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Report to the Commissioner, Internal Revenue Service

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TAX ADMINISTRATION

Audit Trends and Taxes Assessed on Large Corporations

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GAO

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General Government Division

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October 13, 1995

The Honorable Margaret Milner Richardson
Commissioner of Internal Revenue

Dear Ms. Richardson:

This report focuses on the results of the Internal Revenue Service's (IRS) program to audit the tax returns of about 45,000 large corporations. IRS audits of returns filed by these 45,000 corporations plus the 1,700 largest corporations in IRS' Coordinated Examination Program (CEP) have generated about two-thirds of the additional taxes recommended from all income tax audits. Although we have reported on CEP,[1] under which IRS audits the largest corporations, we have not previously studied audits of other large corporations, particularly trends on what IRS invests in and produces from these audits. Until recently, IRS had not analyzed these trends either.

We used IRS data to (1) analyze audit trends for fiscal years 1988 through 1994, (2) compute the assessment rate—the portion of taxes recommended by revenue agents that were eventually assessed, and (3) develop and compare profiles of audited large corporations with those not audited. The second phase of our work, now under way, will analyze factors that affect the assessment rate and review IRS' methodology for estimating it.

Background

For audit purposes, IRS' Examination Division defines a corporation as large or small depending on the amount of assets reported on its income tax return. Small corporations (about 2.4 million) are defined as those that report total assets of less than $10 million.

Corporations reporting higher assets are considered to be large, and IRS audits large corporations in two groups. IRS annually selects about 1,700 of the largest and most complex corporations for CEP. The remaining large corporations (about 45,000) may be audited under a separate IRS program—the subject of this report.

IRS has different ways to select corporations for audits. For small corporations, IRS uses a formula that measures the likelihood of changes to tax liability. This formula helps IRS objectively select returns for audits that

[1]Tax Administration: Compliance Measures & Audits of Large Corporations Need Improvement (GAO/GGD-94-70, September 1, 1994).

are considered to be most likely to produce tax changes. IRS developed the formula by analyzing results of line-by-line audits of a random sample of tax returns. Once selected, a small corporation return is usually audited by an IRS revenue agent. In fiscal year 1994, IRS audited about 44,000 (1.8 percent) of 2.4 million income tax returns filed by small corporations.

For CEP, IRS selects corporations on the basis of criteria for size, complexity, and the like. After considering its audit resources and manually reviewing the audit potential of every CEP return, IRS selects returns for audit. IRS audits CEP returns with teams of revenue agents and specialists, such as economists and engineers. Our 1992 report on CEP noted that IRS audited about 77 percent of the CEP returns for fiscal year 1991.[2]

The remaining large corporations (hereafter referred to as large corporations) are usually selected for audit on the basis of IRS agents' judgment, rather than through a scoring formula or specific criteria. In some cases, revenue agents at a service center select returns and send them to a district office to be audited; in other cases, all relevant returns are sent to the district office, where revenue agents choose those they will audit. Unlike with CEP returns, IRS usually uses a revenue agent (hereafter referred to as auditor) rather than a team to audit the returns from this segment of the large corporation universe. According to IRS Examination officials, these individual auditors recently have been using IRS specialists more than they have in the past.

To give perspective on the sizes of these large corporations compared to other types of businesses, we analyzed average assets reported for 1992 (the most recent year of available data at IRS' Statistics of Income Division). Reported assets ranged from an average of about $0.4 million by small corporations to about $6.8 billion by CEP corporations. Within this wide range, the remaining large corporations reported an average of $130.7 million in assets as compared with partnerships, which reported an average of $1.3 million in assets.

In recording the audit results for large corporations not part of CEP, IRS has created four classes according to asset size, ranging from $10 million to over $250 million. To facilitate our reporting of trends, we collapsed the four classes into two, (1) lower asset ($10 million to less than $100 million) and (2) higher asset ($100 million and over). Narrative in this letter and

[2]Tax Administration: IRS Efforts to Improve Corporate Compliance (GAO/GGD-92-81BR, April 17, 1992).

appendix II focuses on the differences in the trends for the two combined classes but also discusses the four classes, particularly their assessment rates.

Results in Brief

IRS' return on the large corporation audit program appears to be high. For each dollar invested directly in audits, IRS recommended $56 and ultimately assessed $15 in additional taxes for the years 1988 through 1994. These calculations exclude indirect audit costs (e.g., overhead); other IRS costs (e.g., appeals, litigation); and corporations' costs. They also exclude direct audit costs associated with recommended taxes for which the assessed amount has not been finalized.

IRS invested more in directly auditing large corporations but recommended less additional tax per hour invested in 1994 compared to 1988. IRS spent 25 percent more hours and audited only 3 percent more returns. Further, additional taxes recommended per audit hour decreased by 7 percent in current dollars. In 1994 constant dollars, additional taxes recommended decreased 4 percent overall, decreased 7 percent per return audited, and decreased 23 percent per audit hour. IRS Examination officials explained that the increased hours stemmed from auditing more complex returns and issues. As a result, IRS specialists also spent more time on the audits. These officials noted that the tax yield from making these investments lagged because of the complexity, among other reasons.

If IRS auditors conclude that additional taxes are owed, taxpayers may appeal within IRS or agree to pay. IRS assesses any amounts the taxpayer agrees to pay and any appealed amounts ultimately resolved as taxes owed. Between 1988 and 1994, large corporations agreed with ever-higher portions of recommended amounts but still agreed with only 34 percent of the amounts by 1994. They continued to appeal most recommended amounts—they appealed 66 percent for 1994. IRS appeared to lose most appealed amounts. Of the additional taxes auditors recommended over the 7 years, IRS assessed 27 percent after either agreement or resolution in appeals. IRS Examination officials noted that various factors outside the audit (e.g., economic conditions, claims for refunds, or net operating losses) could lower the assessment rate. Thus, they cautioned against using the rate as a measure of audit effectiveness.

This assessment rate varied widely when disaggregated. By the four asset classes, the rates ranged from 20 percent to 38 percent. By IRS District, the rate reached as high as 103 percent and fell to less than 1 percent at 20 IRS districts that recommended over $100 million in additional taxes during the 7 years we analyzed. The reasons for such disparate rates were not apparent, but IRS Examination officials said they were attempting to find out.[3]

IRS auditors can close audits without recommending additional tax changes. Audits that end with no change to taxes owed could have adjustments (e.g., reduced a reported net operating loss but not enough to produce a tax liability) or no adjustments. IRS views the former as productive and the latter as unproductive. These trends are moving in the wrong direction, from what IRS expects. Audits that adjusted taxable income but not enough to change taxes owed dropped over 40 percent. Such adjustments can reduce the net operating loss for the audited year, which also reduces carryover of that loss to other years. The rates for audits closing without any adjustments at all almost doubled.

These no-change trends raise questions about how well IRS selects returns for audit and/or audits them—questions we plan to explore in the second phase of our work. IRS has also been concerned about these and other trends. IRS Examination officials said they convened task forces in 1994 to find ways to select better returns for audit and to then better focus the audits.

Our profile of these large corporations showed that most were engaged in manufacturing or the finance/insurance industries in 1992. Audited corporations tended to report higher average income, tax liability, and other tax amounts than nonaudited corporations.

Objectives, Scope, and Methodology

Our objectives were to (1) analyze audit trends in fiscal years 1988 through 1994 for large corporations, (2) compute their assessment rate, and (3) develop and compare profiles of audited large corporations with those not audited. To identify large corporations, we used IRS data on those reporting assets of $10 million and more. We used IRS data to eliminate CEP corporations.

We used three IRS databases to meet our objectives. To analyze audit trends, we used Audit Information Management System (AIMS) data on large corporate audits closed in fiscal years 1988 through 1994. To compute the assessment rate, we computer-matched the AIMS data on

[3]Rates can exceed 100 percent for such reasons as Appeals assessing more taxes than IRS auditors recommended. Rates can drop significantly whenever the recommended taxes are, among other reasons, reduced or offset by claims filed by the large corporations.

recommended tax assessments to actual tax assessments on the Business Master File (BMF), which contains information about business tax returns. We tracked the BMF data through December 1994. To develop a profile of the large corporations, we obtained the 1992 Statistics of Income (SOI) file for corporations—the most recent at the time we did our work. We matched the SOI and AIMS data to divide our population into audited and not audited groups.

We asked IRS Examination officials at the National Office to review our analyses of the audit trends and assessment rates and to provide any explanations. We performed our work in Washington, D.C., and Mission, KS, between May 1994 and May 1995 in accordance with generally accepted government auditing standards. Appendix I has more information on our objectives, scope, and methodology.

Audit Trends

Figure 1 summarizes trends in large corporate audits for fiscal years 1988 through 1994.

Figure 1: Changes in Measures of Large Corporation Audits Between Fiscal Years 1988 and 1994

Variable	Lower asset corporations: Actual direction — Percent	Current dollars (in percent)	Constant dollars (in percent)[b]	Higher asset corporations: Actual direction — Percent	Current dollars (in percent)	Constant dollars (in percent)[b]	Total — Percent	Current dollars (in percent)	Constant dollars (in percent)[b]
Number of returns audited	14 ↑			16 ↓			3 ↑		
Audit coverage	18 ↑			32 ↓			2 ↑		
Direct audit hours	63 ↑			4 ↓			25 ↑		
Direct audit hours per return	43 ↑			14 ↑			21 ↑		
Additional taxes recommended		17 ↑	4 ↓		16 ↑	5 ↓		16 ↑	4 ↓
Additional taxes recommended per return		3 ↑	16 ↓		38 ↑	13 ↑		12 ↑	7 ↓
Additional taxes recommended per audit hour		28 ↓	41 ↓		20 ↑	1 ↓		7 ↓	23 ↓

■ = Not applicable
↑ = Increase
↓ = Decrease

[a]This represents IRS' expected direction of these indicators for the period 1988 to 1994. This is not intended to reflect IRS' longer term goals.

[b]Presented in 1994 constant dollars.

Source: GAO analysis of IRS data.

More details on these trends follow.

1. Number of audits: The total number of audited returns increased about 3 percent (from 10,062 in 1988 to 10,392 in 1994), after peaking in 1991 at 11,962. This increase largely involved corporations with less than $50 million in assets. The number of audited returns for higher asset corporations fluctuated but decreased 16 percent between 1988 and 1994, particularly in 1989 and 1990. (Refer to table II.1.)

2. Audit coverage: Audit coverage rose from 23 percent in 1988 to 24 percent in 1994, after peaking at 28 percent in 1991. Coverage varied by asset class. It decreased (especially from 1991 to 1992) from 43 percent to 31 percent for higher asset corporations, and it increased from 18 percent to 22 percent for those with lower assets after peaking in 1991 at 25 percent. (Refer to table II.2.)

3. Direct audit hours: A comparison of 1988 and 1994 shows that IRS invested 25 percent more hours in auditing large corporations, particularly those with lower assets. Audit hours decreased for higher asset corporations, particularly 1988 through 1990. (Refer to table II.3.)

4. Direct audit hours per return: This ratio increased 21 percent from 1988 to 1994, driven by audits of lower asset corporations. Their ratio increased 43 percent compared to 14 percent for higher asset corporations. On average, IRS spent twice as long auditing a return with higher assets compared to those with lower assets—184 hours versus 89 hours, respectively. (Refer to table II.4.)

5. Additional recommended taxes: This amount increased 16 percent from about $1.6 billion in 1988 to $1.9 billion in 1994. It also increased for both types of corporations. The amount peaked in 1992 for lower asset corporations and fluctuated year to year for higher asset corporations while peaking in 1993. IRS Examination officials explained that a few large audits produced the peaks in 1991 and 1993. In 1994 constant dollars, however, recommended taxes decreased 4 percent between 1988 and 1994. (Refer to table II.5 for current dollar data on additional taxes recommended and table V.1 for 1994 constant dollars.)

6. Additional recommended taxes per return: As with recommended taxes, this ratio increased overall and for both categories of corporations. It rose 12 percent from about $160,000 in 1988 to $180,000 in 1994 (after reaching $242,000 in 1993). Higher asset corporations drove this increase as its ratio increased 38 percent after declining in 1992 and 1994. Although IRS audited fewer of their returns, IRS recommended a relatively higher amount of taxes. In 1994 constant dollars, recommended taxes per return decreased 7 percent between 1988 and 1994. (Refer to table II.6 and table V.3 for details.)

7. Additional recommended taxes per audit hour: The overall ratio decreased 7 percent from $1,409 in 1988 to $1,313 per hour in 1994. Although the ratio rose for corporations with higher assets, this rise was

more than offset by a declining ratio for those with lower assets. In 1994 constant dollars, the overall ratio decreased 23 percent from 1988 to 1994. (Refer to tables II.7 and V.4.)

IRS Examination officials offered reasons for the increase in direct audit hours outpacing increases in audit coverage and recommended taxes after 1988. IRS has been auditing more complex returns and using more IRS specialists. Both steps took more time and reduced coverage. Also, many auditors have needed more time as they gradually shifted from auditing corporate tax shelters to auditing the whole large corporation return. On the other hand, recommended amounts can be reduced by economic downturns. They also cited 1986 tax law changes that took away audit issues (e.g., investment tax credit) with relatively high yield for a small time investment and that lowered corporate tax rates, affecting additional recommended taxes in later years.

We also analyzed trends in audit closures. The large corporations agreed with higher portions of recommended tax amounts from 1988 to 1994 (34 percent by 1994), but they continued to appeal most amounts (66 percent by 1994). Although they had similar trends over the 7 years, higher asset corporations agreed, on average, with 21 percent of all recommended amounts while lower asset corporations agreed with 33 percent (see table II.9). Even so, large corporations increasingly agreed with most audits (52 percent for 1994) that recommended taxes (see table II.8). In sum, they tended to agree with small tax amounts recommended in many audits but appeal larger amounts recommended in fewer audits.

Audits that end with no change to taxes owed could have adjustments (e.g., reduced a reported net operating loss but not enough to produce a tax liability) or no adjustments. IRS views the former as productive and the latter as unproductive. The no-change trends differed. Those with adjustments dropped from 28 percent to 16 percent; those without adjustments increased from 8 to 16 percent. The without adjustments rate had reached 18 percent for lower asset corporations and 10 percent for those with higher assets by 1994.

IRS Examination officials said they would like to see the no-change rate without adjustments fall below 10 percent. They believed that this rate will start falling as IRS closes ongoing audits that they viewed as more productive. For example, they believed that their investment in audits of more complex returns will start shifting more no-change audits to audits that recommend taxes. Also, more auditors have now learned how to audit large corporations, not just tax shelters. Even so, these officials still want better systems for selecting and classifying (i.e., finding issues that need to be audited) returns. In recognizing this need, they convened task forces during 1994 to overcome such problems with large corporation audits. These task forces are slated to last through 1996.

See appendix II for detailed information about these trends and IRS' explanations and appendix V for trends for recommended tax amounts in constant dollars.

Assessment Rate

In tracking taxes recommended for large corporations from 1988 through 1994, we found that the final assessment had been recorded for $8.6 billion of $12 billion in net recommended taxes. Our computer match, involving about 56,000 audited returns, showed that IRS assessed $2.3 billion of the $8.6 billion (27 percent) through December 1994. In computing this rate, we subtracted the tax refunds recommended from the additional taxes recommended for these audited returns.

The assessment rate was similar for higher and lower asset corporations—26 percent and 28 percent, respectively. The rate, however, differed widely by the four asset classes, ranging from 20 percent to 38 percent. By IRS district, the assessment rate ranged from over 100 percent to less than 1 percent.

The reasons for these wide variations were not apparent in the IRS databases we used to compute the assessment rates. Our work has shown that various factors can cause the rate to exceed 100 percent, such as IRS Appeals assessing more taxes than recommended by the auditors. Also, the rates can drop whenever corporate claims for refunds or net operating losses from other tax years reduce or offset taxes that were recommended in the audit.

Nor did IRS Examination officials know the reasons for the wide variation in the rates. They noted that the lowest rates occurred in two regions and they are starting to pinpoint the reasons. We also plan to explore these reasons during a follow-on review.

Our discussions with IRS Examination officials disclosed possible reasons for low rates. These officials pointed to nonaudit factors that can lower the assessment rate, even if auditors supported the taxes recommended. They cited retroactive tax law changes, court decisions that affect the recommended taxes, and other tax abatements. In addition, they said IRS Appeals can concede recommended taxes to avoid the hazards of litigation or because the corporation provides new information that swayed Appeals' decision; this information could have dissuaded the auditors from recommending the taxes. These officials did not know the extent to which these factors lowered the assessment rate, given limitations in IRS' databases. For this reason, our 1994 report on CEP recommended corrections to IRS' databases.

In sum, IRS Examination officials cautioned against misinterpreting the assessment rates. Because of these nonaudit factors, they believed that the rates reflect more about the tax system and economic fluctuations than the effectiveness of the audits. Appendix III provides details on assessment rates and IRS' explanations.

We also computed the assessment rate for just the additional taxes recommended (i.e., excluding audits recommending refunds). That rate equalled 38 percent. IRS had estimated a similar assessment rate on just the additional taxes recommended for audits closed in fiscal years 1992 through 1994—36 percent.

Regardless of which type of assessment rate is considered, we did not attempt to track how much of the assessed taxes were ultimately collected. IRS Finance officials provided data indicating that IRS collected 23 percent of the taxes recommended and 68 percent of the taxes assessed as of July 1995 for the audits closed in fiscal years 1992 through 1994. IRS based these results on data being tracked in a new system. We plan to analyze the data and methodology being used in this system during the second phase of our work.

Whenever audits recommend additional taxes that go unassessed, IRS can miss opportunities to invest audit resources more productively, and large corporations can incur more costs to challenge those recommendations. Data on many of these costs were not available. Using only the direct audit costs, we calculated that IRS recommended $56 and assessed $15 in taxes for each dollar directly spent on auditing large corporations from 1988 through 1994.[4] These calculations exclude indirect audit costs (e.g., overhead), IRS costs outside of audits (e.g., appeals and litigation processes

[4]We calculated these ratios using the $153 million in direct audit costs alone compared to recommended amounts of $8.6 billion and assessed amounts of $2.3 billion.

to settle on assessed tax amounts), and corporations' costs.[5] It is important to recognize that these ratios provide just one indicator of IRS' audit activities. The ratios do not account for the costs and taxes associated with what IRS calls revenue protection. For example, IRS may audit various corporate claims for tax refunds to determine whether the claims are proper. In doing so, IRS protects the government's revenue. Auditors disallowed $202 million in claims by large corporations during 1994 in addition to the $1.9 billion they recommended in taxes. In 1991—the first year for which IRS tracked protected tax revenue—IRS auditors denied $212 million of these claims.

To provide perspective, we computed a similar ratio for all IRS audits. Although not readily available for assessed taxes, data were available in IRS' 1996 budget to compute the ratio of recommended taxes to the costs of all IRS audits. Our computations showed that the ratio has been about $16 in recommended taxes to $1 in audit costs (including indirect costs) for recent years.

Profiles of Large Corporations

According to 1992 income tax returns, over 60 percent of the large corporations were engaged in manufacturing or in the finance/insurance industry. This profile was similar for both the audited and nonaudited large corporations. Audited large corporations, however, tended to report higher amounts, on average, of total income, taxable income, and income tax liability.

Whether audited or not, large corporations tended to claim the possessions tax credit more frequently than other tax credits;[6] 57 percent of $6.4 billion in tax credits claimed was for the possessions tax credit. Appendix IV provides more details on the profile of large corporations for 1992.

IRS Comments and Our Evaluation

We requested comments on a draft of this report from the IRS Commissioner, and we received comments from her representatives at a meeting on August 9, 1995. These IRS officials included the Assistant

[5]In addition to nonaudit costs, the calculations excluded interest that IRS assessed; assessed interest amounts roughly equaled assessed tax amounts. Further, the assessed tax ratio excluded the direct audit costs associated with 28 percent of all recommended taxes over the 7 years—about $3.4 billion—for which the assessed amounts have not been finalized.

[6]Section 936 of the tax code provides a tax credit that equals the full amount of the U.S. income tax liability on income earned by U.S. firms from operations in U.S. possessions. This credit is referred to as the possessions tax credit.

Commissioner for Examination and his staff that oversee audits of large corporations as well as staff from IRS' Office of Legislative Affairs. While generally agreeing with the trends we analyzed, these officials had comments on our draft. In addition to technical comments that we have incorporated where appropriate, they offered comments on three major issues.

First, they pointed to various efforts undertaken to correct problems with large corporation audits. The major effort entails studying ways to improve the selection of returns for audit. Our letter now refers to these efforts.

Second, they suggested explanations for some trends. For example, they offered various reasons for the increases in audit coverage and additional recommended taxes lagging behind the increase in direct audit time. They noted that IRS has been investing time in auditing more complex issues and in using IRS specialists. They viewed this investment as necessary and as likely to pay off soon. They also cited tax law changes in 1986 and the transition in the early 1990s from auditing corporate tax shelters to all large corporate tax issues. Both factors had dampening effects on recommended tax amounts after 1988, according to these officials. They suggested that these factors, in combination with auditing more complex returns, also contributed to IRS closing more audits with neither changes to taxes owed nor adjustments to taxable income. While we did not validate IRS' suggested explanations, we have added them to the letter and related appendixes.

Third, they asked for clarification on the 27 percent assessment rate. Although our draft report had not labelled this rate as a measure of audit effectiveness, they wanted cautions noted. They said the rate should not be used as such a measure because of nonaudit factors (e.g., net operating losses from other tax years that offset audit yield). They did not know the extent to which these factors affected the rate but they believed that the rate was just as likely to be the product of the tax and economic systems, which they have little control over, rather than of the audits. We have added their comments about the potential effects of these nonaudit factors on the rates.

We are sending copies of this report to the Senate Committee on Finance, the House Committee on Ways and Means, and other interested parties. Major contributors to this report are listed in appendix VI. If you or your staff have any questions concerning this report, please contact me at (202) 512-5407.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy
and Administration Issues

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Abbreviations

AIMS	Audit Information Management System
BMF	Business Master File
CEP	Coordinated Examination Program
IRS	Internal Revenue Service
SOI	Statistics of Income
TIN	taxpayer identification number

Objectives, Scope, and Methodology

Our objectives were to (1) analyze audit trends for large corporations not in the Coordinated Examination Program (CEP) for fiscal years 1988 through 1994, (2) compute the portion of taxes recommended in audits that were actually assessed, and (3) develop and compare profiles of audited large corporations with those not audited.

The Internal Revenue Service (IRS) defines large corporations as those reporting assets of $10 million or more on their income tax returns. IRS divides large corporations into four asset classes as follows:

(1)assets of $10 million to less than $50 million,
(2)assets of $50 million to less than $100 million,
(3)assets of $100 million to less than $250 million, and
(4)assets of $250 million and over.

For these corporations, our analyses focused on data from Forms 1120 (U.S. Corporation Income Tax Return) and other related corporate returns, except for nontaxable returns such as the Form 1120-S. These related income tax returns included the following:

(1)1120-L (U.S. Life Insurance Company Income Tax Return),
(2)1120-PC (U.S. Property and Casualty Insurance Company Income Tax Return),
(3)1120 Consolidated income tax return,
(4)1120L Section 594/1504c income tax return for U.S. life insurance companies,
(5)1120-PC Section 1504c income tax return for U.S. property and casualty insurance companies,
(6)1120 Section 594/1504c income tax return for U.S. corporations.

Our analyses of audit trends, assessment rates, and the profiles excluded large corporations in CEP. We excluded CEP corporations from the profile information using IRS data on CEP.

We asked IRS Examination officials at the National Office to review our analysis of the audit trends and assessment rates and to provide any explanations. We have summarized their comments throughout this report.

Analyzing Audit Trends

To analyze audit trends, we used IRS' Audit Information Management System (AIMS) data. This database includes records from all audits closed during a given fiscal year. We reconciled totals from this database to totals in IRS' annual report.[1]

For audits closed from fiscal years 1988 through 1994, we obtained AIMS data on additional tax recommended, tax decreases recommended, returns audited, and direct audit hours spent on returns. We then calculated such measures as tax recommended per return, tax recommended per hour, and audit hours per return.[2] Appendix II reports these trends, using current dollars for the recommended tax amounts. Appendix V reports those trends in constant dollars.

To calculate audit coverage, we used IRS' method of dividing the number of audits completed in a given fiscal year by the number of returns filed the previous year. We also computed IRS' direct costs for auditing these returns. For audited corporations by asset class, we applied the average cost IRS calculated for fiscal years 1991 and 1992 for each staff year that IRS directly spent on these audits. We adjusted the costs to current dollars for the specific fiscal year of the audit to obtain the average cost for each of the 7 years we analyzed.

We also analyzed the ways in which IRS closed audits of the tax returns. If IRS recommended additional taxes, large corporations could agree to pay or appeal these taxes.[3] If IRS did not recommend such taxes, we analyzed how often IRS closed these no-change audits without any audit adjustments or with adjustments.[4]

Computing the Assessment Rate

To compute the assessment rate—the percentage of recommended taxes ultimately assessed after audits—we did a computer data match of corporate income tax returns between two IRS databases. For all closed audits in our populations, we matched the recommended tax assessments

[1]AIMS data are the most reliable data available on audit results. Other than our reconciliation effort, we did not assess the reliability of the AIMS data.

[2]The term "recommended tax" refers to the amount of additional tax that an auditor concludes should have been paid together with any associated penalties. Our analysis focused on recommended taxes. Penalties involved small amounts (less than 10 percent) of the recommended taxes. Interest amounts were not reflected in IRS' data on audit results.

[3]In analyzing closures, we treated "defaults" as part of "agreed" closures. Defaults arise when the corporation neither formally agrees or appeals, meaning the recommended tax becomes assessed. Over the 7 years, defaults tended to be a small percentage of total additional taxes recommended, ranging from 0 to 9 percent.

[4]These adjustments can affect the amount of income, deductions, and credits on tax returns but be offset by operating losses or excess credits. These adjustments can result in additional taxes in the future because of carryover provisions in tax laws.

recorded on AIMS to the actual tax assessments recorded on the Business Master File (BMF). In addition to the assessed tax liabilities, the BMF contains information on taxable income, taxes not yet paid, penalties, interest, payments, refunds, and audit actions for business tax returns. In both systems, each record contains the taxpayer identification number (TIN), tax year, and return type.[5]

To use BMF data, we eliminated all BMF records of tax returns that had no audit adjustment code. We also eliminated all records with audit transactions that were posted before fiscal year 1988. Because our AIMS data covered fiscal years 1988 through 1994, none of these audit adjustments could have been posted on BMF before fiscal year 1988.

Also, we applied our criterion of a "completed audit." We defined this term as the period in which IRS made at least one tax adjustment resulting from an audit, followed by an audit release indicator. As the starting point, we used the last day of the previous audit period or, if not present, the date that IRS posted the return. The BMF audit release indicator identified the end of an audit. We added 30 calendar days to the audit release date to identify late posting audit adjustments. IRS also does this adjustment on its new Enforcement Revenue Information System to match tax adjustments to taxes recommended.

Using the 25,395 taxpayers identified in AIMS data for fiscal years 1988 through 1994, we were able to match 22,679 TINs to BMF. For these TINs, we obtained records for 56,146 returns for various tax years ranging from 1964 to 1993. AIMS has the recommended tax adjustments for each closed audit. We dropped records that showed recommended taxes of $1 because some IRS districts use this amount if, for some reason, they must close the case on AIMS for a second time.

Across the AIMS and BMF data, we sought the same corporate TINs and same audited tax years for audits closed during fiscal years 1988 through 1994. We matched the AIMS data on recommended assessments from these audits to BMF data on actual assessments for these audits up through December 1994. We then analyzed the assessment rate by variables such as the asset size of the corporation and IRS district office that did the audit.

Profiling Large Corporations

To develop a profile of the large corporations, we obtained the 1992 Statistics of Income (SOI) file for corporations—the most recent file when

[5]We did not validate data recorded in BMF with source documents.

we did our work. We eliminated CEP corporations as we did for our other analyses. We selected the large corporations by using our criteria for return type and the asset size. We matched these data with AIMS data to divide the large corporation population into audited and nonaudited groups. Table I.1 shows the SOI universe and populations for each of these steps.

Table I.1: SOI Universe of Large Corporations for 1992

Groups of SOI corporate returns	Number of returns
Total corporate returns	80,822
Returns left after excluding CEP corporations	79,108
Returns left after applying return type and asset size criteria	24,604[a]
Returns that were not audited	15,666[b]
Returns that were audited	8,938[c]

[a]This number is our universe of large corporate returns. The weighted value equals 39,155 returns.

[b]This number is our universe of nonaudited large corporate returns. The weighted value equals 25,600 returns.

[c]This number is our universe of audited large corporate returns. The weighted value equals 13,555 returns.

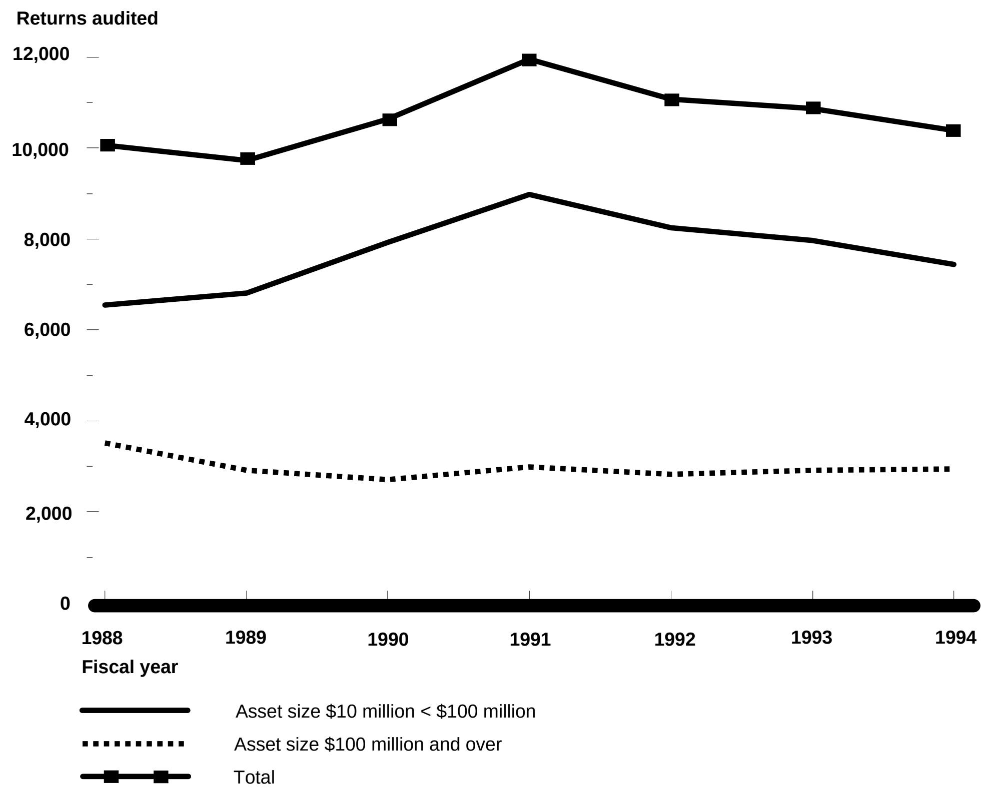
Sampling errors associated with our SOI estimates are less than 5 percent at the 95 percent confidence level, except for the following items:

- For audited lower asset size corporations claiming the net operating loss deduction, the sampling errors were $1.3 billion ± 6.8 percent for the net operating loss deduction claimed and $1 million ± 5.9 percent for the average deduction claimed.
- For the nonaudited corporations, the average Foreign Tax Credit claimed as shown in table IV.2 had a sampling error of $1.593 million ± 5.8 percent.
- For the other tax credits reported in table IV.2, the sampling errors exceeded 5 percent for both audited and nonaudited corporations. The sampling errors for the total amount claimed were $13.9 million ± 5.7 percent and $11 million ± 8.9 percent for audited and nonaudited corporations, respectively. The sampling error for the average amount claimed is as follows: $179 thousand ± 16.6 percent and $225 thousand ± 21.4 percent for audited and nonaudited corporations, respectively.

Audit Trends for Large Corporations

This appendix presents our analysis of IRS' audit results for large corporations, using IRS' AIMS data. We asked IRS Examination officials to explain any major shifts in the trends. The narrative within this appendix reflects any explanations that these officials provided.

Figure II.1: Number of Large Corporation Returns Audited, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.1: Number of Large Corporation Returns Audited, Fiscal Years 1988 Through 1994

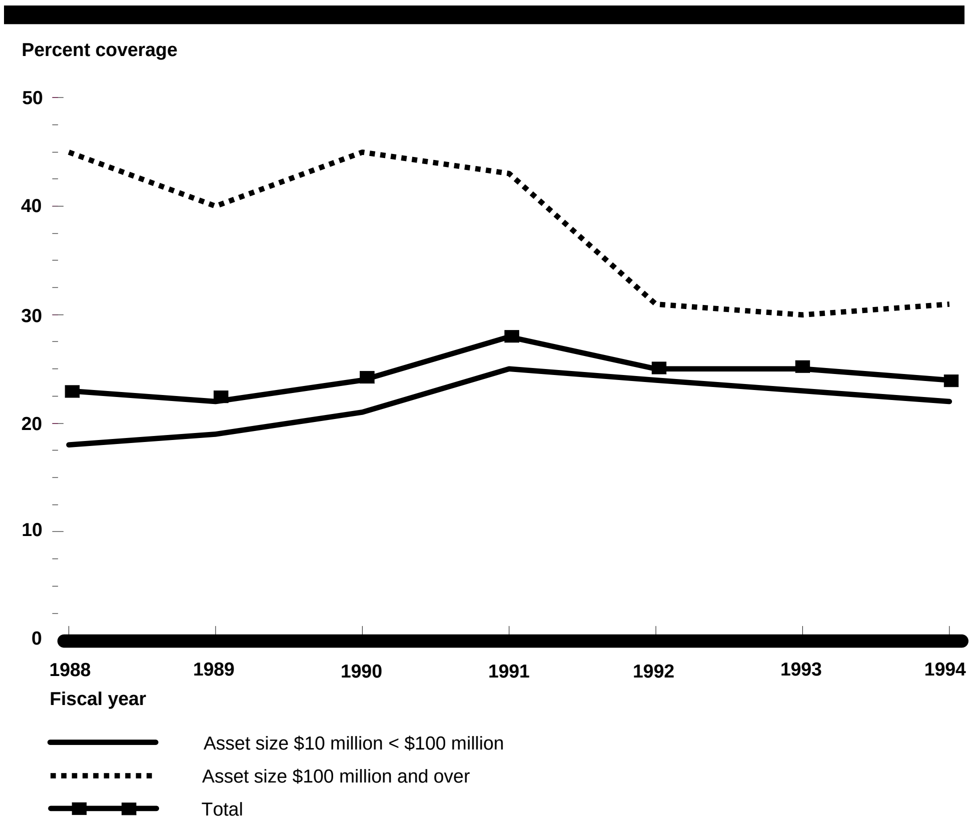
	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Subtotal	$100 mil. < $250 mil.	$250 mil. & over	Subtotal	Total
1988	4,659	1,893	**6,552**	1,823	1,687	**3,510**	**10,062**
1989	5,132	1,679	**6,811**	1,548	1,361	**2,909**	**9,720**
1990	6,210	1,712	**7,922**	1,528	1,184	**2,712**	**10,634**
1991	7,104	1,877	**8,981**	1,627	1,354	**2,981**	**11,962**
1992	6,399	1,849	**8,248**	1,536	1,287	**2,823**	**11,071**
1993	6,292	1,677	**7,969**	1,586	1,321	**2,907**	**10,876**
1994	5,829	1,615	**7,444**	1,612	1,336	**2,948**	**10,392**
Average	**5,946**	**1,757**	**7,704**	**1,609**	**1,361**	**2,970**	**10,674**

Source: GAO analysis of IRS data.

From 1988 to 1994, the number of returns audited has increased slightly, particularly from 1988 to 1991, when it peaked at 11,962 returns and then decreased to 10,392 by 1994. IRS Examination officials attributed the decline since 1991 to auditing more complex returns and issues. Doing so takes more time that could have been spent on more returns. Corporations with less than $50 million in assets accounted for the overall increase in audits during the 7 years. All other asset classes had decreases.

Over the 7 years, the number of returns audited averaged 10,674. Of these audited returns, lower asset corporations filed 72 percent (7,704 returns) on average.

Figure II.2: Audit Coverage for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.2: Audit Coverage for Large Corporations, Fiscal Years 1988 Through 1994

Percent coverage

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Audit coverage lower asset size	$100 mil. < $250 mil.	$250 mil. & over	Audit coverage higher asset size	Total audit coverage
1988	16%	31%	18%	41%	51%	45%	**23%**
1989	17	29	19	38	44	40	**22**
1990	19	32	21	41	52	45	**24**
1991	24	33	25	39	50	43	**28**
1992	23	27	24	28	36	31	**25**
1993	23	24	23	28	33	30	**25**
1994	21	23	22	28	34	31	**24**
Average[a]	20%	29%	22%	36%	44%	39%	**25%**

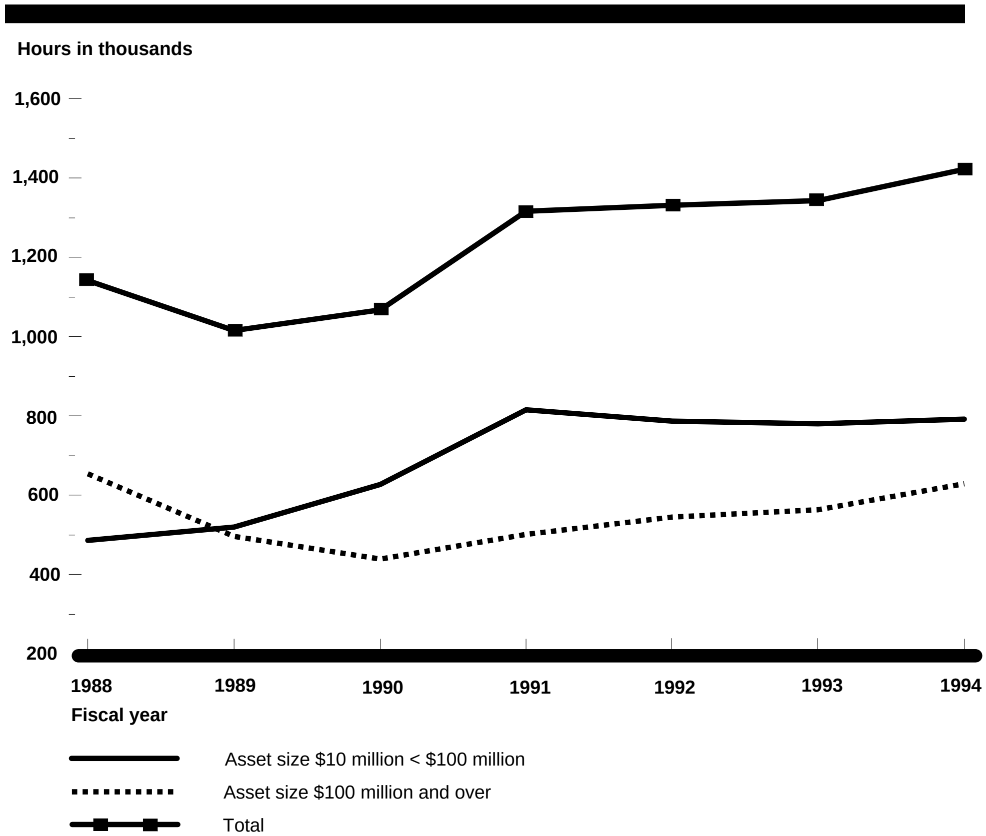
[a]Averages are computed using actual data points and may not equal the averages of the whole numbers in the columns.

Source: GAO analysis of IRS data.

For 1988 through 1994, audit coverage changed as follows:

- It increased from 18 percent to 22 percent, peaking in 1991, for lower asset corporations. This increase stemmed from IRS doing more audits while the number of returns filed remained fairly constant over the 7 years. In fact, the audit rate increased only for corporations with assets of $10 million to less than $50 million.
- It decreased from 45 percent to 31 percent for the higher asset classes. Their rate held fairly steady through 1991 but then dropped through 1994. Over all 7 years, their coverage decreased because more returns were filed but fewer were audited. IRS Examination officials said IRS has spent more time on complex audits since 1991.
- It averaged 25 percent overall. As asset size increased, so did the average coverage rate. Over the four asset classes, the average rate ranged from 20 percent to 44 percent.

Figure II.3: Direct Audit Hours for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.3: Direct Audit Hours for Large Corporations, Fiscal Years 1988 Through 1994

Hours in thousands

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	**$10 mil. < $50 mil.**	**$50 mil. < $100 mil.**	**Subtotal[a]**	**$100 mil. < $250 mil.**	**$250 mil. & over**	**Subtotal[a]**	**Total[a]**
1988	328	159	**487**	241	414	**655**	**1,142**
1989	359	161	**520**	224	272	**496**	**1,016**
1990	462	165	**627**	213	226	**440**	**1,067**
1991	600	216	**816**	266	234	**501**	**1,317**
1992	569	218	**787**	236	308	**545**	**1,331**
1993	560	220	**780**	268	297	**564**	**1,344**
1994	569	224	**793**	284	345	**629**	**1,422**
Average	**493**	**195**	**687**	**248**	**300**	**547**	**1,234**

[a]Difference due to rounding.

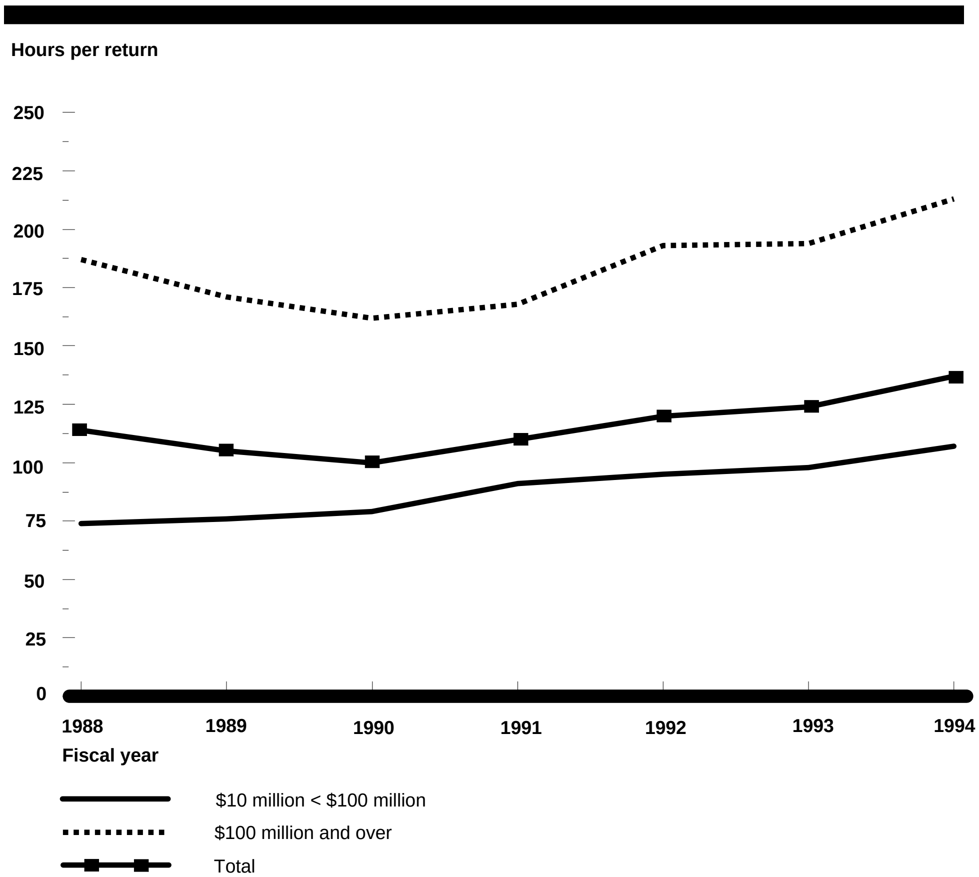
Source: GAO analysis of IRS data.

Time spent directly on the audit is measured in hours.[1] After dropping from 1988 to 1989, the audit hours steadily increased about 40 percent from fiscal years 1989 through 1994. This change represents an increase from about 1 million to 1.4 million staff hours. IRS Examination officials attributed the increase to investing in audits of more complex tax returns and issues.

The increased hours primarily arose from doing more audits of lower asset corporations over the 7 years (see fig. II.1). The audit time for these corporations increased from 487,162 hours in 1988 to 793,115 hours in 1994 (63 percent) after peaking in 1991 and then decreasing slightly through 1994. Audit hours for higher asset corporations decreased from 654,974 hours in 1988 to 628,851 hours in 1994 (4 percent); their hours decreased from 1988 to 1990 and then increased steadily through 1994.

[1]A direct audit hour refers to time spent directly on the audit by IRS technical staff. It excludes training, leave, and time spent by managers. A direct audit staff year equals 2,000 hours.

Figure II.4: Direct Audit Hours per Return for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.4: Direct Audit Hours per Return for Large Corporations, Fiscal Years 1988 Through 1994

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Audit hours per return	$100 mil. < $250 mil.	$250 mil. & over	Audit hours per return	Audit hours per return
1988	70	84	74	132	246	187	114
1989	70	96	76	145	200	171	105
1990	74	96	79	140	191	162	100
1991	84	115	91	164	173	168	110
1992	89	118	95	154	239	193	120
1993	89	131	98	169	224	194	124
1994	98	139	107	176	258	213	137
Average[a]	83	111	89	154	220	184	116

[a]Averages are computed using actual data points and may not equal the averages of the whole numbers in the columns.

Source: GAO analysis of IRS data.

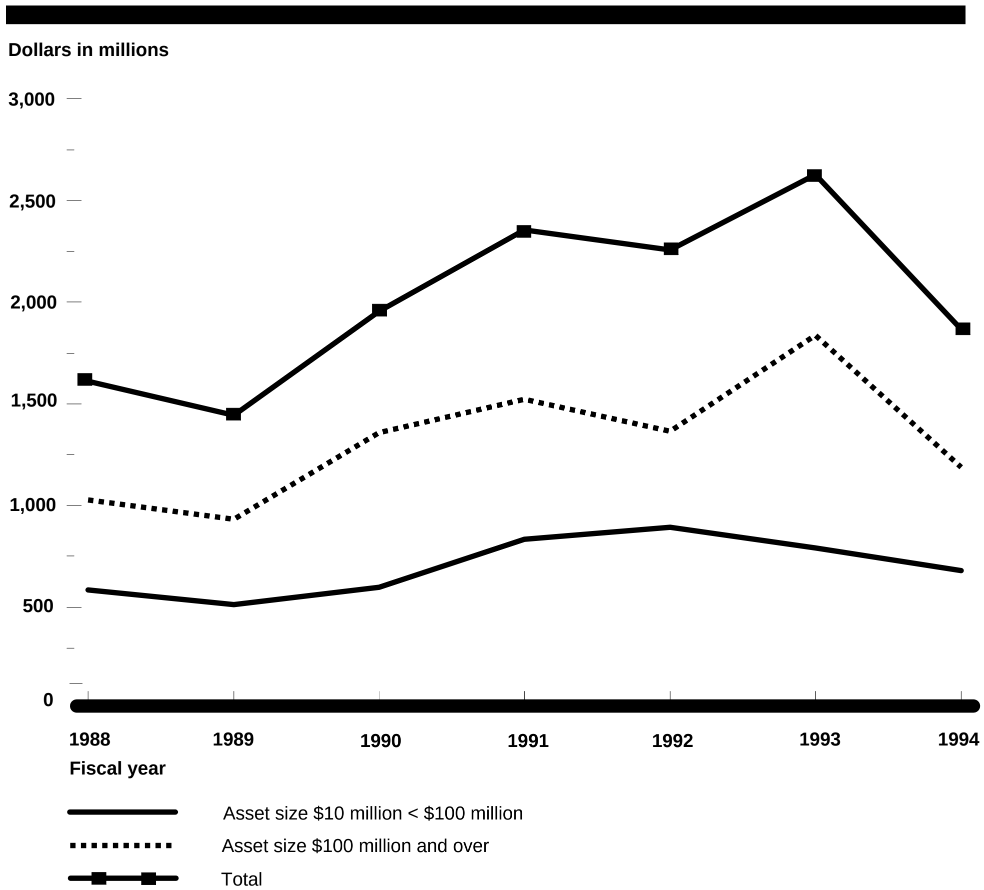
On average, IRS auditors spent twice as long auditing returns from higher asset corporations compared to those with lower assets—184 hours versus 89 hours per return, respectively.

From 1988 to 1994, the direct audit hours per return increased 43 percent (74 to 107 hours) for lower asset corporations, 14 percent (187 to 213 hours) for higher asset corporations, and 21 percent (114 to 137 hours) overall. These increases match the increases in direct audit hours (see table II.3) and in audited returns for lower asset corporations and all large corporations (see table II.1).

However, the number of direct audit hours and audited returns decreased for higher asset large corporations. The increase in direct audit hours per return results from a larger decrease in the number of audited returns (see table II.1) compared to the number of audit hours (see table II.3).

IRS Examination officials said they expected the upward trend in audit hours per return to continue as IRS does more complex audits. They also cited other reasons. The lack of training and experience in auditing an entire large corporation return instead of just corporate tax shelters has added time.

Figure II.5: Additional Taxes Recommended for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.5: Additional Taxes Recommended for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in millions

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Subtotal[a]	$100 mil. < $250 mil.	$250 mil. & over	Subtotal[a]	Total[a]
1988	$402	$182	**$584**	$303	$723	**$1,026**	**$1,610**
1989	317	194	**511**	$246	686	**932**	**1,444**
1990	356	241	**598**	$567	792	**1,359**	**1,957**
1991	610	223	**832**	$449	1,074	**1,523**	**2,356**
1992	594	298	**892**	$498	866	**1,364**	**2,256**
1993	543	248	**791**	$506	1,331	**1,837**	**2,629**
1994	481	200	**680**	$429	758	**1,186**	**1,867**
Average	**$472**	**$227**	**$698**	**$428**	**$890**	**$1,318**	**$2,017**

[a]Difference due to rounding.

Source: GAO analysis of IRS data.

For all large corporations, additional recommended taxes grew 16 percent from about $1.6 billion in 1988 to about $1.9 billion in 1994; except for 1989, these amounts had increased through 1993 and then dropped in 1994. IRS Examination officials did not know the reasons for the 1994 decrease. Both higher and lower asset corporations had similar increases over the 7 years but those with higher assets always accounted for the bulk of the additional tax amounts.

For higher asset corporations, recommended taxes peaked in 1993—about double the amount from 1989—but then decreased 35 percent by 1994. IRS Examination officials attributed the big increases in 1991 and in 1993 to a few large dollar audits. For lower asset corporations, recommended taxes increased 53 percent from 1988 to 1992 but then decreased 24 percent through 1994.

All four asset classes had percentage increases from 1988 to 1994 in taxes recommended; the $100 million to less than $250 million class had the greatest increase (42 percent), while the $250 million and over class had the smallest (5 percent). Each class also had fluctuations over the 7 years and different peak years, ranging from 1990 to 1993.

Table II.5.1: Net Additional Taxes Recommended for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in millions

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Subtotal[a]	$100 mil. < $250 mil.	$250 mil. & over	Subtotal[a]	Total[a]
1988	$354	$137	**$491**	$266	$571	**$ 837**	**$1,328**
1989	245	155	**399**	191	583	**774**	**1,173**
1990	236	184	**420**	521	731	**1,252**	**1,672**
1991	520	169	**689**	367	977	**1,343**	**2,033**
1992	520	259	**778**	412	770	**1,182**	**1,960**
1993	421	211	**632**	440	1,159	**1,598**	**2,231**
1994	423	150	**572**	372	618	**990**	**1,562**
Average	**$388**	**$181**	**$569**	**$367**	**$773**	**$1,149**	**$1,708**

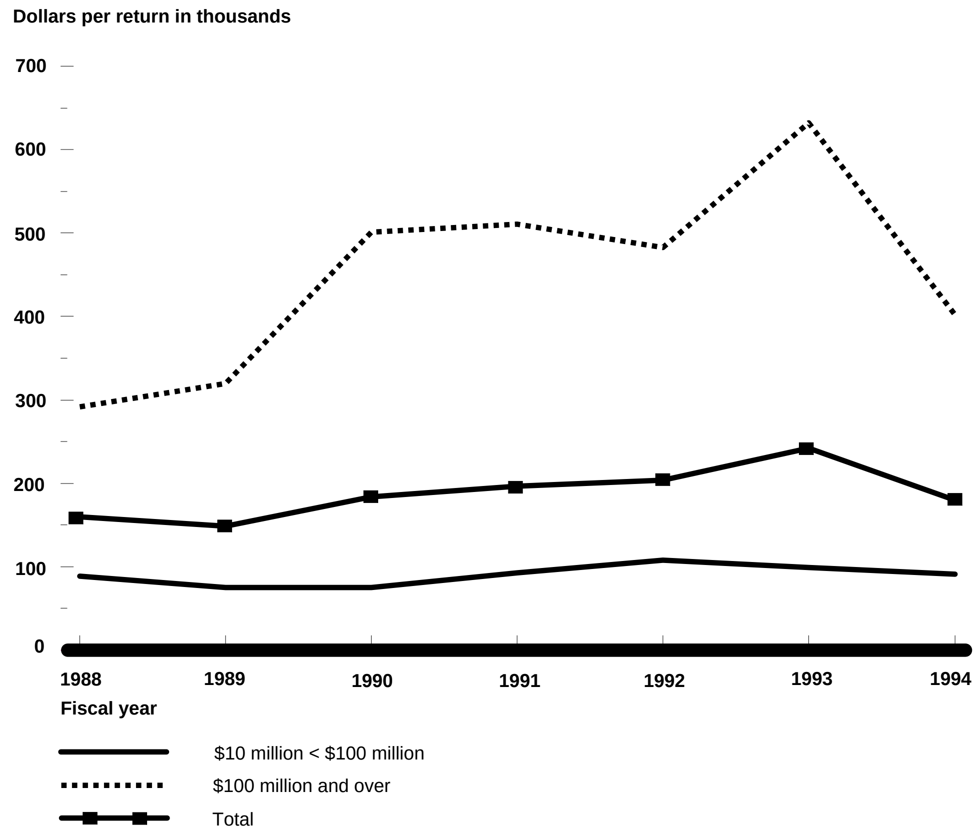
[a]Difference due to rounding.

Source: GAO analysis of IRS data.

IRS' audit mission is to determine the correct tax liability. This includes determining additional taxes that taxpayers owe or that should be refunded to the taxpayers.

Although IRS collects the data, IRS reports on audit results did not offset recommended taxes by recommended tax refunds. Our analysis of IRS data showed that subtracting refunds from reported additional taxes recommended would reduce additional taxes between 8 to 34 percent over the 7 years.

Figure II.6: Additional Taxes Recommended per Return for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.6: Additional Taxes Recommended per Return for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in thousands

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Taxes recommended per return	$100 mil. < $250 mil.	$250 mil. & over	Taxes recommended per return	Taxes recommended per return
1988	$86	$96	$ 89	$166	$428	$292	$160
1989	62	116	75	159	504	320	149
1990	57	141	75	371	669	501	184
1991	86	119	93	276	793	511	197
1992	93	161	108	324	673	483	204
1993	86	148	99	319	1,008	632	242
1994	82	124	91	266	567	402	180
Average[a]	**$79**	**$141**	**$91**	**$266**	**$654**	**$444**	**$189**

[a]Averages are completed using actual data points and may not equal the averages of the whole numbers in the columns.

Source: GAO analysis of IRS data.

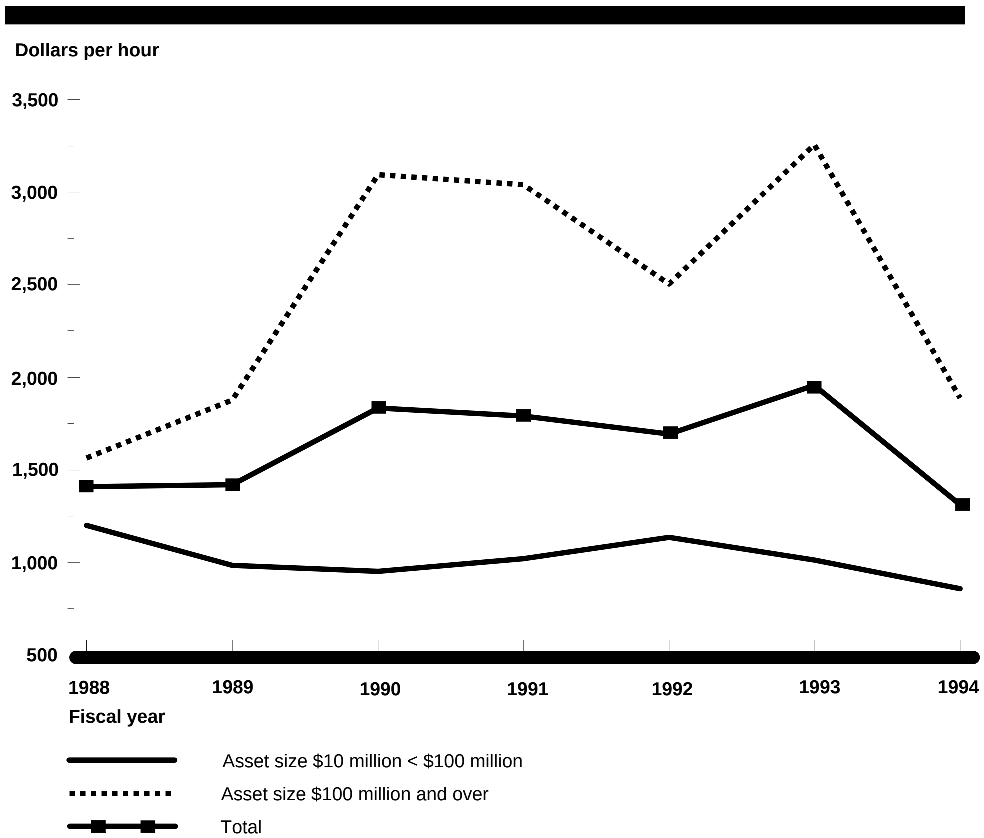
Over the 7 years, the additional taxes recommended per audited return averaged about $189,000 for all large corporations. Audits of higher asset corporations drove this average; these audits averaged about $444,000.

A comparison of 1988 to 1994 showed that the ratio of recommended taxes per return increased for lower and higher asset corporations but at different rates and with different fluctuations, as follows:

- For lower asset corporations, the ratio increased just 3 percent. This ratio increased about 43 percent between 1990 and 1992 and then decreased through 1994.
- For higher asset corporations, the ratio increased 38 percent from 1988 to 1994 after fluctuations. This ratio increased from 1988 to 1990, flattened out for 1990 through 1992, increased in 1993, and then dropped 36 percent in 1994.

As noted after table II.5, a few large cases drove the 1991 and 1993 results according to the IRS officials.

Figure II.7: Additional Taxes Recommended per Direct Audit Hour for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.7: Additional Taxes Recommended per Direct Audit Hour for Large Corporations, Fiscal Years 1988 Through 1994

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Taxes recommended per hour	$100 mil. < $250 mil.	$250 mil. & over	Taxes recommended per hour	Taxes recommended per hour
1988	$1,224	$1,147	$1,199	$1,259	$1,744	$1,566	$1,409
1989	882	1,208	983	1,096	2,525	1,879	1,420
1990	771	1,464	953	2,657	3,504	3,093	1,835
1991	1,016	1,032	1,020	1,685	4,581	3,041	1,789
1992	1,044	1,372	1,134	2,104	2,812	2,504	1,695
1993	969	1,131	1,014	1,892	4,488	3,256	1,956
1994	845	891	858	1,510	2,196	1,887	1,313
Average[a]	**$958**	**$1,165**	**$1,016**	**$1,730**	**$2,972**	**$2,410**	**$1,634**

[a]Averages are computed using actual data points and may not equal the averages of the whole numbers in the columns.

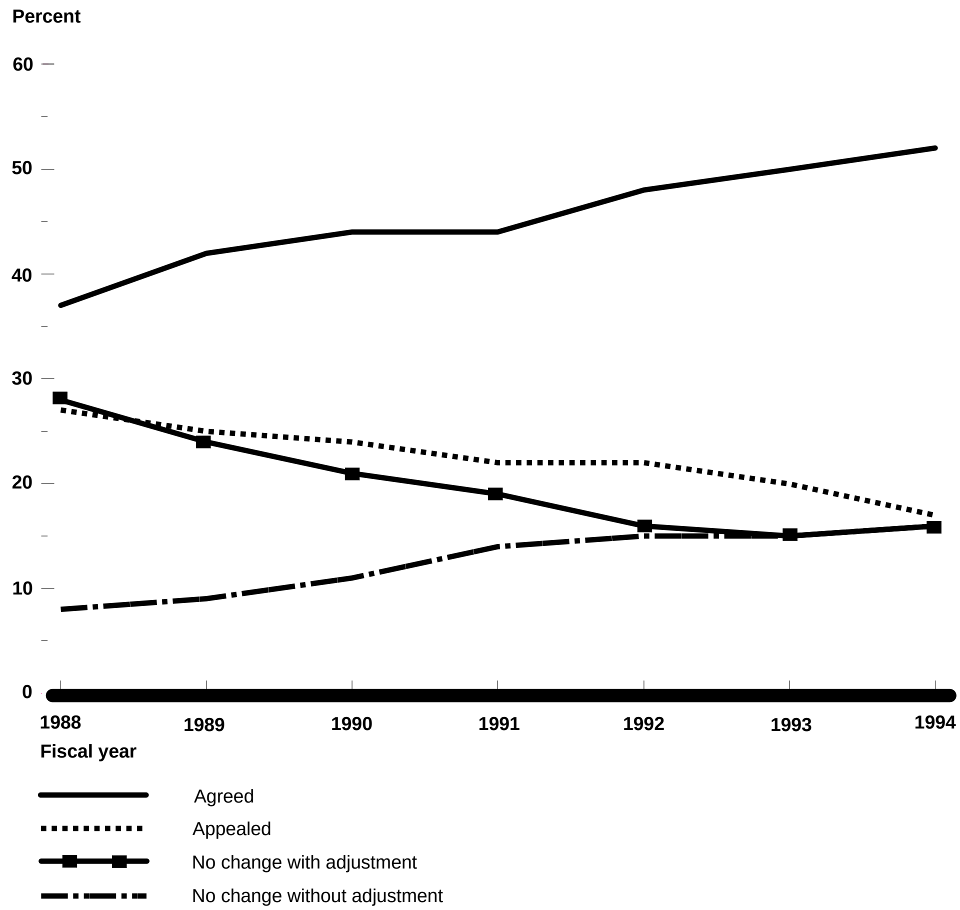
Source: GAO analysis of IRS data.

A comparison of 1988 to 1994 showed that taxes recommended per audit hour decreased 7 percent. This ratio increased from 1988 to 1990 but then fluctuated through 1994. It increased for higher asset corporations and decreased for lower asset corporations. More specifically, this ratio:

- increased for higher asset corporations because audits of those with assets of (1) $100 million to less than $250 million recommended more taxes for a proportionately smaller increase in audit hours, and (2) $250 million or more spent fewer audit hours to recommend a slight increase in the amount of taxes; and
- decreased for lower asset corporations because audits of those with assets of (1) $10 million to less than $50 million required more time to recommend less tax, and (2) $50 million to less than $100 million invested comparatively higher amounts of audit time to recommend higher tax amounts.

IRS Examination officials pointed to a few large audits as major contributors to the 1991 and 1993 results.

Figure II.8: Percent of Returns Audited by Type of Closure for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.8: Percent of Returns Audited by Type of Closure for Higher Asset Large Corporations, Fiscal Years 1988 Through 1994

	Type of audit closure				
Fiscal year	Appealed	Agreed	No change with adjustments	No change without adjustments	Total[a]
Total - lower asset size					
1988	24%	39%	27%	10%	**100%**
1989	20	44	24	11	**100**
1990	20	46	21	13	**100**
1991	19	46	19	16	**100**
1992	18	49	16	17	**100**
1993	17	50	15	18	**100**
1994	16	51	16	18	**100**
Average	**19%**	**47%**	**20%**	**15%**	**100%**
Total - higher asset size					
1988	33%	32%	29%	5%	**100%**
1989	35	36	24	5	**100**
1990	34	36	22	7	**100**
1991	32	39	20	8	**100**
1992	33	43	16	8	**100**
1993	28	47	17	8	**100**
1994	19	54	16	10	**100**
Average	**31%**	**41%**	**21%**	**7%**	**100%**
Total - all asset sizes					
1988	27%	37%	28%	8%	**100%**
1989	25	42	24	9	**100**
1990	24	44	21	11	**100**
1991	22	44	19	14	**100**
1992	22	48	16	15	**100**
1993	20	50	15	15	**100**
1994	17	52	16	16	**100**
Average	**22%**	**45%**	**20%**	**13%**	**100%**

[a]Difference due to rounding.

Source: GAO analysis based on IRS data.

Our analysis of how IRS closed audits of large corporations revealed two distinct trends from 1988 through 1994. These trends were similar for lower and higher asset corporations.

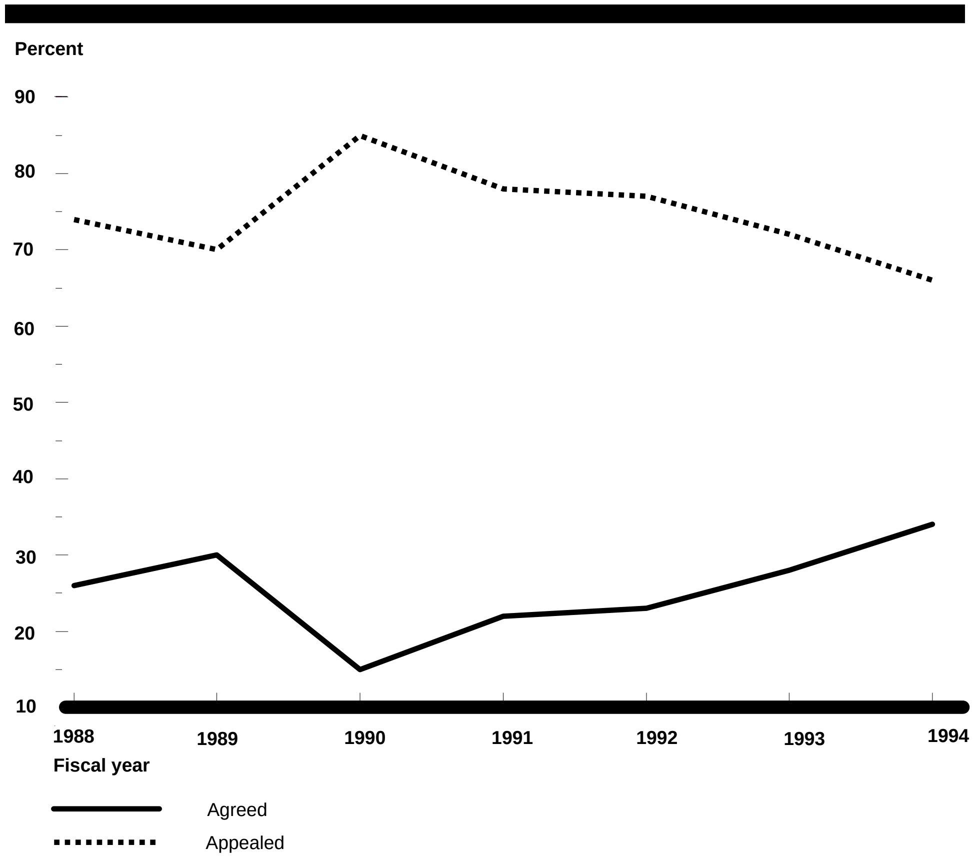
First, large corporations appealed a smaller percentage of the returns that recommended additional taxes and agreed with a higher percentage of these returns. A comparison of 1988 to 1994 showed that higher asset corporations reduced their appeal rate from 33 percent to 19 percent of the audited returns; this rate was 28 percent in 1993. Lower asset corporations reduced this rate from 24 percent to 16 percent of the returns.

Second, the two types of no-change rates moved in different directions over the 7 years. The rate with audit adjustments steadily declined and the rate without audit adjustments slowly increased. The rate without adjustments increased for both types of corporations over the 7 years—a 100-percent increase for higher asset corporations and an 80-percent increase for lower asset corporations. Conversely, the rate with adjustments decreased by over 40 percent for both higher and lower asset corporations.

Further, a comparison of 1988 rates to 1994 rates showed that the no-change rate without adjustments for lower asset corporations was about twice the rate for higher asset corporations. Over the 7 years, the overall no-change rate averaged 34 percent for lower asset corporations and 28 percent for higher asset corporations.

IRS Examination officials noted these increases in the no-change rate without adjustments. For all large corporations, this rate was 16 percent in 1994; this rate had been at or above 10 percent for lower asset corporations and had reached 10 percent for higher asset corporations by 1994. These officials said a more satisfactory rate would be less than 10 percent within all IRS regions. They recognized the need to be more selective in placing returns into the audit stream. They noted that this will only be accomplished by universally using a process that better selects returns for audit and that then identifies issues on those returns that need to be audited. They pointed to a task force that IRS convened in 1994 to develop the universal process across IRS.

Figure II.9: Percent of Additional Taxes Recommended by Type of Closure for Large Corporations, Fiscal Years 1988 Through 1994



Source: GAO analysis of IRS data.

Table II.9: Percent of Additional Taxes Recommended for Large Corporations by Asset Size and Type of Closure, Fiscal Years 1988 Through 1994

	Lower asset total		Higher asset total		Total all asset categories	
	Type of audit closure					
Fiscal year	**Appealed[a]**	**Agreed**	**Appealed[a]**	**Agreed**	**Appealed[a]**	**Agreed**
1988	70%	30%	76%	24%	74%	26%
1989	62	38	75	25	70	30
1990	76	24	88	12	85	15
1991	61	39	87	13	78	22
1992	70	30	82	18	77	23
1993	64	36	76	24	72	28
1994	64	36	67	33	66	34
Average	**67%**	**33%**	**79%**	**21%**	**75%**	**25%**

[a]In 1991, IRS started to track partial agreements for appealed returns. The percent of appealed dollars includes these partial assessments which is less than 6 percent of the total additional taxes recommended.

Source: GAO analysis of IRS data.

As with the trends in closing audited returns, a comparison of 1988 to 1994 showed that the large corporations appealed less and agreed with more of the recommended tax amounts. Unlike with the return trends, the large corporations appealed the majority of these amounts (about two-thirds by 1994).

Further, the larger the asset size, the more likely that the large corporation would appeal the recommended taxes rather than agree to pay them. On average, higher asset corporations appealed 79 percent of the recommended tax amounts compared to 67 percent for those with lower assets over the 7 years.

Assessment Rates for Large Corporations

Table III.1 shows our computation of the assessment rate on net tax recommendations—recommended additional taxes less recommended tax decreases. IRS assessed $2.33 billion (27 percent) of the $8.64 billion in taxes recommended.[1] IRS made the assessments through December 1994 for audits closed in fiscal years 1988 through 1994.

Table III.1: Assessment Rate on Net Additional Recommended Taxes for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in millions

Large corporation asset size	Taxes recommended	Taxes assessed	Assessment rate
$10 mil. < $50 mil.	$2,089	$ 621	29.75%
$50 mil. < $100 mil.	888	220	24.78
$10 mil. < $100 mil.	**2,977**	**841**	**28.27**
$100 mil. < $250 mil	2,043	776	37.98
$250 mil. & over	3,620	714	19.72
$100 mil. & over	**5,663**	**1,490**	**26.31**
Total	**$8,640**	**$2,331**	**26.98%**

Source: GAO analysis of IRS data.

The higher and lower asset corporations had similar assessment rates—26 percent and 28 percent, respectively. By asset class, the rates ranged from 20 percent to 38 percent. The 38 percent rate was driven by audits in the Manhattan District Office. Manhattan accounted for $467.9 million (23 percent) of taxes recommended and $372.7 million (48 percent) of taxes assessed in that asset class.

IRS Examination officials itemized factors outside of the audits that depressed the assessment rate. For this reason, they cautioned against using the rate to measure audit effectiveness. They pointed to net operating losses that large corporations carried over to offset taxes recommended as well as offsets or reductions by claims for refunds, abatements, and retroactive tax law changes and court decisions. They also said recommended taxes can be lost in Appeals due to hazards of litigation and to large corporations withholding tax data until then. If IRS auditors had had these data, they would have been less likely to

[1]This rate approximates our computed CEP rate—22 percent ($7.1 billion of $32.4 billion). Both rates exclude interest. For CEP, interest amounted to $3.3 billion; for other large corporations, interest amounted to about $2.2 billion—$1.6 billion for those with higher assets and $0.6 billion for those with lower assets.

recommend taxes. These officials did not know the extent to which these nonaudit factors affected the assessment rate.

IRS reports audit results by the gross recommended additional taxes. Table III.2 shows the assessment rate when recommended tax increases and tax decreases are not netted.

Table III.2: Assessment Rate on Gross Additional Taxes Recommended for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in millions

Large corporation asset size	Taxes recommended	Taxes assessed	Assessment rate
$10 mil. < $50 mil.	$2,548	$ 985	38.65%
$50 mil. < $100 mil.	1,164	464	39.87
$10 mil. < $100 mil.[a]	**3,713**	**1,449**	**39.03**
$100 mil. < $250 mil	2,413	1,084	44.91
$250 mil. & over	4,304	1,378	32.03
$100 mil. & over[a]	**6,717**	**2,462**	**36.66**
Total[a]	**$10,430**	**$3,912**	**37.51%**

[a]Difference due to rounding.

Source: GAO analysis of IRS data.

Our analysis of just the gross additional taxes recommended showed a higher assessment rate overall (38 percent) and by asset class (32 percent to 45 percent) compared to the net rate. IRS has estimated similar gross assessment rates using data from fiscal years 1992 through 1994 versus our 7-year period. IRS' rate was 36 percent and ranged from 24 percent to 54 percent by asset class.

Table III.3 provides the net assessment rate for the districts that recommended at least $100 million in additional taxes.

Table III.3: Districts With Over $100 Million in Net Additional Taxes Recommended for Large Corporations in Descending Order of Assessment Rate, Fiscal Years 1988 Through 1994

Dollars in millions

District Name	Number of returns	Net taxes recommended	Taxes assessed	Assessment rate
1. Cleveland	1,154	$117	$120	102.70%
2. Manhattan	2,436	507	343	67.63
3. Greensboro, NC	929	187	117	62.41
4. St. Paul	1,162	175	78	44.92
5. Des Moines	535	117	50	43.24
6. Atlanta	1,123	228	96	42.20
7. Newark	2,113	159	54	33.93
8. Detroit	1,654	324	104	32.07
9. Milwaukee	972	118	36	30.20
10. St. Louis	801	163	47	28.55
11. Philadelphia	1,363	106	25	24.03
12. Chicago	1,631	139	31	22.01
13. Salt Lake City	263	111	24	21.66
14. Dallas	2,310	189	36	19.17
15. Houston	796	204	32	15.54
16. Laguna Nigel, CA	948	336	39	11.73
17. Oklahoma City	831	230	19	8.29
18. Los Angeles	966	484	17	3.60
19. San Francisco	549	611	6	0.90
20. Baltimore	1,036	144	0	0.08
All other districts	21,843	1,815	584	32.18
Not allocable to a district office[a]	10,731	2,175	473	21.73
Total[b]	**56,146**	**$8,640**	**$2,331**	**26.98%**

[a]IRS records did not identify a district office for all taxes recommended. The recommended taxes allocable to a district were about $6.5 billion (75 percent).

[b]Difference due to rounding.

Source: GAO analysis of IRS data.

Across IRS' 64 districts, 20 recommended net additional taxes of $100 million or more between fiscal years 1988 and 1994. Three of the 20 districts—San Francisco, Manhattan, and Los Angeles—each recommended about $500 million or more and together accounted for $1.6 billion of the $8.6 billion recommended by all districts.

As table III.3 shows, the assessment rates varied widely across the districts. The rates reached as high as about 103 percent to less than 1 percent. By including all but two IRS districts doing large corporate audits, the lowest rate was negative 20 percent.[2]

Assessment rates that exceed 100 percent indicate that appeals officers assessed more taxes than recommended by revenue agents. This can occur when further adjustments increase tax liability while the case is under Appeals' jurisdiction. For example, liability increases can occur when an adjustment on another tax year decreases a net operating loss carryback deduction on the tax years being appealed, a math error is found, or a taxpayer files an amended return increasing tax liability.

Negative assessment rates occur when the appeals officer not only concedes all taxes recommended but also approves a tax refund because the taxpayer filed a claim for refund or the appeals process reduced the reported tax liability. For example, the appeals officer can decrease tax liability because of an error in the taxes recommended or an increase in a loss carryback deduction from another tax year to the tax year in Appeals.

IRS Examination officials did not know the specific reasons for the lowest rates. They noted that two regions tended to account for these lowest rates. They planned to follow up with the regions to uncover the reasons and see whether actions need to be taken.

Using gross additional taxes recommended, the assessment rate and ranking of the 20 districts changed slightly. The rate ranges from 90 percent to 3 percent. (See table III.4.)

[2]We excluded two districts whose assessment rates exceeded negative 100 percent because all of the net recommended dollars were refunds and IRS eventually refunded even more; the IRS databases did not indicate the reasons. Regardless, the recommended refunds totaled less than 0.1 percent of all net taxes recommended.

Table III.4: Descending Order of Large Corporation Assessment Rates for Gross Additional Taxes Recommended for Those Districts With Over $100 Million in Net Additional Taxes Recommended, Fiscal Years 1988 Through 1994

Dollars in millions

District Name	Number of returns	Gross taxes recommended	Taxes assessed	Assessment rate
1. Cleveland	985	$145	$130	89.88%
2. Manhattan	2,059	723	537	74.32%
3. Greensboro, NC	810	209	139	66.37%
4. Newark	1,727	254	144	56.75%
5. St. Paul	1,003	185	88	47.62%
6. Atlanta	980	248	116	46.86%
7. Des Moines	449	129	60	46.19%
8. Milwaukee	799	138	61	44.41%
9. Philadelphia	1,113	142	60	42.02%
10. Chicago	1,316	214	87	40.84%
11. Dallas	1,890	259	103	39.54%
12. Detroit	1,475	358	135	37.59%
13. St. Louis	661	182	65	35.53%
14. Salt Lake City	215	119	33	27.68%
15. Houston	668	228	53	23.33%
16. Baltimore	871	179	27	15.36%
17. Oklahoma City	690	246	33	13.52%
18. Laguna Nigel, CA	839	365	48	13.16%
19. Los Angeles	806	524	53	10.11%
20. San Francisco	460	628	20	3.26%
All other districts	18,234	2,347	1,026	43.73%
Not allocable to a district office[a]	8,543	2,609	893	34.22%
Total[b]	**46,593**	**$10,430**	**$3,912**	**37.51%**

[a]IRS records did not identify a district office for all taxes recommended. The gross recommended taxes allocable to a district were about $7.8 billion (75 percent).

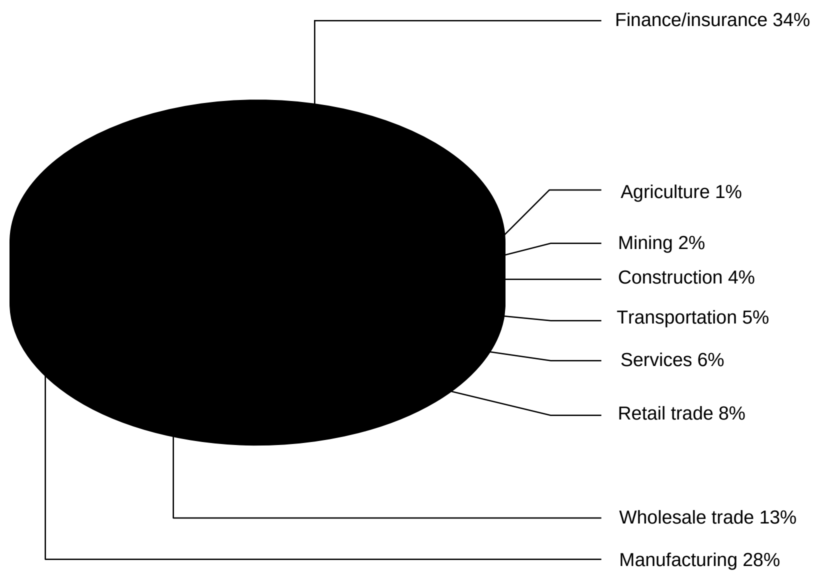
[b]Difference due to rounding.

Source: GAO analysis of IRS data.

Profile of Large Corporations

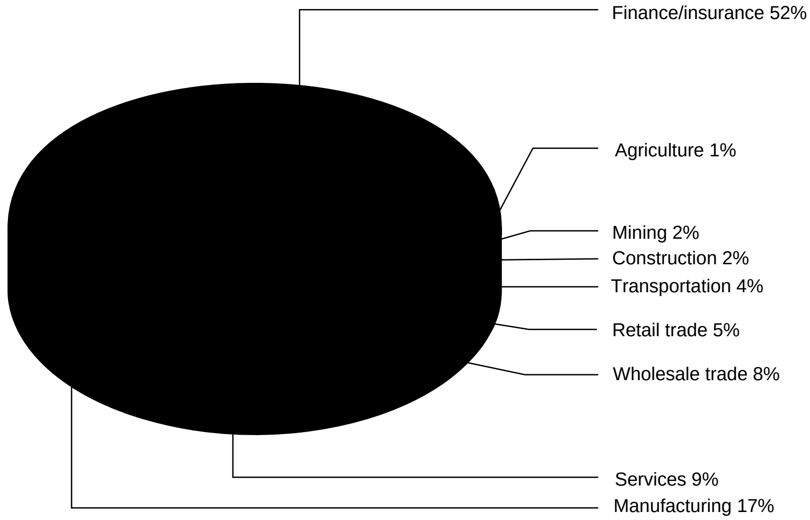
To develop a profile of large corporations, we used SOI data on large corporations that filed income tax returns for 1992. We split our profile into large corporations that were audited and not audited, using AIMS data. Within that framework, the elements we profiled included the type of industry, asset size, reported income and tax, and types of tax credits claimed.

Figure IV.1: Audited Large Corporations by Type of Industry, 1992



Source: GAO analysis of IRS' SOI data.

Figure IV.2: Nonaudited Large Corporations by Type of Industry, 1992



Source: GAO analysis of IRS' SOI data.

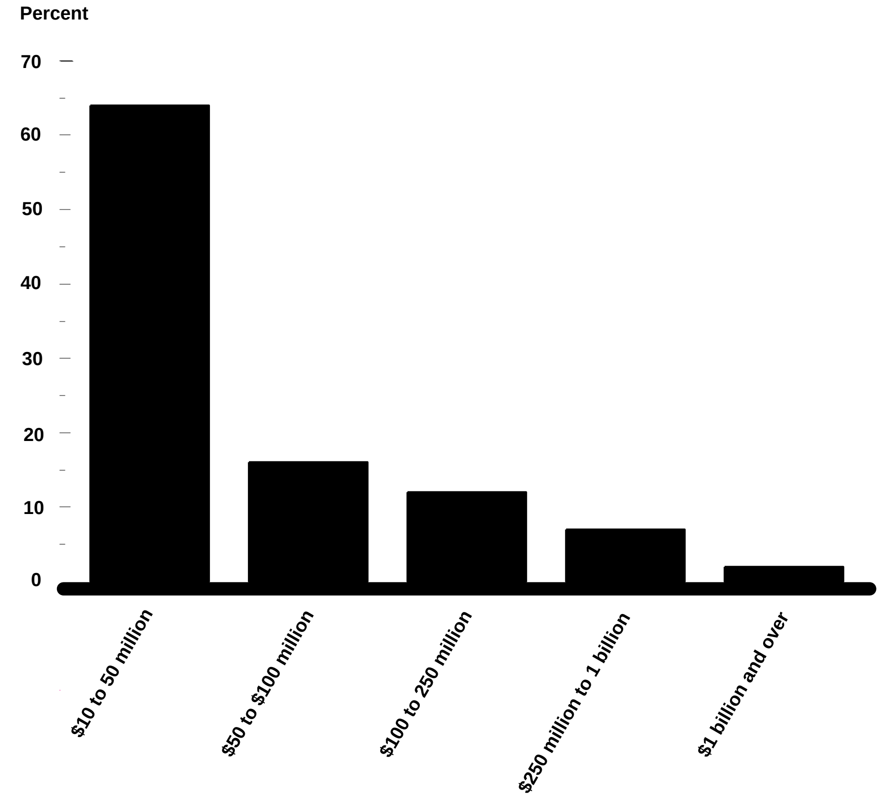
The majority of audited large corporations were engaged in finance, insurance and real estate (34 percent); manufacturing (28 percent); and wholesale trade (13 percent).

The industry profile differs for the large corporations that were not audited. A higher percentage of them were involved in finance/insurance and real estate (52 percent), and a lower percentage were in manufacturing (17 percent) and wholesale trade (8 percent). The third-ranking industry involved services (9 percent).

For both audited and nonaudited returns of the corporations involved in finance, insurance and real estate, the majority involved banks and credit agencies.

In the manufacturing industry for audited returns, the corporations primarily manufactured electronic equipment, fabricated metals (such as metal cans and shipping containers), food, and chemicals. For returns not audited, the manufacturing corporations had a similar industry profile to those that were audited. They were largely involved in the same industries.

Figure IV.3: Percent of Large Corporations by Asset Size, 1992



Source: GAO analysis of IRS' SOI data.

In 1992, 79 percent of the large corporations reported assets of $10 million to $100 million (lower asset size), and 21 percent reported $100 million or more (higher asset size). Over 60 percent reported less than $50 million in assets.

For all corporations, the average asset size was $131 million. The average asset size was $32 million for lower asset corporations and $510 million for higher asset corporations.

Comparing those audited versus not audited, the results were similar. For example, 75 percent of the audited corporations and 81 percent of the nonaudited corporations were in the lower asset group; the rest were higher asset corporations. On average, the audited corporations reported $136 million in assets while those not audited reported $128 million in assets.

Table IV.1: Income and Tax Reported by Audited and Nonaudited Large Corporations by Asset Size, 1992

Dollars in thousands

	Amounts	Average amounts	Amounts	Average amounts
Higher asset size - $100 million & over				
	Audited[a]	Audited[a]	Not audited[b]	Not audited[b]
Total income	$308,701,228	$92,787	$412,707,183	$86,904
Taxable income	36,969,665	11,112	39,261,772	8,267
Income tax	12,576,614	3,780	13,291,383	2,799
Net tax	11,173,474	3,358	10,617,493	2,236
Lower asset size - $10 million to $100 million				
	Audited[c]	Audited[c]	Not audited[d]	Not audited[d]
Total income	$143,372,354	$14,018	$184,122,017	$8,830
Taxable income	15,038,065	1,470	15,504,506	744
Income tax	5,105,788	499	5,233,269	251
Net tax	4,868,725	476	4,773,347	229

[a]Represents 3,327 corporations.

[b]Represents 4,749 corporations.

[c]Represents 10,228 corporations.

[d]Represents 20,851 corporations.

Source: GAO analysis of IRS' SOI data.

In dollar amounts, the nonaudited large corporations reported more total income, taxable income, and income tax than the audited corporations. However, the audited large corporations reported higher average amounts in these categories. These higher average amounts varied by asset group. For example:

- Higher asset corporations that were audited reported higher average amounts in these categories than those not audited.
- Lower asset corporations that were audited reported much higher average amounts in these categories than those not audited. The reported average amounts by the audited group usually doubled or almost doubled these amounts for the nonaudited group, except for total income. For total income, the audited group reported about 59 percent more on average.

Further analysis uncovered other results for 1992, as follows.

- Among all large corporations, the approximate $31.5 billion in reported net tax was about 30 percent of the approximate $106.8 billion in reported taxable income.
- The percentage of returns reporting zero taxable income and zero tax was lower for audited returns compared to nonaudited returns. For example, 22 percent of audited returns reported zero net tax compared to 36 percent for nonaudited returns.[1]

We also analyzed the net operating loss deduction that large corporations claimed to reduce their 1992 taxable income. Audited higher asset corporations claimed about $2.5 billion (average of about $4.9 million), and those not audited claimed about $6.6 billion (average of about $7.8 million). Among lower asset corporations, those audited claimed about $1.3 billion (average of about $1 million), and those not audited claimed about $3.9 billion (average of about $0.9 million).

[1]Of the 13,555 audited corporations, 2,956 reported zero net tax (22 percent); of the 25,600 nonaudited corporations, 9,200 reported zero net tax (36 percent).

Table IV.2: Tax Credits Claimed by Audited and Nonaudited Large Corporations, 1992

Dollars in thousands

Type of credit	Number claiming credit	Total amount claimed	Percent of total amount	Average amount claimed
Audited corporations[a]				
Possessions tax credit	61	$1,037,698	47%	$17,011
Foreign tax credit	995	653,050	30%	656
General business credit	1,577	247,092	11%	157
Alternative minimum tax credit	1,412	236,029	11%	167
Other[b]	78	13,968	1%	179
Total credit	3,359	$2,187,837	100%	$ 651
Nonaudited corporations[c]				
Possessions tax credit	174	$2,628,703	62%	$15,107
Foreign tax credit	697	1,110,210	26	1,593
General business credit	1,660	232,950	5	$140
Alternative minimum tax credit	1,980	257,573	6	$130
Other[b]	49	11,009	[d]	$225
Total credit	**3,875**	**$4,240,444**	**100%**	**$1,094**

[a]Represents 13,555 corporations.

[b]Nonconventional fuel source credit and orphan drug credit.

[c]Represents 25,600 corporations.

[d]Less than 1 percent.

Source: GAO analysis of IRS' SOI data.

For corporations audited, the possessions tax credit accounted for 47 percent of the total credits; the foreign tax credit represented another 30 percent. Both credits were claimed primarily by higher asset corporations. Among corporations not audited, the possessions tax credit accounted for 62 percent, and the foreign tax credit accounted for 26 percent of the total credits claimed.

Because the possessions tax credit was claimed so much, we looked more closely at which types of audited and nonaudited large corporations claimed this credit. The differences were minor, as illustrated below.

- Among audited corporations, manufacturers claimed 98 percent; manufacturers of chemicals/drugs and food claimed 79 percent of the total. The majority of the corporations claiming this credit were in the higher asset group (90 percent).
- Among nonaudited corporations, manufacturers claimed 96 percent; manufacturers of chemicals/drugs and instruments and related products claimed 80 percent of the total. Further, 84 percent of the nonaudited corporations claiming the credit fell into the higher asset group.

Additional Taxes Recommended Presented in Constant Dollars

Table V.1: Additional Taxes Recommended Presented in Constant Dollars for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in millions

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	**$10 mil. < $50 mil.**	**$50 mil. < $100 mil.**	**Subtotal[a]**	**$100 mil. < $250 mil.**	**$250 mil. & over**	**Subtotal[a]**	**Total[a]**
1988	$488	$221	**$709**	$368	$877	**$1,245**	**$1,954**
1989	368	226	**594**	$286	798	**1,083**	**1,678**
1990	397	269	**665**	$631	882	**1,513**	**2,178**
1991	654	239	**892**	$481	1,152	**1,633**	**2,526**
1992	620	311	**931**	$519	904	**1,423**	**2,354**
1993	554	254	**808**	$517	1,359	**1,876**	**2,684**
1994	481	200	**680**	$429	758	**1,186**	**1,867**
Average	**$509**	**$246**	**$754**	**$462**	**$961**	**$1,423**	**$2,177**

Note: Taxes recommended are presented in 1994 dollars.

[a]Difference due to rounding.

Source: GAO analysis of IRS data.

In a comparison of 1988 to 1994, additional taxes recommended decreased 4 percent overall and for lower asset corporations in 1994 constant dollars. For higher asset corporations, the recommended taxes decreased 5 percent from $1,245 million in 1988 to $1,186 million in 1994. The greatest decrease of 14 percent occurred for corporations with assets of $250 million and over ($877 million in 1988 to $758 million in 1994).

Table V.2: Net Additional Taxes Recommended Presented in Constant Dollars for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in millions

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Subtotal[a]	$100 mil. < $250 mil.	$250 mil. & over	Subtotal[a]	Total[a]
1988	$430	$166	**$596**	$323	$692	**$1,016**	**$1,611**
1989	284	180	**464**	222	678	**899**	**1,363**
1990	262	205	**467**	580	814	**1,394**	**1,861**
1991	558	182	**739**	393	1,047	**1,440**	**2,180**
1992	542	270	**812**	430	803	**1,233**	**2,045**
1993	430	216	**646**	450	1,183	**1,632**	**2,278**
1994	423	150	**572**	372	618	**990**	**1,562**
Average	**$418**	**$195**	**$614**	**$396**	**$834**	**$1,229**	**$1,843**

Note: Taxes recommended are presented in 1994 dollars.

[a]Difference due to rounding.

Source: GAO analysis of IRS data.

In 1994 constant dollars, net additional taxes recommended slightly decreased 3 to 4 percent overall and for higher and lower asset corporations in a comparison of 1988 to 1994 results. Of the four asset classes, only the audits of corporations with assets of $100 million to less than $250 million generated more net recommended taxes—about 15 percent (from $323 million in 1988 to $372 million in 1994).

Table V.3: Additional Taxes Recommended per Return, Presented in Constant Dollars for Large Corporations, Fiscal Years 1988 Through 1994

Dollars in thousands

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	$10 mil. < $50 mil.	$50 mil. < $100 mil.	Taxes recommended per return	$100 mil. < $250 mil.	$250 mil. and over	Taxes recommended per return	Taxes recommended per return
1988	$105	$117	**$108**	$202	$520	**$355**	**$194**
1989	72	135	**87**	185	585	**372**	**173**
1990	64	157	**84**	413	745	**558**	**205**
1991	92	127	**99**	296	851	**548**	**211**
1992	97	168	**113**	338	702	**504**	**213**
1993	88	151	**101**	326	1,029	**645**	**247**
1994	82	124	**91**	266	567	**402**	**180**
Average	**$86**	**$140**	**$98**	**$287**	**$706**	**$479**	**$204**

Note: Taxes recommended are presented in 1994 dollars.

Source: GAO analysis of IRS data.

In 1994 constant dollars, a comparison of 1988 to 1994 showed that the amount of additional taxes recommended per return has decreased overall and for lower asset size corporations. For higher asset size corporations, this ratio increased 13 percent (about $355,000 in 1988 to $402,000 in 1994). However, corporations with assets of $10 million to less than $50 million drove the overall change with a decrease of 21 percent of recommended taxes per return (from about $105,000 in 1988 to about $82,000 in 1994).

Table V.4: Additional Taxes Recommended per Direct Audit Hour, Presented in Constant Dollars for Large Corporations, Fiscal years 1988 Through 1994

Dollars in thousands

	Large corporation asset size						
	Lower asset size			Higher asset size			
Fiscal year	**$10 mil. < $50 mil.**	**$50 mil. < $100 mil.**	**Taxes recommended per audit hour**	**$100 mil. < $250 mil.**	**$250 mil. and over**	**Taxes recommended per audit hour**	**Taxes recommended per audit hour**
1988	$1,485	$1,392	**$1,455**	$1,528	$2,117	**$1,901**	**$1,710**
1989	1,025	1,404	**1,142**	1,274	2,935	**2,184**	**1,651**
1990	858	1,629	**1,061**	2,957	3,900	**3,442**	**2,042**
1991	1,089	1,106	**1,094**	1,807	4,912	**3,261**	**1,918**
1992	1,089	1,431	**1,183**	2,195	2,933	**2,612**	**1,768**
1993	989	1,155	**1,036**	1,932	4,583	**3,325**	**1,997**
1994	845	891	**858**	1,510	2,196	**1,887**	**1,313**
Average	**$1,033**	**$1,262**	**$1,098**	**$1,865**	**$3,210**	**$2,601**	**$1,764**

Note: Taxes recommended are presented in 1994 dollars.

Source: GAO analysis of IRS data.

A decrease occurred overall and for each asset class except for corporations with assets of $250 million and over. The overall decrease from $1,710 in 1988 to $1,313 in 1994 was 23 percent. However, corporations with assets of $10 million to less than $50 million experienced the greatest decrease of 43 percent ($1,455 in 1988 to $858 in 1994).

Major Contributors to This Report

General Government Division, Washington, D.C.

Thomas D. Short, Assistant Director, Tax Policy and Administration Issues
Patricia H. McGuire, Computer Specialist
Susan Baker, Computer Assistant

Kansas City Regional Office

Cecelia M. Ball, Project Manager
Royce L. Baker, Issue Area Coordinator
Thomas N. Bloom, Computer Specialist

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