 2003, the hotline received 729 shelter-related telephone calls and e-mails, some of them leading IRS to new listed transactions, promoters, and investors. As another example, IRS expanded its disclosure requirements in June 2002 to include noncorporate taxpayers. Finally, as evidence of increased management attention, IRS established a new senior position reporting to the IRS Chief Counsel to supervise staff and lead task force initiatives to more quickly identify and deal with abusive shelters.

Cases may be resolved at the examination level if taxpayers agree with IRS findings. If taxpayers do not agree, cases are resolved at the appeals level, through litigation, or by alternative dispute resolution.

In addition to these detection and case resolution efforts, IRS is using Schedule K-1 data to research better methods of detecting abusive shelters that involve multiple levels of flow-through entities.¹⁹ These complex structures of related entities pose challenges in analyzing tax compliance by creating opportunities for taxpayers to disguise noncompliance. In the future, IRS hopes to use advanced data analysis tools such as link analysis and graph-based data mining to identify potential abusive shelters. Link analysis is the process of building networks of related entities, such as flow-through entities and Schedule K-1 recipients, in order to expose patterns and trends. Graph-based data mining, a form of link analysis, is intended to enable IRS to identify structures of known abusive shelters and find similar patterns in the population of flow-through networks to discover previously undisclosed potential abusive shelter transactions. IRS has paid a contractor \$200,000 so far to assess the feasibility of these technologies and plans to spend \$575,000 over the next 1.5 to 2 years to develop these concepts into models.

IRS Emphasizes Internal Coordination

Coordination within IRS and interface with Treasury on abusive shelters is a core objective in IRS's plans for addressing those shelters. OTSA is the focal point for all shelter-related activity performed in the Tax Shelter Committee, the 6700 Committee, Counsel, Appeals, and LMSB. For example, if a taxpayer discloses an investment in a tax shelter to IRS, OTSA is to enter the transaction into its database, and OTSA reviews the

¹⁹Appendix I describes the Schedule K-1, flow-through entities, and other compliance efforts using Schedule K-1 data.

transaction in collaboration with IRS technical advisors and counsel. OTSA may also forward it to LMSB examiners for compliance action.

At the IRS-wide level, an executive steering committee provides a forum for coordinating work on both abusive shelters and abusive schemes. It meets monthly and includes participants from LMSB, the Small Business/Self Employed Division, Appeals, Counsel, and other organizations. It operates under the auspices of IRS's Enforcement Committee, which was chartered in July 2003. Chaired by the Deputy Commissioner for Services and Enforcement, a new position created in May 2003, the Enforcement Committee is to guide IRS-wide enforcement strategies, focusing on high-visibility issues involving many divisions or potentially having significant compliance impact.

Although we did not systematically measure whether coordination is facilitated by these mechanisms, we did review minutes of selected executive steering committee meetings. In doing so, we saw such evidence of coordination as the discussion of an LMSB and SB/SE working group on who would work a corporate officer case when LMSB works on a corporation.

IRS Offers Inducements for Taxpayers to Disclose Shelters and Expedite Case Resolution

LMSB attempts to leverage its limited resources by using inducements to achieve compliance. These tools include penalty relief, "fast track" issue resolution, and various structured settlement programs that allow participating taxpayers to keep a percentage of a shelter's benefits in exchange for conceding most benefits and expediting case resolution. For example, under a disclosure initiative that expired on April 23, 2002, taxpayers who revealed shelters and their respective promoters avoided accuracy-related penalties. IRS's aim was to more readily identify promoters who had not registered shelters and, through the promoters, find taxpayers who had not disclosed their shelter participation. As a result of this initiative, IRS received 1,664 disclosures from 1,206 taxpayers, disclosing tens of billions of dollars of losses and deductions.

IRS offered taxpayers various alternative dispute resolution mechanisms as inducements to settle abusive shelter issues with IRS, mitigating the hazards of litigation for both sides and moving more cases through the administrative system quickly. For example, from October 2001 through April 7, 2003, 17 taxpayers agreed with IRS on their respective shelter issues in the Fast Track Issue Resolution program, resolving about \$1.6 billion in proposed adjustments to income (potentially about

\$540 million in tax). In another example, IRS announced initiatives in October 2002 to resolve disputes related to three shelters: COLI, basis-shifting shelters, and contingent liability shelters.²⁰ In these initiatives, if taxpayers agreed to settle their cases with IRS by a certain date, with the last initiative closing March 5, 2003, they would pay a large percentage of the full amount IRS disallowed. A summary as of early May 2003 of the number of investors involved in the three settlement initiatives and the potential tax dollars conceded or to be conceded appears in table 3.²¹

Table 3: Investors Accepting Abusive Shelter Settlement Initiative Offers and Potential Tax Dollars Conceded or to Be Conceded as of Early May 2003

Settlement initiative	Number of taxpayers accepting IRS settlement offer	Number of taxpayers for whom IRS had information on taxes conceded or to be conceded	Potential tax dollars conceded or to be conceded (billions)
COLI	24	14	\$0.2
Basis shifting	267	33	0.6
Contingent liability	62	62	2.8 ^a
Total	353^b	109^b	\$3.6

Source: Compiled by GAO from IRS data.

^aGAO estimated this number using an average of certain capital loss percentages to be conceded.

^bWe do not know if a particular taxpayer was involved in more than one type of settlement initiative.

Generally IRS Does Not Have Long-Term Performance Goals or Measures Linked to Goals

Although IRS has outlined and begun to implement a multipart strategy for combating tax shelters, it has not yet generally defined performance goals for the effort and established the measures it would use to track progress in achieving those goals. Performance goals define what an organization is

²⁰IRS Notice 2001-51 identifies certain listed transactions. It describes basis-shifting transactions as “certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer.” It describes contingent liability transactions as “transactions involving a loss on the sale of stock acquired in a purported [Internal Revenue Code section] 351 transfer of a high basis asset to a corporation and the corporation’s assumption of a liability that the transferor has not yet taken into account for federal income tax purposes.”

²¹Some of these investors are also included in the fast track program just described.

trying to achieve over time, preferably focusing on the outcome desired rather than activities or outputs. To date, according to IRS officials, their shelter-related goals cover the number of staff years to be devoted to shelter examinations and the number of shelter examinations to be closed. Also, LMSB planning documents have a few short-term goals. For example, LMSB had a short-term goal to begin compliance actions on all voluntary shelter disclosures by June 30, 2003, a goal IRS officials told us was met. IRS management officials recognize that developing other performance goals and associated measures to track progress is desirable but point to challenges they face in assessing the scope of the abusive shelter problem. Nonetheless, IRS intends to establish such goals in the future when it has more information on activities it is currently tracking.

IRS has already started down this road by developing several measures that, while not tied to longer-term performance goals, are to be used in tracking its progress in combating abusive tax shelters. It devised these measures for fiscal year 2003 responding to a September 2001 TIGTA recommendation to develop performance measures so managers could better target problem areas, highlight successes, evaluate alternatives, and track whether OTSA is achieving desired outcomes. IRS is mostly tracking outputs related to case management, such as the number of tax shelter examinations closed and tax shelter return cycle time, and is using output measures of IRS program activities, such as published guidance issued and hotline contacts. IRS is also using some measures that track tax enforcement outcomes, namely adjustments proposed to tax returns from disallowing abusive shelters and tax shelter penalties proposed.²² Since fiscal year 2003 was the first year IRS used these measures, it had no baseline data with which to evaluate its performance measures. However, LMSB plans to evaluate its measures over time to assess their usefulness.

²²LMSB called the tracking of adjustments a “record of tax enforcement results.” IRS does not use performance measures for outcome measures like these because the IRS Restructuring and Reform Act of 1998 prohibited it from using tax enforcement results to evaluate any employee or to impose or suggest production quotas or goals.

Resource Shifts Are Significant but IRS Faces Challenges in Addressing Abusive Shelter Workload

Using admittedly limited information, IRS used a systematic decision-making process in deciding to shift a large portion of LMSB examination staff resources toward addressing abusive shelters. From fiscal year 2002 through fiscal year 2004, LMSB expected to increase the portion of its examination resources devoted to combating abusive shelters from 3 percent in 2002 to 20 percent in 2004. In doing so, it will have shifted resources out of examining the category of cases including such areas as net operating losses and claims for refunds. Even so, IRS faces challenges, especially in the near term, in addressing expected increases in its shelter workload because of the growing number of shelter cases and limited information it has on how long it takes to conduct shelter examinations. As will be described, GAO has previously raised questions about IRS's ability to shift compliance resources as planned.

IRS Used Systematic Planning and Budgeting Process to Determine Staffing Priorities

At an agencywide level, IRS decided staffing resource levels to be devoted to addressing abusive shelters through a systematic planning and budgeting process based on experience and professional judgment because IRS did not and does not have a reliable measure of the abusive shelter problem. Early in calendar year 2002, IRS's divisions completed strategic assessments in which they studied trends, issues, and priorities affecting their operations. In April 2002, IRS's senior management team, including the Commissioner, Deputy Commissioner, division heads, and others used two rounds of considering IRS's programs to rank the needs for new or redirected funding for fiscal year 2004. Of 33 programs considered, the program including tax shelters received the third most votes. According to an IRS official, this process also informed how funds already requested for fiscal year 2003 would actually be spent. After the senior management team reached consensus, the Commissioner issued overall planning guidance for fiscal years 2003 and 2004 to reflect the jointly set strategic direction, and the divisions wrote fiscal year 2003 and 2004 "strategy and program plans" outlining staffing resources needed.

IRS Shifts Significant Levels of Examination Resources to Shelters

In 2002, LMSB put forward plans to increase its work on abusive shelters from 3 percent of its examination resources to 20 percent between fiscal years 2002 and 2004, assuming congressional funding. To support this shift in examination resources, LMSB needed to allocate examination resources away from other areas. One area to receive less audit coverage was

industry audits.²³ As shown in table 4, from fiscal year 2003 to fiscal year 2004, IRS planned to move resources away from specific types of mandatory examinations and from some high-risk nonmandatory returns.²⁴ IRS's strategy is to mitigate the impact of resource reallocations away from nonshelter areas by using such issue management strategies as fast-track resolution and prefiling agreements, thereby requiring less staff time to close cases and freeing staff to be used in other areas.

Table 4: Percentage of LMSB Examination Resources in Different Examination Areas

Examination area	FY 2002 ^a	FY 2003	FY 2004
Shelters	3%	15%	20%
Other mandatory examinations (including coordinated industry, ^b claims for refunds, net operating losses, compliance initiative projects, and flow-through entities related to wealthy individuals)	N/A	55%	54% ^c
Related returns	N/A	5%	4% ^c
High-risk, nonmandatory returns	N/A	15%	13%
Nonreturn examination activities	N/A	10%	10%
Total	--	100%	100% ^d

Source: LMSB September 20, 2002, presentation to the IRS Oversight Board, as amended after the presentation.

^aInformation for most of the rows in this column was not available, as the presentation to the Oversight Board did not include it.

^bCoordinated industry cases are examinations of the nation's largest corporations, those under continual IRS audit.

^cAt the time of the September 20, 2002, presentation to the Oversight Board, the 54 and 4 percent were 52 and 5 percent, respectively.

^dThe column does not add to 100 percent because of rounding.

²³IRS defines an "industry" case return as the return of an organization with assets of more than \$10 million but without being part of the largest corporations that are under continual IRS audit.

²⁴According to LMSB officials, mandatory examinations are those LMSB knows it will do, such as those for abusive shelters and promoters. Nonmandatory examinations are what remain after mandatory work is accommodated. High-risk nonmandatory examinations are those in the nonmandatory category that have the highest probability that a taxpayer needs compliance activity.

In addition to LMSB examination staff, IRS has managers, attorneys, and others who work on abusive shelters. For instance, in February 2003, OTSA and its parent body, the Office of Pre-Filing and Technical Guidance, had 39 full-time and 34 part-time technical experts, program analysts, and managers. Also at that time, a contact list for listed transactions included 17 attorneys. These numbers did not include many of the IRS legal resources involved with abusive shelters. In addition, as of September 30, 2003, LMSB had assigned about 1,900 abusive and potentially abusive shelter transactions involving non-LMSB taxpayers to IRS's Small Business/Self-Employed Division, which supplies examination staff resources of its own.

IRS Faces Challenges in Addressing Increasing Shelter Workload

Although IRS appeared to be on track to shift planned resources to shelter work in fiscal year 2003, it faces challenges in addressing the abusive shelter workload, especially in the near term. This is because of (1) the growing numbers of transactions and promoters to be examined and (2) limited information on how long it takes to conduct shelter examinations.

From fiscal year 2002 through fiscal year 2004, LMSB planned to use 1,879 full-time equivalents (FTE) to address abusive shelters. During fiscal year 2002, LMSB used 239 FTEs to address tax returns that included abusive shelters.²⁵ According to IRS's fiscal year 2004 congressional budget justification, LMSB planned to allocate 691 and 949 FTEs in fiscal years 2003 and 2004, respectively. In a draft strategy and program plan dated September 2003, LMSB projected it would actually use 615 FTEs for shelter work in fiscal year 2003, or 88 percent of the planned amount and an increase of 157 percent over the fiscal year 2002 FTE level including this work.

Because (1) the known abusive shelter workload has increased, (2) IRS has limited experience to judge how many resources will be needed to work the cases for how long a period, and (3) the workload may continue to increase, it remains uncertain whether the substantial shift of resources to shelter work will enable IRS to examine in a timely manner the growing workload associated with shelters. For instance, the number of potential

²⁵According to LMSB officials, the fiscal year 2002 FTEs include time spent on the entire returns containing shelters, not on the shelter issues alone. The estimates for fiscal years 2003 and 2004 are focused more on the shelter issues.

examinations of listed transactions disclosed has grown since the inception of OTSA, adding significantly to IRS resources required to address the problem. Table 5 shows the number of listed transactions disclosed by taxpayers grew from 51 to 2,182 between December 31, 2000, and September 30, 2003, and other transactions disclosed to IRS grew from none to 663. The total of all listed and nonlisted LMSB-related transactions in the OTSA database, not only those disclosed by taxpayers, as of September 30, 2003, was 4,897.

Table 5: Taxpayer Disclosures of Listed and Other Reportable Transactions between 2000 and September 30, 2003

Section 6011 disclosures	Calendar year (CY) 2000	CY 2001	CY 2002	CY 2003 through September 30	Total
Listed transactions disclosed	51	63	1,251	817	2,182
Other reportable transactions disclosed	0	214	308	141	663

Source: IRS.

IRS workload from promoter investigations has also grown since May 2002. At that time, IRS planned that 7 promoter investigations would be ongoing in fiscal year 2003. As of June 30, 2003, IRS had 98 promoter investigations approved. Based on early promoter investigations, an IRS official stated that promoter investigations can take thousands of hours to develop, and several have been litigated, each requiring a large expenditure of resources.

LMSB has limited information on the amount of time required to examine abusive shelter cases. LMSB developed estimates of the amount of examination time required for such cases based on its experience examining various types of shelters but acknowledged that examiners can spend hundreds or thousands of hours depending on the type of shelter examined and the facts and circumstances of the case. For example, according to an LMSB official, based on personal experience, OTSA estimated that it would take about 800 hours to examine a potentially abusive transaction reflected in the return of a CIC corporation although LMSB had little data to support the estimate. During fiscal year 2003, IRS began collecting data on examination time that it plans to use for estimating the resources needed to address its abusive shelter workload.

The future abusive shelter workload also could increase, at least in the short term. For example, as IRS learns more about the use of shelters, it may identify and list new kinds of transactions as being abusive. As IRS

conducts the 98 promoter investigations approved as of June 2003, more investors are likely to be identified, and investor cases could lead to identifying more promoters. In addition, IRS expanded the types of taxpayers subject to disclosure requirements to include taxpayers like individuals, partnerships, and S corporations. According to IRS officials, disclosures from these types of taxpayers are first due to IRS for filing year 2003 and generally do not yet appear in the OTSA database.

In the longer term, what happens to the abusive shelter workload is less certain. To the extent that IRS actions and other factors reduce the size of the abusive shelter problem, IRS might not need to continue devoting as large a percentage of its examination resources to abusive shelters. How much and how soon such a drop may occur in abusive shelter cases is uncertain.

We have previously raised questions about IRS's ability to shift compliance resources as planned. We recently testified that many parties have expressed concern about declining IRS compliance—especially audit—and collection trends for their potential to undermine taxpayers' motivation to fulfill their tax obligations.²⁶ Concerned about these trends, IRS has sought more resources, including increased staffing for compliance and collections since fiscal year 2001. Despite receiving requested budget increases, staffing levels in key occupations were lower in 2002 than in 2000. These declines occurred for reasons such as unbudgeted expenses consuming budget increases and other operational workload increases. Based on past experience and uncertainty regarding some expected internal savings, fiscal year 2004 anticipated staff increases might not fully materialize. Thus, if IRS carries through with its intentions to increase resources devoted to abusive shelters, it may not have the desired level of resources in other areas of compliance.

Concluding Observations

Abusive tax shelters represent a potentially significant, although imprecisely understood, loss in tax revenues. IRS developed and is following a broad-based, multifaceted strategy to combat abusive shelters even though it had limited data on the full scope of the problem. IRS's strategy generally does not contain long-term performance goals and

²⁶U.S. General Accounting Office, *Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives*, GAO-03-732T (Washington, D.C.: May 7, 2003).

associated measures that can help Congress evaluate IRS's progress. Although establishing performance goals and measures is inherently difficult since the scope and nature of abusive shelters is elusive, the need for such goals and measures is heightened because IRS is shifting large amounts of examination staff resources to support combating abusive shelters. IRS's initial decisions on shifting resources might need to be reevaluated as IRS develops better information on the size of the abusive shelter problem and the amount of time it takes to examine abusive shelter cases. We encourage IRS to continue its efforts to obtain a better analytic basis for determining the resources needed to address schemes and shelters—while providing sufficient attention to other tax compliance areas—and to develop goals and measures that it and Congress can use to gauge IRS's progress.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

Contact and Acknowledgements

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IRS Compliance and Research Programs

Using the Schedule K-1

Schedule K-1s are information returns that link flow-through entities with their income recipients and therefore can be used for various compliance and research purposes, such as the automated underreporter (AUR) program¹ and profiling potential nonfilers.

Partnerships, S corporations, trusts, and estates are collectively known as flow-through entities because they can legally pass net income or loss through to their partners, shareholders, and beneficiaries. Flow-through entities are required to provide IRS and each partner, shareholder, or beneficiary with a Schedule K-1 stating the individual share of net income or loss to be reported. These individuals are then responsible for reporting this income or loss on their individual income tax returns and paying any applicable tax. According to IRS in tax year 2001, over 9 million flow-through entities reported passing through almost \$1 trillion to approximately 24 million partners, shareholders, or beneficiaries. IRS research efforts suggest that 6 to 15 percent of the K-1s attached to flow-through returns are currently being omitted from beneficiary, partner, and shareholder returns. To better detect such noncompliance, IRS began transcribing nonelectronically submitted Schedule K-1s for tax year 2000 at a cost of about \$20 million.

In 2001, IRS added Schedule K-1 document matching to its AUR program. It began matching Schedule K-1 data to individual tax returns to identify taxpayers who had underreported flow-through income and had consequently underpaid their taxes. IRS estimated that K-1 matching program costs would be about \$23.5 million total for both K-1 transcription and AUR program operations and that program yield would be \$36 million in direct tax assessed. IRS also estimated that if voluntary compliance improved one percent due to the matching program, approximately \$1.23 billion of additional tax would be generated annually. In the first year of the program, IRS issued about 69,000 notices to taxpayers and assessed about \$29 million in additional taxes directly attributable to Schedule K-1 underreporting.² GAO estimates that when program assessments are compared to the costs of the program's AUR operations, the return per

¹The AUR program matches information return data, such as Forms W-2 and 1099 and Schedule K-1, with individual tax return data to verify that all income is reported.

²IRS began notifying taxpayers of potential discrepancies between income reported on the K-1 and individual tax returns in April 2002. However, after receiving complaints that notices were being sent to compliant taxpayers, IRS stopped issuing notices in August 2002. IRS data on number of notices sent and tax assessed were provided in August 2003.

dollar of the K-1 matching program was about \$9.31. If the cost of transcribing the K-1 data is included, the return per dollar decreases to about \$1.25.³ Both of these assessment-to-cost ratios are substantially lower than that for the AUR program as a whole.⁴ The AUR program returned about \$25 for every dollar spent in tax year 2000.⁵

IRS has also used Schedule K-1 data to determine characteristics of potentially noncompliant taxpayer populations. Its preliminary profiling efforts identified over 227,000 business entities with almost \$64 billion in Schedule K-1 income for tax year 2000 that potentially did not file tax returns. As of September 2003, IRS had begun to discuss ways of analyzing these cases to determine whether these businesses were required, but failed, to file returns, or whether inaccuracies in Schedule K-1 data produced false nonfiler leads. In addition, in response to a Treasury Inspector General for Tax Administration report issued in September 2002,⁶ the agency has begun to research the effectiveness of using information returns, such as the K-1, to identify business nonfilers.

³To increase efficiency and improve the accuracy of K-1 data, IRS is exploring two-dimensional bar coding of Schedule K-1s. Instead of transcribing K-1 data, IRS would scan a bar code on the K-1 and electronically upload the information.

⁴Because the Schedule K-1 document matching program is new, its return on investment may be low compared to mature AUR programs.

⁵Information about the AUR program is based on IRS data from December 28, 2002.

⁶Treasury Inspector General for Tax Administration, *The Internal Revenue Service Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns*, Report Number 2002-30-185 (Washington, D.C.: Sept. 18, 2002).

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