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**TAX
ADMINISTRATION**

**IRS' Partnership
Compliance Activities
Could be Improved**





General Government Division

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The Honorable Bill Archer
Chairman
The Honorable Robert Packwood
Vice Chairman
Joint Committee on Taxation
Congress of the United States

In fiscal year 1992, the number of partnerships totaled about 1.5 million—about the same as in 1981. Yet, during this time period, the number of partners nearly doubled from 9.1 million to 15.7 million, partnership assets increased from \$1 trillion to \$1.9 trillion, and partnership net income went from a net loss of \$4.1 billion to a net gain of \$42.9 billion.¹ Tax law changes made in the 1980s affected partnerships' reportable income as well as the Internal Revenue Service's (IRS) approaches to administering partnerships' compliance with the tax laws.

This report responds to your predecessors' request that we determine (1) the extent of partnership compliance with federal tax laws, (2) any steps IRS is taking to improve partnership compliance, and (3) any additional efforts that IRS could take to improve partnership compliance.

Background

A partnership is an association of two or more entities or persons that join together to carry on a trade or business, with each partner contributing money, property, labor, or skill and each partner expecting to share in the profits and losses. Partnerships are not taxed directly on their income. Rather, all income (or loss), credits, and other tax-related items "flow through" to the partners, who are to report their individual shares on their own returns.² Partners can be individuals, corporations, other partnerships, or virtually any other legal entity.

Partnerships are required to file a Form 1065, U.S. Partnership Return of Income, Credits and Deductions, Etc., which includes the Schedule K that shows the partnership's income or loss, deductions, and credits that are to be distributed to the partners. Partnerships also are required to file Schedule K-1, Partner's Share of Income, Credits and Deductions, Etc., which shows each partner's separate share of the total partnership business activity.

¹Dollar figures are expressed in 1992 constant dollars.

²The amount of partnership loss a partner may deduct is limited by basis rules, at-risk limitations, passive activity limitations, and limitations applicable to specific deductions.

Because partnership income and deductions flow through to partners, partnerships can provide an attractive structure for sheltering income from tax. A tax shelter is an investment in which a significant portion of the investor's return consists of tax benefits that not only offset any tax liability that might otherwise arise from the investment, but also "shelter" other income of the investor, usually from the investor's business or professional activities. This tax sheltering aspect led to the development of abusive tax shelters during the 1970s and early 1980s, which generally took advantage of loopholes in the law in ways that were not intended by Congress. IRS generally defines an abusive tax shelter as one that lacks economic reality or viability when viewed in its entirety.

Legislation enacted by Congress over the past decade has significantly reduced the potential to use a partnership as a tax shelter. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) introduced (1) special partnership audit mechanisms to streamline the audit process for partnerships and (2) various penalties to deter the promotion of and investment in abusive tax shelters. For example, section 6700 of the Internal Revenue Code, added by TEFRA, provides a nontaxpayer penalty to those who promote abusive tax shelters.

Of various substantive provisions directed at tax shelters, the at-risk rules and the passive activity loss rules are the most prominent.³ The at-risk rules of section 465 of the Code limit the deductibility of losses from an activity to the amount the taxpayer has at risk with respect to the activity. The passive activity loss rules found in section 469 of the Code, added by the Tax Reform Act of 1986 (TRA), provide the broadest attack on tax shelters by preventing a taxpayer from using net losses incurred in a passive activity from offsetting income derived from nonpassive activities.

Results in Brief

The current extent of partnership tax compliance is unknown. IRS' most current partnership compliance data were collected under its tax year 1982 partnership Taxpayer Compliance Measurement Program (TCMP).⁴ These data showed that partnerships underreported their net income by \$13 billion in 1982 which we estimate resulted in an underpayment of taxes by partners approaching \$3.6 billion. Even when partnerships

³For this purpose, the term "passive activity" is defined as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate and rental activities.

⁴Under TCMP, IRS examiners do line-by-line audits of tax returns on a probability sample taken for the entire return population. IRS uses TCMP data to determine compliance levels, develop formulas for objectively selecting returns for audit, and allocate audit resources.

reported all of their income, partners sometimes failed to include it in their own tax returns. Thus, IRS estimated that individual partners owed an additional \$2.4 billion in taxes in 1982. But significant tax law changes in the intervening years make these data unreliable indicators of the present situation. IRS will not have more current partnership compliance data until October 1998 when its TCMP audits of tax year 1994 partnership returns are scheduled to be completed.

We found that IRS' compliance strategy for addressing partnership compliance relied almost exclusively on audits to detect noncompliance. The strategy did not include either a nonfiler or computer document matching component. IRS did have a limited document matching program to identify partners who do not report partnership income on their individual income tax returns.

We made several observations concerning the audit program.

- In recent years, relatively few partnership returns were audited because IRS focused its business audit resources on taxable entities, such as corporations. In fiscal year 1992, IRS audited 0.5 percent of the partnership returns filed and changed 63 percent of those audited, making positive income adjustments of \$4.2 billion. The partnerships appealed about \$3.5 billion, or 84 percent, of the adjustments, and the results are still pending on \$2.4 billion.
- Partnership audits were not as productive as other types of business returns when measured by the percent of returns audited that resulted in audit adjustments, which is one measure that IRS uses to determine audit productivity. About 37 percent of the returns audited were closed without any change to the partnership return, while the no-change rate on corporate returns was 23 percent. The partnership no-change rate may be higher because the formula used to select returns for audit was developed from 1982 TCMP data, while the corporate formula was based on 1987 TCMP data. Also, we found that the partnership audits may be more productive than indicated by the no-change rate because adjustments made to partners' returns that did not change the partnership return were considered no-change audits.
- IRS' primary measure of audit productivity—the amount of net taxes assessed per hour of audit time—could not be used for partnership audits because IRS did not have data on the additional taxes partners were assessed or refunded as a result of partnership audit adjustments. These data would help IRS to more fully evaluate audit productivity and could be developed as IRS modernizes its computer systems.

- Until a new partnership audit selection formula is developed, IRS could analyze current partnership audit results for leads to the types of partnership returns that are more likely to be adjusted during audits.

IRS did not have an active program to detect partnerships that stopped filing required returns. It discontinued this program in 1989 to concentrate its nonfiler efforts on taxable business returns, such as corporation and employment tax returns. IRS plans to reinstate a delinquent return program for partnerships in calendar year 1996.

While IRS used information returns it received for individuals in a computer document matching program, it did not have a similar program for information returns it received for partnerships.⁵ IRS already processes information returns that can be used in a partnership document matching program. We could not estimate the total cost for a matching program because IRS is in the process of modernizing its computer and other tax administrative systems, which would affect these costs. IRS plans to complete its modernization projects by the year 2001. IRS would need to begin planning now if it decides to have a partnership document matching program in place by that time.

In its 1991 individual document matching program, IRS processed about 12 percent of the Schedules K-1 it received and matched them against partners' income tax returns. The match resulted in additional tax assessments of \$6.3 million. We estimated that at an additional cost of \$18.6 million to IRS, about \$219.5 million in additional taxes may have been assessed had IRS matched all of the schedules. As part of a fiscal year 1995 compliance initiative, IRS plans to transcribe an estimated 4.1 million Schedules K-1 and, after October 1995, determine whether more schedules should be transcribed. We found that all schedules would need to be transcribed if IRS is to have the compliance system it envisions by the year 2001. In this regard, IRS would need to find ways to reduce data transcription costs, such as developing a schedule that can be electronically scanned into the computer.

Since it has conducted relatively few partnership audits in recent years, IRS began a study in 1994 to collect data for training revenue agents on how to identify partnership compliance issues. For the study, IRS began audits of

⁵IRS has a computer matching program to identify individual taxpayers who potentially underreported their taxable income or failed to file returns. Third parties, such as banks and other businesses, are required to file annual information returns to report various payments made to or by individuals and partnerships. IRS matches amounts on information returns against amounts reported on individual tax returns, but not partnership returns.

about 220 partnerships in February 1995. The agents are to be trained by October 1995 at which time partnership TCMP audits are scheduled to begin. Our evaluation of IRS' study plan showed that to meet its training and TCMP audit schedule, IRS would need to supplement the study with data from recently completed audits because it takes, on average, about 12 months to complete audits of the types of partnerships included in the study. IRS is now collecting these data.

Objectives, Scope, and Methodology

Our objectives were to determine (1) the extent of partnership compliance with federal tax laws, (2) any steps IRS is taking to improve partnership compliance, and (3) any additional efforts that could be taken to improve partnership compliance.

To determine the extent of current partnership compliance, we reviewed data from the last partnership TCMP, which IRS conducted on returns filed in 1982. Using these data, we estimated the tax effect of partnerships underreporting their tax year 1982 income. We also obtained data from IRS' tax gap estimates on the estimated amount of taxes taxpayers owed on income received from partnerships, but did not report on their individual income tax returns.

To determine what steps IRS is taking to correct partnership compliance, we analyzed IRS' Audit Information Management System (AIMS) database on cases closed in fiscal year 1992 to determine audit results by various characteristics. We also reviewed the examination workpapers from 177 partnership audits to determine the types of compliance issues identified by IRS. These audits were randomly selected from the 8,229 audits completed in fiscal year 1992. The results of our analyses are not projectable to the universe. We excluded tax shelters because TRA removed the major incentive for using partnerships as tax shelters. We analyzed tax year 1990 Statistics of Income (SOI) data on partnerships and IRS' 1990 and 1991 Returns Transaction File (RTF) data for partnership audits closed in fiscal year 1992 to identify and compare characteristics of the universe of partnerships with characteristics of audited partnerships. Appendix I discusses this analysis and its limitations. We also met with IRS officials to discuss their plans for addressing partnership compliance issues and how these plans fit into IRS' new compliance strategies.

To determine what additional efforts IRS could undertake to improve partnership noncompliance, we analyzed the examination workpapers

from 177 partnership audits to determine whether the audit issues could have been identified and resolved through computer matching.

We did our work in IRS' San Francisco District Office; the Fresno Service Center; and Washington, D.C., headquarters in accordance with generally accepted government auditing standards between June 1993 and December 1994. We requested comments on a draft of this report from the Commissioner of Internal Revenue. On April 26, 1995, IRS officials provided us IRS' comments. IRS representatives at that meeting included the Assistant Commissioner for Examination and the National Director, Service Center Compliance. Their comments are summarized on page 19 and incorporated in this letter where appropriate.

The Current Extent of Partnership Tax Compliance Is Unknown

The latest compliance data available on partnerships are from IRS' 1982 Partnership TCMP Survey. These data showed that partnerships understated their net income and investment income by \$13 billion in 1982, which was about 26 percent of these income types that should have been reported. IRS did not estimate the amount of additional taxes associated with this unreported income because it did not collect tax assessment data on the partners who were liable for the taxes. To develop such an estimate, IRS officials agreed that it would be reasonable to assume that the \$13 billion was taxable at the 28-percent marginal tax rate for individuals for 1982. Using this rate, we estimated the partners would have potentially owed about \$3.6 billion in taxes had partnerships reported this income to them.⁶

In its tax gap study, IRS did have estimates on the taxes owed by individuals on income reported to IRS by partnerships, but not reported by partners on their tax returns.⁷ IRS estimated that in 1982 this amount was about \$2.4 billion in taxes. Therefore, the total potential tax loss associated with partnership noncompliance may have been about \$6.0 billion in 1982.

The unreported income estimated in the 1982 partnership TCMP is not a reliable indicator of unreported partnership income for later years. Over

⁶While we believe this estimate provides a reasonable indication of the underpaid taxes attributable to partnership noncompliance, it is far from being precise. We do not know the tax position of the individual partners and whether additional partnership income would have increased their tax liability.

⁷IRS computes a partnership tax gap as a part of its tax gap estimates for individuals. The tax gap is the difference between income taxes owed and income taxes voluntarily paid. The partnership tax gap does not include taxes on income that partnerships fail to report, but reflects the tax effect of individual partners' not reporting income reported to them by partnerships on Schedule K-1.

10 years have elapsed since these data were collected—a time period in which significant tax law changes have affected partnerships. TEFRA and TRA made major changes to partnership law. Under TEFRA, the tax treatment of partnership items is to be determined by IRS in one consolidated audit and the results applied automatically to the partners. TRA removed most incentives for individual partners to use partnerships for tax reduction purposes. IRS plans to include partnerships in its 1994 TCMP survey, but does not plan to collect data on audit adjustments made to partners' tax returns. Without this information, IRS will not be able to estimate the tax effect of partnership noncompliance.⁸

IRS Had a Limited Partnership Compliance Program

Generally, three enforcement tools can be used in a comprehensive taxpayer compliance program. The first is an audit program that selects for audit those taxpayers most likely to be noncompliant. The second is a program that identifies taxpayers who fail to file required returns. And third is a computer matching program that matches information returns against tax returns to identify taxpayers who may have underreported their income. Data and resource limitations prevented IRS from making full use of these tools in its partnership compliance program. As a result, its partnership compliance program was limited.

Almost all of IRS' partnership compliance activities consisted of audits. While less than 0.5 percent of partnership returns were audited by revenue agents in fiscal year 1992, about 37 percent of the returns audited did not result in adjustments to partnership returns. This no-change rate was higher than that for other business return audits. One reason for the higher partnership no-change rate may be that IRS neither had current compliance data nor gathered data on audit results to help it target noncompliant partnerships. Also, IRS did not use its limited resources for an active partnership nonfiler program and a computer document matching program for determining whether income reported on information returns was reported on partnership returns. IRS did use about 12 percent of the Schedules K-1 it received in its tax year 1991 matching program for individual taxpayers to determine whether individual partners reported their partnership income.

⁸In our report *Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program* (GAO/GGD-95-39, Dec. 30, 1994), we proposed that IRS collect such data, but we were told that it would be too costly to collect. We suggested that as an alternative IRS could apply the marginal tax rate for individuals to the unreported partnership income found in the 1994 TCMP.

Partnership Audit Program Was Less Active and Productive Than Other Business Audit Programs

From fiscal year 1988 to fiscal year 1992, audit coverage of partnerships decreased by almost one-half, while it more than doubled for corporations and remained relatively unchanged for nonfarm sole proprietors. IRS has tended to focus its business audit resources on taxable entities, such as corporations. As a result, the number of partnership audits has steadily declined. Table 1 shows the audit rates for partnerships, corporations, and nonfarm sole proprietors for fiscal years 1988 to 1992.

Table 1: Revenue Agent Audit Rates for Business Returns, Fiscal Years 1988 to 1992

Numbers in percent

Fiscal year	Partnership	Corporation	Nonfarm sole proprietors
1988	0.93	1.33	2.35
1989	0.72	2.02	2.13
1990	0.80	2.59	2.04
1991	0.63	2.36	2.14
1992	0.50	2.89	2.06

Source: IRS Annual Reports.

In fiscal year 1992, IRS audited 8,229 partnership returns as compared to 75,797 corporate returns and 135,099 nonfarm sole proprietor returns.⁹ Overall, IRS made positive income adjustments of \$4.2 billion to 4,653, or 57 percent, of the partnership returns it audited in fiscal year 1992. However, \$3.5 billion, or 84 percent, of the adjustments were appealed. At the time of our review, about \$1 billion of the adjustments had been settled in appeals, and the remaining \$2.5 billion were still open. We could not determine the final settlement amounts because IRS tracked these appealed cases by adjustments made to partners' returns, but not to the partnerships' returns.

While adjustments were made to 63 percent of the returns audited, partnership audits were less productive than audits of other business entities when measured by the no-change rate. The no-change rate is the percentage of audits conducted where no changes were made to the return as a result of the audit. Our analysis of IRS data showed that 3,019, or 37 percent, of the 8,229 partnership returns audited in fiscal year 1992 were no-change audits. In contrast, the no-change rate was 23 percent for corporations and 12 percent for nonfarm sole proprietors.

⁹The actual number of partnerships audited was lower than the number of returns audited because IRS audited several years of returns filed by a partnership. For fiscal year 1992, there were 5,565 partnerships associated with the 8,229 partnership returns that were audited.

One reason for the relatively high partnership no-change rate may be that the formula IRS used to select returns for audit was based on 1982 partnership TCMP results. On the other hand, the formula used to select most corporation returns for audit was based on the 1987 corporate TCMP, and the nonfarm sole proprietor selection formula was developed from the 1988 individual TCMP. According to IRS officials, the older the audit selection formula becomes, the less reliable it is for predicting returns most likely to be adjusted. IRS data showed that since the current formula was first used for 1986 partnership returns the no-change rate remained constant at about 18 percent for 1986 through 1988. In 1989, the no-change rate increased to 21 percent and then reached the 30-percent range in 1990, 1991, and 1992.

We found that partnership audit productivity could be reported as being higher than reflected by the current no-change rate because IRS reports the results of a partnership audit as a no-change when the adjustments do not change the partnership return, but do change the partner's(s') return. For the 85 no-change audits reviewed, we found 7 examples where this practice occurred. For example, in one case a partnership with two partners claimed a loss of over \$60,000 on its return. Partner A, who had taxable income, was allocated 100 percent of the loss. Partner B had no taxable income for the year. The revenue agent determined that the allocation was improper because it was done solely to shift losses to the partner with taxable income.¹⁰ The revenue agent reallocated the loss to both partners. Partner A was assessed over \$10,000 in additional tax. The reallocation of loss did not change Partner B's tax position.

IRS' primary measure of audit productivity is the amount of net additional tax assessed per hour of audit time. For partnerships, this measure of productivity is not readily available because they are not taxable entities. Further, IRS' Audit Information Management System (AIMS), which contains audit result data, did not have data on the additional taxes partners were assessed or refunded as a result of audit adjustments made to partnership returns.

To have better measures of partnership audit productivity in terms of the no-change rate and tax assessments per hour of examination time, IRS would have to collect and analyze data that is not readily available on AIMS. Under the Tax Systems Modernization (TSM) initiative, IRS plans to have the

¹⁰Internal Revenue Code section 704(b) requires there be a "substantial economic effect" to the distribution of partnership gain, loss, deduction, or credit. A partnership may not allocate partnership gains or losses to partners merely to reduce the tax burden of one of the partners.

computer capability to collect these data on AIMS so that it can better measure partnership audit productivity.

Analysis of Partnership Computer Files Could Help IRS Target Its Partnership Audit Resources

IRS does not plan to develop new partnership audit selection formulas until late 1998 when its tax year 1994 TCMP audits are scheduled to be completed. In the meantime, IRS could consider using other partnership data to help target its audit resources toward those partnerships with the greatest audit potential. IRS has at least three files that contain useful partnership data that could be used for this purpose—AIMS, which contains data on audit results; RTF, which contains all of the data that are transcribed from partnership returns; and SOI files, which contain more data than found on RTF, but are from a representative sample of all partnership returns filed in a year.

We analyzed these files to determine whether the characteristics of partnerships with audit adjustments were different from those of partnerships where IRS made no adjustments. Our analysis was limited because we did not have comparable tax year data for all three files. We had fiscal year 1992 AIMS data, tax years 1990 and 1991 RTF data, and tax year 1990 SOI data. Appendix I discusses the methodology we used for our analysis and its limitations.

Using these files, we compared characteristics of partnerships where IRS proposed audit adjustments with characteristics of partnerships where no audit adjustments were proposed. Our analysis of the SOI data showed that partnership income generally fell into three categories: (1) ordinary income from trade or business, (2) income from rental real-estate activities, and (3) portfolio or investment income.

Our analysis of AIMS and RTF data showed that for audits closed in fiscal year 1992, the most productive audits in terms of total income adjustment per hour of examination were those where one source of income was 90 percent or more of total reported income and the partnerships were not tax shelters but were subject to TEFRA audit procedures.¹¹ For the 3,547 cases for which we had data, about 18 percent of the audited partnerships fell into this category. These cases accounted for about 42 percent of total dollars adjusted and 23 percent of the partnership examination hours. This analysis suggests that more productive audits may have occurred if resources had been directed to those partnerships subject to TEFRA audit

¹¹Generally, these procedures cover partnerships with 10 or more partners and partnerships with 1 or more nonindividual partners (i.e., a corporation or another partnership). TEFRA requires that IRS follow certain notification procedures when conducting these consolidated audits.

procedures that had 90 percent or more of their income from any one source.

We recognize the limitations of our analysis and do not expect IRS to change its selection criteria on the basis of the results. Instead, we made our analysis to demonstrate how IRS' computerized files may be used to better target its partnership audit resources. In this regard, IRS has established 31 District Office Research and Analysis sites throughout the United States to do compliance research at the district and regional office levels, which were formed to do these types of analyses.

IRS Did Not Pursue Partnerships That Stopped Filing Returns

One of IRS' strategic objectives for fiscal year 2001, as described in its Business Master Plan, is to (1) encourage all taxpayers to voluntarily file timely and accurate tax returns and (2) take appropriate enforcement action when taxpayers fail to follow this practice. However, in 1989, IRS discontinued pursuing partnerships under its computerized delinquency check program, which identifies businesses that stop filing required returns.¹² According to IRS officials, the program was discontinued because IRS wanted to concentrate its business nonfiler resources on returns that could produce additional tax revenues directly, such as corporation and employment tax returns. The decision to discontinue the delinquency check program was also based on IRS' policy not to process and match delinquent Schedule K-1 forms to partners' tax returns. IRS officials said that a delinquency check program for partnerships that did not file tax year 1994 returns will be reinstated in calendar year 1996.

IRS did not have readily available data on the number of partnerships that stopped filing required returns. However, our analysis of the 5,565 partnerships whose audits were closed in fiscal year 1992 showed that 556, or 10 percent, had not filed required partnership returns for tax year 1991. Of these partnerships, IRS had made over \$655 million in audit adjustments for prior years for 380, or 68 percent, of the partnerships. Without tax returns for these partnerships, IRS has no way of knowing whether they are operating in compliance with the tax laws.

¹²Under the delinquency check program, IRS matches business tax returns filed to that business' filing requirements recorded on IRS' business master file. If the program identifies a business that has a filing requirement, but no corresponding return, the business is to be classified as a nonfiler and sent a series of notices requesting the return or an explanation as to why the return does not have to be filed. If no response to the notices is received, IRS is to attempt to contact the business by telephone, and the case may later be given to revenue officers for further investigation.

IRS Did Not Fully Use Information Returns to Verify Partnership Compliance

Our analysis of 181 partnership audits completed in fiscal year 1992 showed that information returns were useful for identifying various types of unreported partnership income. We found that 25 of 116 partnerships for which income was reported on an information return did not report over \$2 million of the income reported on the returns. In one case, information returns issued to a partnership showed gross stocks or bonds sales of over \$1 million. However, the partnership did not report a capital gain or loss on its partnership return. In a second case, a partnership failed to report a gain or loss from the gross sale of over \$600,000 in stocks or bonds. According to IRS officials who reviewed these cases for us, in neither case did the revenue agent identify the unreported income.

IRS officials said that auditors routinely receive transcripts of all information returns associated with partnership returns they are auditing. The audit files we reviewed did not contain these transcripts. However, we did verify with IRS San Francisco District Office officials that information return transcripts were provided to revenue agents for use in partnership audits.

While IRS' current policy is to use information return data for the partnerships it audits, a matching program could help identify underreporting of income by many partnerships not selected for audit. For tax year 1991, IRS received 5.9 million information returns showing payments of \$487 billion made to 829,000 partnerships. About \$277 billion, or 57 percent, of the \$487 billion was gross stocks and bond sales. The remaining amount of about \$211 billion of information return income represented about 37 percent of the \$572 billion in business receipts and investment income reported by the 1.5 million partnerships in 1991. Yet, IRS has no plans to develop a computer document matching program to verify partnership income.

In 1987, IRS took the position that consolidated audit procedures of TEFRA would effectively preclude an information returns matching program for partnerships subject to the TEFRA procedures. These procedures generally cover partnerships with 10 or more partners and partnerships with 1 or more nonindividual partners (i.e., a corporation or another partnership). IRS procedures for its individual matching program include assessing additional tax where the taxpayer agrees with IRS and issuing a statutory notice of deficiency where the taxpayer does not agree or does not respond. The TEFRA procedures do not preclude merely matching information returns to the partnership return. However, an IRS contact with a partnership about a potential underreported income issue could

constitute an audit requiring the TEFRA notice procedures to be followed before IRS could make any adjustment to the partnership's reported income. According to IRS officials, the TEFRA procedures are extremely complex and have produced procedural and administrative problems for IRS.

We found that most partnerships are not subject to the TEFRA audit rules. Our estimate is based on tax year 1990 SOI data, which showed that about 358,000 (23 percent) of 1.6 million partnerships were TEFRA partnerships. The remaining 1.2 million (77 percent) partnerships could have been included in an information returns matching program under current assessment and statutory notice procedures. TEFRA partnerships could be included in a matching program without adversely affecting most of IRS' partnership audits. Most partnerships would be selected for audit before the start of the matching program. IRS' individual matching program starts about 16 months after tax returns are required to be filed. The same time frames would probably apply to partnerships, and by this time, IRS would have already selected most of the partnership returns it planned to audit.

We did not estimate the potential cost to develop and operate a partnership document matching program because data were not available to make reliable estimates. However, IRS already transcribes Forms 1065 and Schedule K information and receives and processes partnership information returns so little or no additional data transcription cost should be incurred. The unknown costs are those associated with matching the documents and investigating the potential underreporter cases. According to IRS officials, these costs would be higher in a partnership document matching program than in the individual document matching program. They said additional costs would be incurred to make flow-through adjustments in addition to costs related to the added complexity of reconciling information documents to fiscal year accrual basis taxpayers.

Costs to match and investigate potential underreporter cases are difficult to estimate because IRS is in the process of developing various TSM systems that would affect program costs. These systems are planned to improve IRS' ability to efficiently match documents and resolve various compliance issues including potential underreporter issues. To take advantage of its modernization efforts, IRS could begin planning now to have a partnership document matching program by 2001.

IRS Does Not Transcribe All Schedules K-1 for Use in Its Individual Document Matching Program

While IRS did not computer match information returns to verify partnership income, it did use a limited number of Schedules K-1, submitted by partnerships in its individual computer document matching program, to verify that partners correctly reported their partnership income. For tax year 1991, 2.5 million (12 percent) of the 20.5 million Schedules K-1 partnerships filed were processed for use in this program. About 52 percent, or 1.3 million of the 2.5 million schedules, were filed electronically, while the remaining 1.2 million were manually transcribed onto IRS computers.¹³

For tax year 1991, IRS assessed partners \$6.3 million in additional taxes, penalties, and interest attributable to unreported partnership income by matching the Schedules K-1 to individual tax returns.¹⁴ IRS estimated that it assessed about \$11.80 in additional taxes for each \$1.00 spent on underreporter cases attributable to Schedules K-1. On the basis of these data, we estimated that at a total additional cost of \$18.6 million, about \$219.5 million in additional taxes may have been assessed if IRS had transcribed and used in its matching program for all of the tax year 1991 Schedules K-1 it received. Appendix II shows how we derived these estimates.

The \$11.80 to \$1.00 revenue-to-cost ratio for matching tax year 1991 Schedules K-1 data to individual tax returns was lower than the tax year 1990 revenue-to-cost ratio, which was \$19.30 to \$1.00. IRS officials believe the difference in the two revenue-to-cost ratios may reflect the large differences in the volume of cases worked during those two periods. They said IRS worked 855 cases for tax year 1990, all of which had potential for a high audit adjustment. However, they said for tax year 1991, IRS worked 37,789 cases which, overall, had potential for lower audit adjustments.

IRS' Business Master Plan for fiscal years 1995 to 1999 contains a compliance initiative to increase the use of Schedule K-1 information. Also, as a part of its fiscal year 1995 budget, IRS received an additional

¹³To determine which Schedules K-1 to match, IRS randomly sampled taxpayers' social security numbers ending in certain digits.

¹⁴For tax year 1992, approximately 2 million, or 12 percent, of the 17.3 million Schedules K-1 filed were used in the matching program. In contrast, IRS used 100 percent of Forms 1099 information returns. The results of matching these documents to individual returns were not available when we completed our work.

\$2.7 million to transcribe and match an estimated 4.1 million schedules.¹⁵ By October 1995, IRS plans to establish a workload selection system to increase its use of these schedules. After this time, IRS plans to determine how many additional Schedules K-1 it should transcribe and match.

To reduce the cost of transcribing additional Schedule K-1 data, IRS could encourage more partnerships to file the schedules electronically. Partnerships currently have the option of filing Schedules K-1 electronically. Of the total 17.3 million Schedules K-1 filed for tax year 1992, 344 partnerships filed 1.7 million (9.8 percent) electronically, which was over 40 times the 41,000 electronically filed tax year 1986 schedules. Another alternative to manually transcribing paper documents would be to develop a Schedule K-1 that can be electronically scanned into the computer. IRS already does this for certain tax forms, such as the Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents.

If more Schedule K-1 data could be computerized, IRS could use these data to identify potential compliance issues other than unreported income. In addition to the partner's share of income, deductions, and credits, the schedule shows the partner's percent of interest in gains, losses, and ownership; and, it shows an analysis of the partner's capital account. Analysis of this information, together with information from the Form 1065, could identify potential inappropriate allocations of partners' gains and losses. This analysis could be done by comparing the information on Schedule K-1, showing the percent of income and loss to which each partner is entitled, with (1) the amount actually allocated to the partner and (2) the aggregated amount of income or loss shown on Schedule K.

It is especially important that all Schedules K-1 be transcribed as IRS moves forward with its modernization efforts. IRS envisions that under TSM it will have an integrated case-processing system by the year 2001 that would allow the computer to make various compliance checks (e.g., underreporter and nonfiler). This system, as planned, would also allow all compliance issues for a taxpayer to be handled at the same time. To be efficient, however, IRS would have to build cross-reference files to do these checks. Otherwise, IRS would be unable to create a comprehensive compliance case on the taxpayer, making separate audits of a taxpayer's individual, corporate, and partnership returns more likely. An integrated

¹⁵IRS did not have data on the exact number of partnership Schedules K-1 that will be transcribed. IRS officials said that we could extrapolate from tax year 1991 data which indicated that 65.7 percent of all paper Schedules K-1 received were from partnerships. The remaining 34.3 percent were received from S-corporations, trusts, and estates.

system would enable IRS to audit the taxpayer rather than the return and could result in more effective and timely audits.

IRS' Efforts to Change Its Partnership Audit Strategy

In 1994, IRS began changing its partnership audit strategy after IRS compliance officials determined that some partnerships were being established solely for the purpose of avoiding taxes. The Department of the Treasury issued regulations to help combat this problem. Also, IRS began making plans to increase the number of partnership audits and to train auditors to identify partnership issues when they conduct operational audits and audits for the 1994 TCMP survey.

IRS did not have data on the number of partnerships that were established to avoid taxes. On the basis of their knowledge of partnership issues and experience in auditing partnerships, IRS compliance officials said that some partnerships, such as those that invest in certain types of financial instruments, were being formed for this purpose. Further, to ensure that taxpayers understood that IRS had the authority to recast transactions that exploit and misuse the partnership provisions of the Internal Revenue Code to avoid paying taxes, anti-abuse regulations were issued in December 1994. These regulations were designed to make it clear that the literal application of partnership rules to create losses was inconsistent with tax laws and regulations and would be questioned by IRS.

In September 1994, IRS began a partnership study to collect data for determining how it will revamp its partnership audit program. In February 1995, IRS began auditing about 220 partnerships to (1) identify potential partnership compliance issues, (2) develop new techniques for auditing partnership returns, and (3) develop a partnership training program for revenue agents. These partnerships were identified from SOI's tax year 1992 partnership data. About 180 of the returns were for partnerships engaged in the finance, insurance, and real-estate industries. Revenue agents having extensive backgrounds in partnership issues are conducting the audits. Information collected during the audits is to be used to complete a questionnaire and transcribed into a computer database for analysis. IRS plans to incorporate the study results into a training program for revenue agents who are to audit about 12,500 partnerships as part of the 1994 TCMP survey. These revenue agents are scheduled to be trained by September 1995, and the TCMP audits are scheduled to begin in October 1995.

To coordinate the study and the partnership audit program, IRS established a new team under its Industry Specialization Program for partnership audits.¹⁶ This new partnership team is also to coordinate audit issues raised under the proposed partnership anti-abuse regulations.

It is very important that revenue agents be trained to identify partnership compliance issues when conducting TCMP audits because it has been over 10 years since the last partnership TCMP survey. However, IRS' schedule for collecting and analyzing data to develop the training program and train the revenue agents may be optimistic. Of IRS' partnership audits completed in fiscal year 1992 that fell within the description or category of the study's industry types, more than one-half took over 12 months to complete. Less than one-half of them had adjustments. If this year's audits require similar time and achieve similar results, IRS may neither have enough data to develop an effective training program nor have the time to train the agents.

To better ensure that it has enough data to meet its TCMP training and audit schedule, we suggested to IRS officials that they supplement the study with other audit data. IRS could evaluate those recently completed audits that have audit adjustments and are in the industries being studied. IRS officials agreed with our suggestion and on March 30, 1995, informed field staff to gather data on closed audit cases.

Conclusions

In recent years, resource constraints have not allowed IRS to place much emphasis on partnership compliance activities. As a result, partnership audit coverage declined, and IRS discontinued its partnership delinquency check program. At the same time, IRS did not have current compliance data to help it target its partnership audit resources to returns with compliance issues.

IRS is taking some steps to address partnership compliance issues. For example, it is planning to conduct partnership TCMP audits to determine the level of partnership compliance and to develop audit selection formulas. However, the results of these audits will not be available until late 1998. IRS is also in the process of modernizing the tax system with plans such as developing an integrated case-processing system that would allow IRS to more effectively and efficiently identify noncompliant taxpayers. This system is scheduled to be in place by 2001.

¹⁶The Industry Specialization Program is an existing national program to provide oversight and coordination of all issues in a designated area.

In concert with its TCMP and modernization efforts, IRS could begin now to improve its partnership compliance activities. IRS could begin developing plans to modify its audit information management system so that tax changes made to partners' returns that result from audits of partnership returns, including allocation issues, could be entered into the system. These data would allow IRS to better evaluate the effectiveness of its audit program. IRS could also use its various computer files that contain partnership data to help develop audit leads until new partnership audit selection formulas are developed.

IRS may start a delinquency check for partnerships that did not file tax year 1994 returns. This program would be consistent with IRS' strategic objective of improving voluntary compliance by encouraging taxpayers to file timely and accurate returns and taking appropriate enforcement actions when they do not.

Also, to take full advantage of modernization efforts, IRS could plan for the orderly development of a partnership computer document matching program. Similarly, to meet planned TSM integrated case-processing needs, IRS could begin to develop ways, such as forms that can be scanned onto the computer, to enter all Schedules K-1 data onto the computer without having to manually transcribe them.

IRS is doing a study to gather data so that agents can be trained on current partnership compliance issues. However, the study may not produce enough data in time to meet IRS' training and TCMP audit schedule. As a backup, IRS could use data from recently closed audits so that it can improve its chances of meeting these schedules. IRS is now collecting these data.

Recommendations

We recommend that as IRS moves forward with its modernization efforts, the Commissioner of Internal Revenue

- develop plans to modify audit management information systems to more fully reflect the results of partnership audits by including information on the (1) tax assessment on partners' income tax returns and (2) changes in allocations of profits and losses among partners,
- analyze computer partnership files to develop audit leads and select returns for audit,
- reinstitute the delinquency check program for partnerships to identify partnerships that do not file required tax returns,

- develop plans for a document matching program using information returns to verify partnership income, and
- devise ways to enter all Schedules K-1 onto the computer so they can be used in the individual computer document matching program and for other compliance purposes.

Agency Comments and Our Evaluation

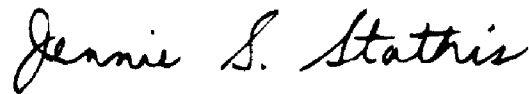
We requested comments on a draft of this report from the Commissioner of Internal Revenue. Responsible IRS officials, including the Assistant Commissioner for Examination and the National Director, Service Center Compliance, provided IRS' comments in a meeting on April 26, 1995. The officials generally agreed with our recommendations and said that:

- IRS' current information systems are unable to accommodate data on partners' income tax assessments and changes in allocating partners' profits and losses. IRS will address the need for expanded data on partnerships and partners in its plans to modernize information systems.
- IRS is beginning to use partnership computer files to develop leads and select returns to audit through its newly established District Office Research and Analysis sites. In addition, IRS will use results from its partnership study started in October 1994 to select returns for audit. Ultimately, the data gathered from the 1995 TCMP will be used to select potentially more productive partnership audits.
- IRS will reinstate the partnership delinquency check program for tax year 1994 in calendar year 1996.
- IRS will test the feasibility (cost/benefit) of a document matching program for non-TEFRA partnerships. If the test proves successful, IRS will develop plans for a non-TEFRA partnership matching program as TSM progresses. IRS did not believe that TEFRA partnerships could be included in a matching program without adversely affecting IRS' audit program.
- IRS will consider additional steps that could be taken to more fully utilize Schedule K-1 data, including encouraging more partnerships to file electronically and determining the feasibility of devising a scannable Schedule K-1. IRS cautioned that because of limited resources and its inability to require partnerships to file electronically, it may not be able to capture data and use all Schedule K-1 information.

We believe the actions that IRS proposes are responsive to our recommendations.

As agreed with the Committee, we will send copies of this report to the Commissioner of Internal Revenue and other interested parties. We also will make copies available to others upon request.

This report was prepared under the supervision of Natwar M. Gandhi, Associate Director. Major contributors to the report are listed in appendix III. If you have any questions, please contact me at (202) 512-5407.



Jennie S. Stathis
Director, Tax Policy
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**Table II.1: Estimates of Costs and Benefits of Matching
Schedules K-1 to Individual Partner Tax Returns**

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Abbreviations

AIMS	Audit Information Management Systems
IRS	Internal Revenue Service
RTF	Returns Transaction File
SOI	Statistics of Income
TCMP	Taxpayer Compliance Measurement Program
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TRA	Tax Reform Act of 1986
TSM	Tax Systems Modernization

Methodology for Analyzing Partnership Audits Closed in Fiscal Year 1992

This appendix describes our methodology for analyzing partnership audits closed in fiscal year 1992. We analyzed these audits to identify characteristics of audited cases that could help the Internal Revenue Service (IRS) to better target its partnership audit resources.

We obtained IRS' Audit Information Management System (AIMS) data for all partnership audits closed in fiscal year 1992. Because return data for the actual years audited were not available, we obtained Returns Transaction File (RTF) data for tax years 1990 and 1991 for nontax shelter and tax shelter partnerships, respectively, closed in fiscal year 1992. We used the AIMS and RTF data to identify characteristics of audited returns. We used Statistics of Income (SOI) partnership data for tax year 1990 to identify characteristics of the nationwide universe of partnerships.

AIMS Data

The AIMS data contained information on 8,229 audited returns filed by 5,565 partnerships. The tax years audited ranged from 1970 to 1991 with most of the audited years being 1983 through 1990. Table I.1 shows the distribution of audited returns by tax year.

Table I.1: Population of Partnership Tax Year Audits Closed in Fiscal Year 1992

Tax year	Tax shelter partnerships	Nontax shelter partnerships	Total audited returns
1970 - 1980	21	33	54
1981	19	32	51
1982	46	68	114
1983	530	88	618
1984	184	108	292
1985	202	147	349
1986	238	350	588
1987	313	715	1,028
1988	226	1,992	2,218
1989	143	1,690	1,833
1990	59	982	1,041
1991	2	41	43
Total	1,983	6,246	8,229^a

^aNumber represents audited returns of 5,565 partnerships.

Source: IRS' AIMS data for fiscal year 1992.

To determine which partnerships were tax shelters, we identified all returns that had a tax shelter source code and then identified the taxpayer identification number associated with those returns. If a partnership had more than one return examined and any one of the returns had a tax shelter source code, we considered the partnership to be a tax shelter. Using this approach, we identified 1,209 tax shelter partnerships associated with 1,983 returns and 4,356 nontax shelter partnerships associated with 6,246 tax returns.

Our computations of audit adjustments and examination hours are aggregated figures for all returns associated with one partnership. The net adjustment amount for each entity determined whether an audit result was treated as a decrease in income, no change in income, or an increase in income.

RTF Data

IRS' AIMS file contains little information about an audited partnership. To increase the number of partnership characteristics we could analyze, we obtained tax year 1990 and 1991 RTF information. Return data for the actual years audited were not available. For nontax shelters, we obtained tax year 1990 data; and, for tax shelters, we obtained tax year 1991 data.¹ Because of the differences in tax years, we limited our analyses to those characteristics that we believe remain fairly stable: (1) major industry, (2) major income source, (3) Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) status, and (4) tax shelter status. We were able to obtain data for 3,547 (64 percent) of the 5,565 partnerships. The remaining 2,018 partnerships did not file tax years 1990 or 1991 returns.

SOI Data

We analyzed the 1990 SOI partnership data to develop estimates of characteristics of the universe of partnerships. In analyzing these data, we used the return elements in the SOI database that matched directly with elements on RTF.

Studies of Audited Partnerships

We selected a simple random sample of 200 partnership audits for a detailed analysis of the examination workpapers. IRS provided workpapers for 92 partnership audits where the revenue agent had recommended adjustments and 85 partnership audits where no audit adjustments were proposed. We analyzed these 177 audited partnership returns to determine why the return had been selected for audit, the nature of the audit

¹IRS was unable to provide us with tax year 1991 data for all partnerships in time for use in this report.

changes, and whether the noncompliance identified by the revenue agent could be identified through computer matching.

Analysis of Partnership Files

We did a number of computer analyses of the AIMS, RTF, and SOI files to determine whether certain characteristics of audited returns with audit adjustments could be used to identify partnerships that may be more likely to be adjusted if audited. Because the data from the three files are not comparable, our analyses are not intended to conclusively show where IRS could direct its audit resources. Instead, we made our analyses to demonstrate how IRS' computerized files may be used to better target its partnership audit resources. IRS is better able to access its computer files than we are and can do more detailed analyses.

We found that analyzing these data by major industry group and predominant revenue source showed there were differences. We analyzed the audited partnerships from the AIMS file with partnership RTF and SOI data to determine the predominant source of revenue reported by partnerships on Forms 1065 and Schedules K. We used IRS' Principal Business Activity codes to determine in which major industry groups the partnerships were shown. We determined how many partnerships received 90 percent or more of their total revenue from one of the following categories:

- Ordinary trade or business activities.
- Rental real-estate activities.
- Other rental activities.
- Investment activities.
- Other activities.

We also analyzed the data that showed no positive revenue reported in any of the above categories.

As one example, our analysis by major industry group showed that the distribution of audited partnerships among industry groups generally paralleled the distribution of partnerships in the universe. The only group where there appeared to be a large difference was real estate. As shown in table I.2, 44 percent of the partnerships in the universe were in this industry group compared to 26 percent of the audited partnerships for which we obtained return information.

**Appendix I
Methodology for Analyzing Partnership
Audits Closed in Fiscal Year 1992**

Table I.2: Comparison of Universe of Partnerships and Partnerships With Audits Closed in Fiscal Year 1992 by Major Industry Group

Industry group	Estimated universe of partnerships		Audited partnerships	
	Number of partnerships	Percent of total ^a	Number of partnerships	Percent of total
Agriculture, forestry, and fishing	124,164	8	431	12
Mining	40,594	3	81	2
Construction	55,806	4	197	6
Manufacturing	28,972	2	184	5
Transportation, communication, etc.	24,107	2	172	5
Wholesale trade	16,725	1	101	3
Retail trade	155,109	10	355	10
Finance, insurance	115,015	7	159	4
Real estate	682,776	44	903	26
Services	279,831	18	794	22
Unknown	30,431	2	170	5
Total	1,553,530	100	3,547	100

^aTotal may not add due to rounding.

Sources: The estimated universe of partnerships' data was derived from IRS' SOI data, and the estimates were associated with sampling errors that were ignored for this comparison. The audited partnerships' data were derived from IRS' RTF and AIMS data, and only 3,547 of 5,565 audited partnerships are included in these data.

Our analysis by predominant source of revenue showed more differences. As shown in table I.3, we found that the most productive audits were of nontax shelter partnerships, subject to the TEFRA audit rules, which received 90 percent or more of their total revenue from one source. About 18 percent of the partnerships for which we had data met these criteria. These cases accounted for about 42 percent of the total dollars adjusted and 23 percent of the partnership examination hours.

**Appendix I
Methodology for Analyzing Partnership
Audits Closed in Fiscal Year 1992**

Table I.3: Partnerships With 90 Percent or More of Revenue From a Single Revenue Category

Type of partnership	Percent of estimated universe of partnerships	Percent of audited partnerships	Percent of total examination hours	Percent of total audit adjustment
TEFRA nonshelter	17.3	18.0	22.9	41.8
Non-TEFRA nonshelter	64.7	50.7	42.0	19.4
TEFRA tax shelter	1.4	6.9	8.7	13.3
Non-TEFRA tax shelter	0.3	0.7	0.4	^a

^aLess than 0.1 percent.

Sources: The estimated universe of partnerships' data was derived from IRS' SOI data, and estimates were associated with sampling errors that were ignored for this comparison. All other data were derived from IRS' RTF and AIMS data, and percents were based on 3,546 partnerships for which we received information. One partnership with a total adjustment of over \$800 million was excluded because it skewed the analysis.

Another observation we made was that the average audit adjustment per examination hour varies depending on what percent of a partnership's total revenue comes from a single revenue category. Tables I.4 through I.7 show the results of our analysis by percent of total revenue from a single category, number of partnerships, total dollar adjustment, total examination hours, and average audit adjustment by examination hour. These analyses are based on information we obtained for 3,546 of the 5,565 partnerships with audits closed in fiscal year 1992.

Table I.4: Analysis of Audited TEFRA Tax Shelter Cases by Percent of Total Revenue From a Single Revenue Category

Percent of revenue	Number of partnerships	Total dollar adjustment	Total exam hours	Average change/hour
No positive revenue	46	\$22,624,627	3,671	\$6,163
Less than 70 percent	10	5,777,236	701	8,241
70 to 79.9 percent	4	-134,201	902	-149
80 to 89.9 percent	12	4,486,390	894	5,018
90 percent or more	243	100,797,813	22,485	4,483
Total	315	\$133,551,865	28,653	\$4,661

Source: GAO analysis of IRS' RTF and AIMS data.

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Methodology for Analyzing Partnership
Audits Closed in Fiscal Year 1992**

Table I.5: Analysis of Audited Non-TEFRA Tax Shelter Cases by Percent of Total Revenue From a Single Revenue Category

Percent of revenue	Number of partnerships	Total dollar adjustment	Total exam hours	Average change/hour
No positive revenue	22	\$1,083,407	1,349	\$803
Less than 70 percent	4	2,297	152	15
70 to 89.9 percent	2	4,929	295	197
90 percent or more	25	78,505	1,143	69
Total	53	\$1,169,138	2,939	\$398

Source: GAO analysis of IRS' RTF and AIMS data.

Table I.6: Analysis of Audited TEFRA Nonshelter Cases by Percent of Total Revenue From a Single Revenue Category

Percent of revenue	Number of partnerships	Total dollar adjustment	Total exam hours	Average change/hour
No positive revenue	72	\$18,461,080	7,687	\$2,402
Less than 70 percent	48	11,647,421	5,766	2,020
70 to 79.9 percent	30	3,738,723	3,350	1,116
80 to 89.9 percent	43	1,906,176	5,756	331
90 percent or more	639	317,881,435	58,993	5,388
Total	832	\$353,634,835	81,552	\$4,336

Source: GAO analysis of IRS' RTF and AIMS data.

Table I.7: Analysis of Audited Non-TEFRA, Nonshelter Cases by Percent of Total Revenue From a Single Revenue Category

Percent of revenue	Number of partnerships	Total dollar adjustment	Total exam hours	Average change/hour
No positive revenue	232	\$24,839,227	12,861	\$1,931
Less than 70 percent	134	38,229,336	10,461	3,654
70 to 79.9 percent	89	54,270,367	7,126	7,616
80 to 89.9 percent	91	7,389,686	5,117	1,444
90 percent or more	1,800	147,491,243	108,329	1,362
Total	2,346	\$272,219,859	143,894	\$1,892

Source: GAO analysis of IRS' RTF and AIMS data.

As can be seen from table I.4, the greatest dollar adjustment per examination hour (\$8,241) occurred with tax shelter partnerships, subject to TEFRA, where the revenue sources were diversified. That is, the largest single source of revenue was less than 70 percent of the partnerships' total revenues. Table I.7 shows that the next highest dollar return per hour of

Appendix I
Methodology for Analyzing Partnership
Audits Closed in Fiscal Year 1992

examination (\$7,616) occurred with nonshelter partnerships, not subject to TEFRA, where the revenue sources diversified. For these partnerships, the largest single revenue source was between 70 percent and 79.9 percent of the total revenues. The third largest dollar return per hour examination (\$6,163), see table I.4, was for tax shelter partnerships, subject to TEFRA, which had no positive revenue.

Cost Estimated for Partnership Document Matching Program

We estimated that if IRS matched 100 percent of the Schedules K-1 to individual partner tax returns, it may have been able to assess an additional \$219.5 million in tax revenue at an additional cost of \$18.6 million. IRS matches a limited number of Schedules K-1 that it receives to tax returns filed by individual partners. To arrive at our estimates, we extrapolated IRS' estimated costs and tax revenues for the Schedules K-1 used in its tax year 1991 individual document matching program to all of the schedules that it received that year.

For tax year 1991, 20,504,693 partnership Schedules K-1 were received by IRS and 2,525,825 were processed into computer format, while the remaining 17,978,868 were not processed.¹ Of the 2,525,825 schedules processed, IRS used 2,382,190 (94 percent) in its matching program. To determine which Schedules K-1 to match, IRS randomly sampled taxpayers' social security numbers ending in certain digits. IRS estimated that it costs \$0.75 to transcribe a Schedule K-1 and \$17.61 to close an individual underreporter case. Finally, IRS estimated that for each \$1.00 spent to match Schedules K-1, it assessed a net \$11.80 in additional tax revenue. According to IRS officials, it is possible that if all Schedules K-1 were matched, the net additional tax revenue could decrease. The officials said that as more cases are worked the marginal yield becomes lower for all cases.

Table II.1 shows the basis of our estimates of costs and benefits of matching Schedules K-1 to individual partner tax returns.

¹In tax year 1991, of the 2,525,825 processed partnership Schedules K-1, 2,382,190, 94 percent, were posted to the Information Returns Master File. The remaining 143,635 Schedules K-1 had invalid or no social security numbers and could not be used in a matching program.

Appendix II
Cost Estimated for Partnership Document
Matching Program

Table II.1: Estimates of Costs and Benefits of Matching Schedules K-1 to Individual Partner Tax Returns

Data used to develop estimates of costs and benefits	Estimates of costs and benefits
Number of partnership Schedules K-1 used in tax year 1991 matching program	2,382,190
Number of potential underreporter cases identified for tax year 1991	39,948
Ratio of Schedules K-1 to potential underreporter cases (2,382,190 / 39,945)	59.6
Number of partnership Schedules K-1 not used in tax year 1991 matching program	18,122,503
Number of partnership Schedules K-1 transcribed that had valid social security numbers and could be matched (18,122,503 x .94)	17,035,152
Number of potential underreporter cases developed (17,035,152 / 59.6)	285,825
Cost to transcribe 18,122,503 Schedules K-1 (18,122,503 x \$0.75)	\$13.6 million
Cost to close underreporter cases (\$17.61 x 285,825)	\$5.0 million
Total additional cost for matching program	\$18.6 million
Potential additional tax revenues (\$18.6 million x \$11.80)	\$219.5 million

Source: IRS underreporter data.

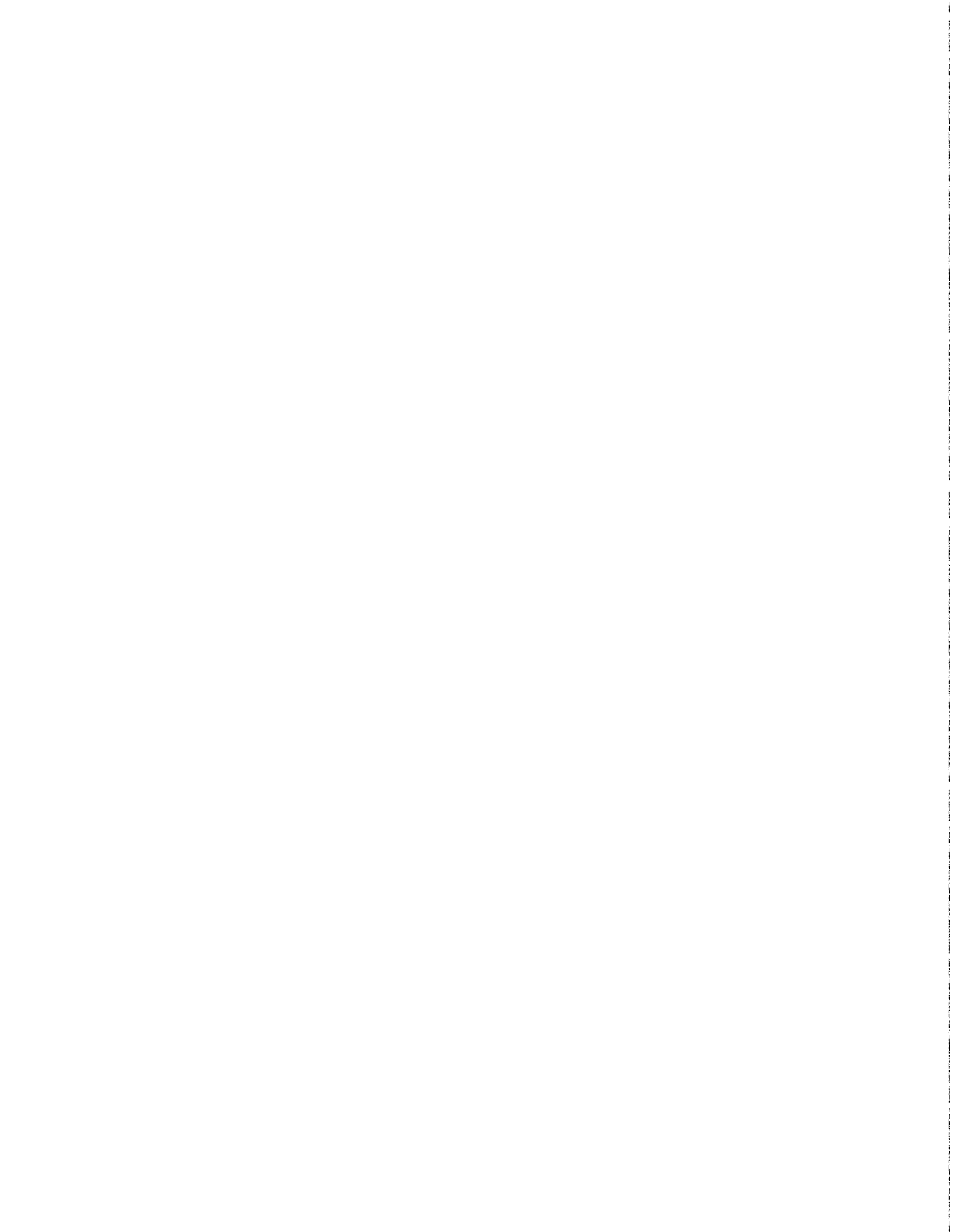
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