The IRS Audit Myth

By Gary M. Barnbaum

Gary Barnbaum examines a recent GAO report to determine whether the IRS is operating at a profit as the agency claims or at a deficit as the GAO report figures seem to indicate.

"*I know that you'll be honest if you can't always be kind.*" Carole King—Singer

Does the IRS make a profit?

That is an interesting question that most of us would generally, quickly, answer in the affirmative. But what does the question really mean? In this context what does a "profit" mean? (Without regard to the IRS's function as a bank teller—collecting taxes for the Department of the Treasury.)

We have always accepted the assertion that the IRS "makes a profit," even though that claim has always come from the IRS itself. But has that contention ever been independently validated or verified?

Would it be appropriate to use the IRS's definition of a "profit?"

Recently, an IRS territory audit manager in a Southern California region spoke to the San Fernando Valley CPA discussion group, one of the larger CPA groups in the area. The subject of the presentation was an "IRS Audit Update." There were approximately 75 CPAs in attendance for this breakfast and one-hour continuing education lecture.

During the presentation, as part of the handout of materials there was a bar graph entitled "IRS Enforcement Revenue." It covered fiscal years 1996 through 2005. For the year 1996 the amount was shown to be $38.1 billion. When specifically asked "what does the terminology and amounts mean—because the IRS has been known to intermingle terminology?," the IRS spokesman blithely stated that the term meant "collections after audits"

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During the presentation the audit manager compared the current IRS budget of approximately $11 billion to the 2005 total on the graph—$47.3 billion, and stated with great bravado, "we make a profit."

Therefore, we must conclude that by the IRS's own definition, a "profit" simply means collections on audits, over the cost of running the agency.

But does the story end there? Is there any way to verify those figures? Has there ever been an independent study made to validate the claims made by the IRS that they make a "profit?"

It turns out there is. That independent study was made by the General Accounting Office (recently renamed the General Accountability Office).

For the year 1996 the table in the GAO report GAO/T-GGD-97-186, published September 26, 1997, Appendix 1 page 12, entitled "Selected Information About the Returns Filed and Examined and Recommended Additional Taxes (Fiscal Years 1992-1996)" states that in the year 1996 there were 2,136,819 tax returns audited. That was a 1.38% coverage ratio out of 155,279,600 tax returns filed. Of that, $28.1 billion in tax was RECOMMENDED. That was somewhat lower than the graph that was presented. (See Figure 1)

For the year 1996 the table in GAO report GAO/GGD-98-128, published June 1998, Appendix II page 28, entitled "Status of Additional Amounts Recommended for Audits Closed in Fiscal Years 1993–1997 Across Seven Types of Audits" states that "collection status" of "individual nonbusiness" tax returns the collection ratio "as a percent of amount recommended" was 24 percent. Across the entire spectrum of all seven categories the ***collection*** ratio was 22 percent. (See Figure 2)

Right away there appears to be some confusion in terminology. The IRS used the term "Enforcement Revenue" on its own chart, while the GAO used two different terms—tax ***recommended***, and tax ***collected*** in their charts.

We know exactly what the two terms used by the GAO mean. The former is the amount reflected on the audit report. The later is funds that are actually paid into the U.S. Treasury, after negotiations, settlements, trials, bankruptcies, nonpayments, defaults, disappearances and other reasons for reductions or nonpayments. The IRS term "enforcement revenue" is defined as "collections," by the spokesperson for the agency, but is it?

Getting back to the statistics, 22 percent (tax collected) out of the $28.1 billion (tax recommended) is $6.18 billion. During that year, 1996, the IRS budget was $7.2 billion. Based on these figures, would it be fair to assume that the IRS operated at about a $1 billion loss for the year? Or, is the loss even greater? That is a valid question because in reviewing the IRS budget we note that a significant item is missing from the overhead—the cost of operating the tax court system.

So the next obvious question appears to be; does the IRS really make a profit?

There are a few other questions that ought to be asked as well:

1. Was that presentation by the territory manager merely the work of a rogue employee of the IRS, or is that presentation representative of some type of misinformation the IRS is trying to disseminate?
2. Has the IRS used that type of presentation in other situations? For example, before Congress during budget hearings to increase their budget?
3. Are the GAO charts truly representative of what is really going on?
4. Although the numbers have fluctuated over the years in terms of tax returns audited, tax recommended, tax collected, the IRS budget, *etc.,* have the *ratios* changed appreciably over the years, or have the *ratios* remained virtually steady?
5. Has the GAO prepared similar studies since those quoted above?
6. Would it be appropriate for the GAO to engage in similar studies every few years to determine if the IRS is doing any better in terms of profitability?
7. A question for the territory manager could also be; how could his chart contain the results of fiscal year 2005, (recommended or collected) when it sometimes takes six years or more to obtain results on some large, complicated audits?

But the problems do not stop at those two sets of information from the GAO. So lets get even more detailed in our analysis.

For the year 1996, the table in GAO reportGAO/T-GGD-97-186, published September 26, 1997, Appendix IV, Pages 22 and 23, entitled "Number and Percent of Individual Returns Audited by Audit Source (Fiscal Years 1992-96" the column for 1996 reflects that for 13 categories of audit sources, there were 1,941,560 individual income tax returns audited. The chart for the total number of audits for 1996, according to the September 26, 1997, GAO report (above), states that there were 2,136,819 audits of all tax returns. This means that approximately 90 percent of all audits were against individuals. (See Figures 3 and 4) (According to IRS statistics published yearly, 49 percent of all collections into the treasury are from personal income tax.)

The same GAO report (Figure 1) states that the tax ***recommended*** after audits came to $7.6 billion. That comes to about $3,914 per tax return. However, according to the GAO chart in June 1998, the percentage of ***collections*** for

Figure 1:
Selected Information About the Returns Filed and Examined and Recommended Additional Taxes (Fiscal Years 1992–96)

Description	1992	1993	1994	1995	1996
Number of returns					
Filed	152,031,900	153,453,600	152,732,800	154,293,700	155,279,600
Examined	1,452,009	1,300,230	1,426,573	2,100,144	2,136,819
Percent coverage	.96	.85	.93	1.36	1.38
Recommended additional tax and penalties (in billions)	$26.9	$23.1	$23.9	$27.8	$28.1
Individual returns	6.3	5.7	6.2	7.8	$7.6
Corporate returns	18.1	14.7	15.1	17.7	$18.0
All other[a]	2.5	2.7	2.6	2.3	$2.5
Average tax and penalty per return examined by					
Revenue agent for non-CEP[b]	$25,161	$24,704	$18,177	$21,237	$24,407
Revenue agent for CEP	3,940,148	2,700,352	3,279,298	4,032,528	3,998,409
Tax auditor	2,280	2,625	3,113	3,497	3,051
Service center	2,541	2,934	1,945	1,427	1,733

[a]Other includes fiduciary, estate, gift, employment, excise, windfall profit, and miscellaneous taxes.

[b]CEP = Coordinated Examination Program, under which IRS audits the largest corporations.

the three types of individual audits, including audits at the Service Center level, was 25 percent. Therefore, the amount collected was approximately $1.9 billion. If we were to simply allocate 90 percent if the IRS budget to individual audits, the result would be $6.48 billion. Give or take a couple of hundred million on the cost side, would it be fair to say that the IRS is (or at least was) loosing huge amounts on their individual income tax audit program? Is this an effective use and allocation of funds?

Figure 2:
Status of Additional Amounts Recommended for Audits Closed in Fiscal Year 1996 Across Seven Types of Audits, as of September 27, 1997

Table II.4: Status of Additional Amounts Recommended for Audits Closed in Fiscal Year 1996 Across Seven Types of Audits, as of September 27, 1997

Dollars in millions

		Settlement status of recommended amounts[a]			Collection status		
Type of audit	Recommended amounts	Percent of disputes unsettled	Percent not assessed	Percent assessed	Collected amounts	As percent of amount assessed	As percent of amount recommended
Service center	$1,468	1%	16%	83%	$469	38%	32%
Individual nonbusiness	3,379	17	18	65	826	38	24
Individual business	1,633	15	16	69	363	32	22
Small corporation	880	25	27	48	251	60	29
Large corporation	3,135	42	16	41	762	59	24
Coordinated Exam Program	18,093	63	17	20	3,331	92	18
Other[b]	2,183	16	34	50	734	67	34
1996 Total[c]	**$30,771**	**46**	**18**	**36**	**$6,737**	**61**	**22**

[a]Percentages do not total to 100 percent due to rounding.

[b]"Other" includes audits of returns for employment tax, estate tax, excise tax, and gift tax; audits conducted in IRS training; and audits categorized by IRS as other.

[c]Amounts do not add to total due to rounding.

Source: GAO analysis of IRS ERIS data.

The IRS may argue that a substantial portion of their budget is directed to other matters, and not the enforcement and collection effort and should not be considered as part of the overhead cost in this analysis. However, while it may be true that some areas of the IRS budget are not directly related to enforcement and collection, the counter argument would be that based upon its mandate, everything that the IRS does can be attributed in some way to the all inclusive concept of enforcement and collection. This is the same concept that requires all direct and indirect costs to be allocated to the cost of inventory.

The June 1998 report, GAO/GGD-98-128 is entitled, "IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs." It is a rather typical GAO report, addressed to the person who commissioned the report, in this case Representative Rob Portman, of the Committee on Ways and Means. The report is 38 pages long and contains the typical redundancies found in most government reports. But the report does make a few revealing statements, which reflects what one government agency says about another government agency:

"For audits closed in fiscal years 1992 through 1997, the IRS recommended tens of billions of dollars in additional taxes for each year. IRS reported these recommended taxes to Congress as its audit results. However, not all recommended taxes are assessed; and not all taxes are collected." The report goes on to give an example that for 1992 audits, only 25 percent of all recommended tax had been collected. (Page 3)

"IRS has traditionally measured the overall results of audits by the amount of recommended additional taxes and by the amount of direct staff time used in the audit," (Page 1)

"Likewise, the IRS does not measure indirect costs incurred by the Examination Division for training, office space, and the like or the direct and indirect costs that audits create outside of the Examination Division for the IRS." (Page 4)

In effect, the GAO is saying that the IRS uses information to provide a misleading picture. They inflate "revenue" and reduce or eliminate costs and expenses. This is about as direct as any government report ever gets.

Therefore, the information is out there, it has been recognized, but it remains quite esoteric. The GAO never

Figure 3:
Number and Percent of Individual Returns Audited by Audit Source (Fiscal Years 1992–96)

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

Figure 4:
Number and Percent of Individual Returns Audited by Audit Source (Fiscal Years 1992–96)

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

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

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

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

Source: GAO analysis of IRS data.

went the extra step to ask the operative question and put the information together. They just put the fragmented information out there in various reports. Or, perhaps the GAO knew it all along, but because nobody ever asked the question, they never published it. It became a matter of time before someone put the final pieces together to create the full and complete picture.

However, if the IRS continues to ignore the admonitions of the GAO over their reporting policies, then would it be fair to ask the next question? Which is worse? When misleading information is disseminated and they know that the information is deceptive, or, when someone spreads erroneous information and does not know the information is false, but should know the information is fabricated because after so many years they should know better?

This writer made a thorough detailed search of all GAO reports published on tax policy and administration from January of 1997 to the present. The charts, tables, and reports cited in this article that were published by the GAO seem to be the only ones published, that when stitched together, provide any indication of the overall efficiency and profitability of the IRS. One has to wonder if the GAO was ever pointedly told to never again publish that kind of material, which could prove to be extremely embarrassing for the IRS. Yet, this type of analysis could also prove to be extremely important to Congress and to the IRS in terms of the most efficient use of resources.

In all fairness, it must be stated that especially in corporation audits; sometimes it takes many years for them to be concluded. Often, settlements and collections in these cases are delayed for as long as six to eight years. This would have the effect of raising the collection ratio in this specific area somewhat. That is why, there is an indication that the only area where the IRS does make a profit, is in the large corporation audit program. The only question is, does the IRS have enough experienced, highly trained examiners in this area to expand this program?

Conclusion

It appears that the IRS has been using its own set of figures in an attempt to confirm that they "make a profit," while the GAO has published other sets of figures, which indicate that at best, the IRS operates at a moderate overall loss. However, it appears that in some specific areas, the loss is substantial. So the last question we must ask is, where does the GAO get their figures from, if not from the IRS?