

GAO

Report to the Chairman, Committee on
Finance, U.S. Senate, and the
Chairman, Committee on Ways and
Means, House of Representatives

July 1991

TAX
ADMINISTRATION

IRS Experience Using
Undercover
Operations' Proceeds
to Offset Operational
Expenses



General Government Division

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The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

This report responds to section 3301 of the Crime Control Act of 1990. Section 3301 requires that we study Internal Revenue Service (IRS) undercover investigative operations that were done using the authority provided in section 7608(c) of the Internal Revenue Code of 1986. This authority exempts IRS undercover operations from certain laws and allows IRS to use the proceeds from the undercover operation to offset necessary and reasonable expenses incurred in the operation. The Crime Control Act required that we evaluate (1) IRS' use of the proceeds in these operations, (2) the operations' results, and (3) the financial audits of the operations done by IRS.

Background

IRS does some undercover operations that involve setting up various business activities as a "cover" to assist in obtaining evidence of illegal actions. The Anti-Drug Abuse Act of 1988, which became law in November 1988, gave IRS the authority to use the proceeds from such business activities to pay for—offset—the expenses of carrying out the undercover operation. The Anti-Drug Abuse Act also allowed IRS to exempt this type of undercover operation from several laws controlling the use of government funds and from certain contracting and budgeting procedures.¹ The income earned from an individual undercover operation can only be used to offset the expenses of that particular operation. Any income remaining at the end of the operation is to be transferred to the General Fund of the U.S. Treasury.

IRS must make a written certification that the offset action and the exemptions are necessary to carry out the undercover operation. Although the initial authority allowing IRS to offset proceeds against expenses and to obtain the legal exemptions expired after December 31, 1989, the November 1990 passage of the Crime Control Act of 1990

¹In general, these restrictions limit the ability of agencies and employees to expend funds or to make contracts without specific approvals or other safeguards. Additionally, undercover operations may be exempt from rules for establishing and acquiring corporations and the submission of budgets by wholly-owned government corporations.

extended the authority through December 31, 1991, and made it retroactive to January 1990.

The law requires IRS to do a detailed financial audit of closed undercover operations involving the offset authority in which (1) the gross receipts (excluding interest) exceed \$50,000 or (2) recoverable and nonrecoverable expenditures (other than employee salaries)² exceed \$150,000. The act defines a closed operation as one in which all criminal proceedings other than appeals are concluded or when all covert activities are concluded, whichever occurs later. The law is silent on which unit within IRS should do the detailed financial audit. IRS has decided that these audits will be done by its Internal Audit function, organized as a part of Inspection, which is headed by the Chief Inspector. The audit results are to be reported to the Secretary of the Treasury and to Congress. In addition, IRS procedures require that the Criminal Investigation Division audit all undercover operations—whether they use the offset provision or not.³

IRS is also required by law to report annually to Congress regarding its use of the offset provision.⁴ As of May 1991, IRS had submitted two reports to Congress, one covering fiscal year 1989, and one covering fiscal year 1990.

Results in Brief

The undercover operation offset provision allows IRS to carry out high cash flow operations—such as money laundering—that might not otherwise be possible within its undercover budget. IRS has made limited use of the offset authority. From November 1988 through May 1991, IRS had approved the use of the offset authority in only 19 of its undercover operations—less than 5 percent of the total undercover operations initiated for the same period.

²Recoverable expenditures are the funds used in an operation that are expected to be returned. Nonrecoverable expenditures are the expenses of conducting the undercover operation.

³The IRS Manual requires that Criminal Investigation do an audit of the financial records of an undercover operation. IRS Internal Audit officials indicate that this is really not an audit but more of a financial review. In a separate evaluation, our observations of financial reviews done by the Criminal Investigation Division showed that they are mainly reconciliations of expenses to receipts and invoices and do not usually include an assessment of the reasonableness of the expenses incurred. To avoid confusion we will use the IRS Manual terminology in this report.

⁴A February 1991 IRS legal analysis of the annual reporting requirement raised questions about whether the law requires IRS not only to report on undercover operations involving the offset provision but also to provide information on all undercover operations. Information on the legislative intent of the reporting provision is lacking. IRS officials told us that they are currently in the process of clarifying the congressional intent regarding that aspect of the reporting requirements.

The 19 undercover operations using the offset provision have produced about \$545,000 in income. Of the income earned, approximately \$121,000 was used to offset operational expenditures; \$269,000 had not yet been offset against expenditures; and about \$155,000 had been returned to the General Fund. IRS reported that as of May 1, 1991, undercover operations using the offset provision had resulted in seizing over \$207 million in cash and significant amounts of drugs, including cocaine and heroin, and in obtaining 75 convictions.

Identifying a direct cause and effect relationship between the financing mechanism provided by the offset authority and the results of a given investigation is difficult if not impossible, as many variables come into play. However, the additional funds made available through the use of the offset provision allow IRS to either undertake more investigations than it could without those funds or to expand the range of activities for each investigation.

Questions about controlling the funds remain to be answered. None of the operations involving the offset provision had met the statutory criteria requiring a detailed financial audit. In some cases, IRS Internal Audit may not have sufficient access to all the information needed to do a thorough audit because it does not now have complete access to information on investigations done under the control of a grand jury. Thirteen of the 19 operations using the offset authority were grand jury cases. IRS is working to resolve this issue, but the outcome is not clear.

Further, we believe that IRS' use of Internal Audit to audit undercover operations using the offset provision should not be limited to those operations meeting a specific dollar threshold. IRS' use of Criminal Investigation Division employees to do audits of offset operations in which activity falls below the prescribed dollar thresholds raises questions of organizational independence, a general standard for government auditing. Such questions could be avoided by having Internal Audit do all the audits. In addition, the sensitivity of the activities being undertaken and the exemption of the expenditures from normal controls over appropriated funds increase the need for the audits to be done by an independent entity.

If IRS reports to Congress contained additional details and were more timely, the reports could enhance Congress' understanding of the use and results of undercover operations involving the offset provision.

Objectives, Scope, and Methodology

Our objectives were to evaluate (1) use of the proceeds from undercover operations, (2) results of the operations, and (3) the financial audits conducted by IRS. In addition, we provide our observations regarding possible changes to the content and timing of IRS reports to Congress on the use and results of undercover operations involving the offset authority.

To meet our objectives, we

- requested IRS to extract and summarize from its case files the amount and use of proceeds and the results of all 19 IRS undercover operations in which offsetting was authorized;
- analyzed IRS interim guidelines for offsetting income earned in undercover operations;
- interviewed IRS Internal Audit officials about their responsibility to do the detailed financial audits;
- reviewed the recently approved internal IRS memorandum of understanding regarding access to grand jury matters for internal audit purposes; and
- analyzed the format and timing of the reports IRS is required to submit to Congress about undercover operations, including reviewing the two reports IRS has already submitted to Congress.

We did our work from March through June 1991 at IRS' National Office in Washington, D.C. We did not verify the information that IRS provided by comparing it with source documents, primarily because of grand jury secrecy provisions. Of the 19 operations, 13 were grand jury cases, to which we do not have access. Of the remaining six, five were closed cases for which documentation will be made available to us in July in accordance with 6103 (i)(7) of the Internal Revenue Code. We plan to review this documentation and report back to the committees if any significant discrepancies are noted. With this exception to our normal verification procedures, our study was done in accordance with generally accepted government auditing standards.

Limited Use of the Offset Provision

Since receiving the authority in November 1988, IRS had authorized the use of the offset provision in 19 undercover operations. As of May 1991, the offset authority had been used in 10 operations in fiscal year 1989, 4 operations in fiscal year 1990, and 4 operations in fiscal year 1991. Fourteen operations involved money laundering, three operations were directed at organized crime activities, and two operations were directed at excise tax fraud. Appendix I lists these operations by fiscal year.

The ratio of undercover operations using the offset authority to total undercover operations is low. An IRS official said that as of May 1, 1991, IRS had initiated 169 undercover operations in fiscal year 1989, 152 operations in fiscal year 1990, and 130 operations in fiscal year 1991.

IRS Criminal Investigation officials said the limited use of the offset provision is due to the on-again off-again nature of the authority. The initial authority to offset expired December 31, 1989, 3 months into fiscal year 1990. Additional authority to offset was not received until November 1990. The extended authority expires on December 31, 1991. IRS Criminal Investigation officials said that use of the authority would likely increase if (1) it were made more permanent and (2) agents became more familiar with its application as a result of experience and increased IRS training (such training is now being planned).

Proceeds Have Partially Offset Operational Expenses

IRS reported that proceeds, or income, in the 19 undercover operations in which the offset authority was used totaled about \$545,000. Fifteen operations produced at least some income while the remaining four operations generated no income.

The average operation earned \$28,656; three operations earned in excess of \$50,000, one of which earned \$208,000. Appendix II summarizes the proceeds by operation. The statutory authority allows IRS to use the proceeds to offset necessary and reasonable expenses incurred in the operation. Neither the law nor current IRS guidelines define what constitutes a necessary and reasonable expense. The Internal Revenue Manual indicates that since each undercover operation is unique, it is impossible to prepare a comprehensive list as to what is and what is not an allowable expenditure. The manual, however, directs that prior to the operation, the undercover team and IRS management understand what is properly chargeable and what spending limits are in place before management approves an operation. Income that exceeds the authorized expenditures for a given operation is to be returned to the General Fund.

IRS indicated that as of May 1, 1991, it had applied about \$121,000 of the total proceeds earned in the 19 operations against operational expenses. IRS officials stated that these expenses primarily consisted of (1) the expenses associated with conducting the undercover operation, including the undercover agents' per diem, travel costs, telephone expenses, bank fees, and cover documents and (2) specialized equipment.

such as cellular phones, pagers, undercover agents' vehicles, and video and cassette tapes.

In addition to the above amount of income applied, IRS reported that about \$269,000 of income has yet to be offset against expenses for ongoing operations. Also, IRS reported that it has returned about \$155,000 to the General Fund.

Results of Undercover Operations Involving the Offset Authority

IRS Criminal Investigation Division officials reported that undercover operations using the offset authority resulted in seizing significant amounts of money and narcotics. In addition, IRS reported that these operations have resulted in additional cases being initiated and in obtaining numerous convictions. The results IRS reports, however, are for the entire undercover operation—not just for the period during which the offset authority was used. For example, the IRS operation with the most results reported (including the seizure of \$170 million and significant amounts of illegal drugs) was active for almost 4 years prior to receiving the offset authority.

IRS reported that undercover operations using the offset provision resulted in the seizure of about \$207 million in cash. The operations also resulted in the seizure of significant amounts of illegal drugs, including over 10,000 kilograms of cocaine; 28 pounds of heroin; and 115 pounds of marijuana. In addition, these undercover operations resulted in 187 additional cases being initiated and in obtaining 75 convictions. Appendix III summarizes the results by operation.

IRS Criminal Investigation officials said that the offset provision allows them to carry out certain high cash flow operations that they might not otherwise be able to do with their undercover budget, which for fiscal years 1989 to 1991 averaged \$1.7 million per year. They cited certain undercover operations—such as money laundering—that require significant amounts of cash to set up and operate. Each dollar of income received frees a dollar of appropriated funds for use in carrying out additional investigative activities.

No Undercover Operations Have Met the Criteria Requiring a Detailed Financial Audit

IRS is required to do a detailed financial audit for undercover operations involving offsetting in which

- both the covert phase and criminal proceedings phase (other than appeals) have been concluded;
- gross receipts exceed \$50,000 or expenditures (other than employees' salaries) exceed \$150,000; and
- operations are exempt from sections 3302 and 9102 of title 31 of the United States Code.⁵

IRS officials said that as of May 1, 1991, no IRS undercover operation had met the statutory criteria requiring a detailed financial audit. IRS has decided that the detailed financial audits will be done by IRS' Internal Audit. Draft guidelines outlining the audit approach to follow were prepared by the Criminal Investigation Division in consultation with Internal Audit. Criminal Investigation Division officials indicate that these guidelines are expected to be completed in late July 1991.

It is too soon to determine whether Internal Audit's access to records necessary to do a detailed financial audit will be restricted in those cases where the undercover operation was carried out under the auspices of a grand jury. Internal Audit indicated that in some prior instances it has been denied access to files that at some point were under the auspices of a grand jury. At such times Internal Audit was unable to make a complete review, resulting in a qualified audit report because of scope impairment. IRS reported that 13 of the 19 undercover investigative operations involving offsetting are grand jury cases.

In March 1991, an IRS memorandum of understanding between the Criminal Investigation Division and Internal Audit was approved regarding access to grand jury matters for internal audit purposes. The agreement describes what material can be made available to Internal Audit, how the Criminal Investigation Division should handle Internal Audit's requests for materials, and how disputes should be handled concerning whether materials should or should not be considered grand jury matters. The memorandum, however, does not change the condition that Rule 6 (e) of the Federal Rules of Criminal Procedure prevents disclosure of items considered to be matters occurring before the grand jury, such as transcripts of witnesses' testimonies, target identification data, and grand jury subpoena data. Internal Audit officials said that

⁵Section 3302 provides rules regarding custodians of public money. Section 9102 requires specific legislative authority for establishing and acquiring corporations.

IRS is attempting to address the Rule 6 (e) restriction by obtaining from the Department of Justice the authority to name internal auditors to the list of persons allowed to have access to grand jury matters. IRS officials added that Justice has yet to grant this authority to IRS.

Audits of All Offset Operations Should Be Done by IRS' Internal Audit

We support IRS' decision to have the more organizationally independent Internal Audit do the required detailed financial audits. However, Internal Audit is expected to audit only those undercover operations involving offsetting in which those proceeds exceed \$50,000 or expenditures exceed \$150,000.⁶ The Internal Revenue Manual directs the Criminal Investigation Division to audit the financial records of undercover operations, including those that do not meet these thresholds. The IRS Manual also directs that, if practical, these audits be done by an agent outside of the group that did the undercover operation.

IRS case statistics indicate that the detailed financial audits done by Internal Audit may represent at most only about one-third of the audits of undercover operations using the offset authority. Only 1 of the 13 operations in which the covert phase had been completed and 4 of the 6 operations in which covert operations were open, met the prescribed dollar thresholds for triggering a detailed financial audit by Internal Audit. However, these detailed financial audits are not required to be done until both the operation's covert and criminal proceedings phases are concluded. The majority of the undercover operations involving offsetting do not meet the dollar thresholds and therefore will be audited not by Internal Audit but by the Criminal Investigation Division.

We are concerned about this two-tiered approach to audit IRS undercover operations using the offset authority. A general standard for government auditing requires that auditors should be organizationally independent. Having Internal Audit do the detailed financial audits provides that independence; having Criminal Investigation employees do these audits does not. IRS Criminal Investigation officials indicated that they would prefer having Internal Audit do the audits because of the organization's independence and expertise. Internal Audit officials indicated that, while they could do the audits, it was difficult to determine what effect such an expanded requirement would have on their need, if any, for additional resources. In addition, they were not sure whether a

⁶Internal Audit, however, has the authority to audit additional activities if it decides such an audit is needed.

detailed audit would be necessary if the dollar activity of the undercover operation was immaterial.

We recognize that requiring Internal Audit to audit all undercover operations using the offset authority would have some effect on its ability to audit other IRS activities and that there may be some instances where the amount of funds involved would not warrant a detailed examination. Nevertheless, we believe that the sensitivity of the activities being undertaken, the fact that the funds involved are not subject to all the controls applied to appropriated funds, and the basic principle that audits should be done by an independent entity argue for Internal Audit to be charged with responsibility for auditing all undercover operations using the offset authority.

IRS Reports to Congress Can Be Enhanced

IRS is required by section 7608(c)(4)(B) of the Internal Revenue Code to report annually to Congress on its use of undercover investigative operations. The annual reports IRS submitted for fiscal year 1989 and fiscal year 1990 contained limited details—primarily the number of those operations using the offset authority within each program.⁷ Details are limited because of the reporting requirements contained in the law and the open status of the undercover operations. For example, results are not to be reported until the covert and criminal proceedings are concluded, a process that can take years. Additional investigative details, which we believe could enhance Congress' understanding of the use of the offset authority, are not a report requirement.

Officials in IRS' Criminal Investigation Division agreed that certain investigative details could be reported without endangering the safety of agents or the success of the operation. Examples of useful details include the following:

- date undercover investigative operation was initiated;
- date offsetting was approved;
- total current expenditures;
- amount and use of current proceeds;
- general description of the type of undercover operation projected to generate proceeds (e.g., money laundering, bookmaking);

⁷The two reports contained errors regarding the operations using the offset authority. In preparing the summary data for GAO, IRS discovered that two operations in which the authority was approved in fiscal year 1989 were not reported, while two operations in which using the authority was anticipated, but not approved, were included. IRS also discovered that a clerical error in keypunching resulted in IRS failing to report one operation in its fiscal year 1990 report.

- potential violation being investigated;
- indication whether the operation is being conducted under grand jury auspices;
- if applicable, date covert phase of operation was concluded; and
- results to date (indictments made, nonprosecutions, convictions, fines, etc.).

IRS is also required by law to report to Congress regarding the detailed financial audits it is required to do of those closed undercover operations that involved offsetting and met specified dollar thresholds in either gross receipts or expenditures. The reporting requirements state that IRS must report to Congress within 180 days of the date the undercover investigative operation is closed. In some cases, however, IRS officials stated that it takes years before the criminal proceedings are closed, thereby delaying the reporting of such an audit. We believe Congress could receive more timely data if it required IRS to complete and report on the detailed financial audits after the covert phase has been completed but before criminal proceedings are finished.

IRS officials said that it would be feasible for Internal Audit to do the detailed financial audits after the covert phase of the undercover operation is completed but before the criminal proceedings are concluded. These officials added that reporting the audit results to Congress after the covert phase would be acceptable, as long as it could be done in a format that would not jeopardize the undercover agents' safety and the success of the operation's criminal proceedings.

Conclusions

IRS' limited use of offsetting indicates that offsetting is a potentially valuable funding mechanism for carrying out undercover operations. Some questions remain to be resolved, however, about auditing and reporting to Congress on these operations.

Accountability for IRS' use of the offset authority could be enhanced if audits of IRS undercover operations involving offsetting were done by an IRS office independent from the Criminal Investigation Division, which is responsible for carrying out the operations. Requiring Internal Audit to audit all undercover operations using the offset authority, regardless of any predetermined level of receipts or expenditures, would provide that independence.

IRS reports to Congress lack certain details that, if required, could provide the Congress with more informative data on IRS' use of the offset

authority. In addition, requiring IRS to report on the results of its detailed financial audits when the undercover operation's covert phase is completed—instead of waiting until the criminal proceedings are over—could enhance Congress' ability to oversee the offset authority.

Matter for Congressional Consideration

Should Congress decide to extend the offset authority, it may also wish to revise the current IRS reporting requirements. Expanding the information IRS is required to include in its annual reports to Congress and requiring IRS to report the results of its detailed financial audits after the covert phase instead of when the operation is closed could provide Congress with more timely and complete information on undercover operations involving offsetting. Such reporting should not jeopardize undercover agents' safety or success of criminal proceedings.

Recommendation

We recommend that the Commissioner of Internal Revenue direct the Chief Inspector to ensure that Internal Audit expands its financial audits to include all undercover operations involving offsetting, regardless of the amount of expenditures or proceeds.

The contents of this report were discussed with IRS officials. They generally agreed with the information presented, and their comments on the recommendations have been incorporated into the relevant sections of the report as appropriate.

We are sending copies of this report to other congressional committees, the Commissioner of Internal Revenue, and other interested parties.

Major contributors to this report are listed in appendix IV. If you have any questions regarding this report, please call me on (202) 275-6407.



Jennie S. Stathis
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Characteristics of IRS Undercover Operations Involving Offsetting: FY 1989 Through May 1991

Fiscal year	Program	Status as of May 1991	Grand jury
1989			
1	Money laundering	Open	Yes
2	Money laundering	Closed	No
3	Organized criminal activity	Covert operations have been completed	Yes
4	Money laundering	Covert operations have been completed	Yes
5	Money laundering	Covert operations have been completed	No
6	Money laundering	Closed	No
7	Money laundering	Closed	No
8	Money laundering	Covert operations have been completed	Yes
9	Money laundering	Open	Yes
10	Organized criminal activity	Covert operations have been completed	Yes
1990			
1	Money laundering	Closed	Yes
2	Organized criminal activity	Covert operations have been completed	Yes
3	Excise tax fraud	Closed	No
4	Money laundering	Covert operations have been completed	Yes
5	Money laundering	Covert operations have been completed	Yes
1991			
1	Money laundering	Open	Yes
2	Money laundering and income tax evasion	Open	Yes
3	Fuel excise tax fraud	Open	No
4	Money laundering	Open	Yes

Amount and Use of Income Earned in IRS Undercover Operations Involving Offsetting: FY 1989 Through May 1991

Fiscal year	Income earned	Income offset	Income returned to General Fund
1989			
1	\$208,000	\$63,590	\$81,38
2	851	851	
3	11,772	540	11,23
4	1,200	1,194	
5	1,000	990	1
6	0	0	
7	0	0	
8	38,123	13,645	22,47
9	26,000	4,256	
10	38,225	4,913	33,31
1990			
1	3,000	2,841	15
2	0	0	
3	0	0	
4	8,093	1,677	6,41
5	8,860	1,860	
1991			
1	85,174	2,428	
2	20,176	2,878	
3	31,660	19,154	
4	62,335	0	
Total	\$544,469^a	\$120,817	\$154,99

^aIncludes \$268,658 of income that is pending offset. This amount plus the income offset of \$120,817 and the income returned to the General Fund of \$154,994 equals the \$544,469 of income earned.

Results of IRS Undercover Operations Involving Offsetting: FY 1989 Through May 1991

Fiscal Year	Additional Cases Initiated	Convictions	Seizures ^a
1989			
1	87	37	\$170,227,711 8,454 kilograms of cocair 22 pounds of heroin 115 pounds of marijuana none
2	1	0	none
3	1	0	none
4	6	4	none
5	11	0	none
6	0	0	none
7	0	0	none
8	2	2	\$117,492 in currency \$300,000 in bank accounts 2,000,000 pills (doxidin)
9	54	28	\$17,929,170 530 kilograms of cocaine
10	13	2	none
FY 1990			
1	0	0	none
2	2	0	none
3	0	0	none
4	1	0	none
5	4	2	\$157,136
FY 1991			
1	1	0	\$13,149,850 548 kilograms of cocaine 6 pounds of heroin none
2	0	0	none
3	0	0	none
4	4	0	\$5,471,026 587 kilograms of cocaine
Total	187	75	

Note: Fiscal year indicates that in which offsetting was approved. The undercover operation can be initiated prior to receiving the offset authority.

^aIn addition to money and narcotics, four undercover operations resulted in seizures of real estate or other property. Also, the seizures of narcotics were made by other law enforcement agencies working jointly with IRS. The seizures were a direct result of the undercover operation.

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