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Testimony before the House Committee on Government Operations: Commerce, Consumer and Monetary Affairs Subcommittee; by Victor L. Lowe, Director, General Government Div.

Contact: General Government Div.
Organization Concerned: Internal Revenue Service; Federal Power Commission.
Congressional Relevance: House Committee on Government Operations: Commerce, Consumer and Monetary Affairs Subcommittee.
Authority: Internal Revenue Code, sec. 162(e).

The Internal Revenue Code prohibits taxpayers from taking deductions from amounts paid or incurred on behalf of political candidates or legislative matters, elections, or referenda. A report on the Federal Power Commission's audits of political advertising by utilities recommended development of better methods for classifying advertising costs and separating political advertising and improvement of audit procedures. The Internal Revenue Service (IRS) has not provided sufficient guidance to help examiners make judgments about the political nature of corporate advertising. Proposed actions by IRS to improve regulations and auditing techniques should provide better guidance. Tax returns do not provide sufficient information concerning grassroots lobbying by tax-exempt organizations or corporations. IRS should make regulations for taxpayers as clear as possible, require taxpayers to file sufficient information for adequate enforcement of the code, and assess what changes in reporting requirements will facilitate proper compliance. (HTW)

6514

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STATEMENT OF

VICTOR L. LOWE, DIRECTOR, GENERAL GOVERNMENT DIVISION,

BEFORE THE

SUBCOMMITTEE ON COMMERCE, CONSUMER,

AND MONETARY AFFAIRS

HOUSE GOVERNMENT OPERATIONS COMMITTEE

ON

TAX DEDUCTIONS FOR GRASSROOTS LOBBYING

Mr. Chairman and Members of the Subcommittee:

Our testimony today deals with IRS' efforts to insure that corporations and tax-exempt organizations properly account for political lobbying expenditures.

GAO first became involved in this area as a result of an October 30, 1974, request from Senator Stevenson to review the Federal Power Commission's audits of political advertising by utilities. The work also involved looking at the adequacy of IRS' guidance to its revenue agents on how to examine political lobbying expenditures. We issued a report on those issues on July 16, 1976.

Subsequently in early 1977, this Subcommittee initiated a study of grassroots lobbying. As a result of the Subcommittee's

interest, we initiated follow-up work at IRS in October 1977. Our testimony summarizes the findings in our 1976 report and presents additional findings and conclusions as a result of the follow-up work done for the Subcommittee in preparation for these hearings.

FPC's AUDITING OF POLITICAL ADVERTISING

FPC's functions are now carried out by the Department of Energy's Federal Energy Regulatory Commission. Since our work was done before the reorganization, we will still refer to the Federal Power Commission.

FPC is responsible for assuring that wholesale rates charged by electric utilities and natural gas pipeline companies for sales in interstate commerce are just and reasonable. One way that FPC obtains the cost information it needs to make its determinations is by prescribing a Uniform System of Accounts for use by utilities and pipeline companies.

In determining rates, FPC generally does not permit utilities to include any promotional advertising costs or to consider expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances, or for the purpose of influencing the decisions of public officials. Costs for institutional and goodwill advertising and dues paid to industry associations, excluding that portion used

for political advertising, generally are allowed in arriving at rates.

FPC and State regulatory commissions rely on the Uniform System of Accounts and on audits of utilities' accounting records in arriving at their decisions in rate cases. Thus, the records should be complete and accurate and transactions should be consistently recorded.

However, we determined that utility companies and FPC auditors did not have adequate criteria for classifying advertising costs under the Uniform System of Accounts. This lack of criteria resulted in inconsistent and sometimes arbitrary classifications.

FPC auditors sometimes noted misclassified advertising costs but did not require the companies to reclassify them. Other times, FPC auditors noted questionable advertisements but took no audit exceptions, primarily due to the small amounts involved.

Although the criteria for classifying advertising costs left room for differences of opinion, audit guidelines required FPC auditors to determine, through discussions with company personnel, a company's advertising policies and criteria for separating the cost of political advertising from the cost of other types of advertising. Workpapers prepared by the auditors for the 10 utility companies we reviewed indicated that this step was not done or, at least, was not documented.

FPC required its auditors to review advertising expenses for the last 2 years. Since audits are conducted every 5 years, however, we noted that FPC could improve its audits by redefining the scope to include random testing of advertising expenses for the 3 years not currently reviewed.

We recommended that FPC

--better define its regulations on classifying advertising costs under the Uniform System of Accounts to eliminate differences of opinion between utility companies and FPC auditors;

--pending redefinition of the regulations, develop more definitive criteria, such as a listing of advertising themes, for its auditors to use in separating political advertising from other types of advertising; and

--instruct its Office of Accounting and Finance to (1) consider redefining audit scope to include testing the classification of advertising expenditures for the 3 years not currently reviewed by auditors, (2) insure that auditors are following audit steps as required in the audit program, unless deviations are justified, and (3) establish specific guidelines for auditors to follow with regard to requiring utility companies to correct their accounting records when deficiencies are found.

FPC has taken the following actions, in line with our recommendations.

--Issued Order No. 549 on June 15, 1976, revising the Uniform System of Accounts to include the establishment of two special accounts. The language of the first account clarifies the requirements for advertising dealing with rate increases and environmental issues, while the second account is primarily concerned with advertising dealing with energy conservation.

--Furnished its auditors with additional guidelines on subjects of controversy relating to political advertising, including the identification of certain themes of such advertising to help auditors make judgments on classifications.

--Revised its audit program to expand coverage, on a test basis, to the entire audit period.

--Instructed its audit staff to strictly adhere to FPC policy by taking exception to any improper classification of expenditures, no matter how insignificant.

--Emphasized to its auditors the need to take all steps required by the audit program or clearly document why such steps were not taken.

Although we have not tested the effectiveness of FPC's implementation of the above actions, they are consistent with our recommendations.

INADEQUATE IRS INSTRUCTIONS REGARDING DEDUCTIONS FOR GRASSROOTS LOBBYING

The Internal Revenue Code (section 162(e)(2)) prohibits taxpayers from taking a trade or business expense deduction for any amount paid or incurred (1) for participation in, or intervention in, any political campaign on behalf of any candidate for public office or (2) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

IRS had been aware of congressional concern about proper accounting for political advertising by corporations as early as May 1974. At that time Senator Hart, Chairman of the Subcommittee on Environment of the Committee on Commerce held hearings which illustrated the lack of clear, concise guidance for determining what constitutes non-deductible grassroots lobbying advertising campaigns.

We noted in our July 1976 report that, despite the Code's prohibitions and previous congressional interest, IRS provided little guidance to help its examiners make judgments about the political nature of corporate advertisements. Our conclusion was based on an analysis of the "Audit Technique Handbook for Internal Revenue Agents."

In October 1977, as a result of this Subcommittee's interest, we re-examined IRS' guidance in this area to determine what

changes, if any, the Service had made since July 1976. In addition to the revenue agent's audit technique handbook, we obtained several other IRS documents which instructed examiners on how to detect and analyze possible grassroots lobbying expenses. These documents included pertinent regulations, the "Field Audit Case Managers' Handbook," basic revenue agent training material on lobbying expenses, and various audit technique handbooks for specialized industries. In general, the instructions in these documents were no more specific or helpful to the auditor than the instructions contained in the revenue agent audit technique handbook, which remained unchanged.

Indeed, from our review of these instructions and discussions with IRS officials, it appeared that IRS had done little, if anything, to clarify for either the taxpayers or its auditors how to classify certain advertising expenses.

Therefore, in November 1977 we recommended that IRS:

--Clarify existing regulations in the area of political advertising and grassroots lobbying to provide taxpayers and auditors with better definitions for classifying such expenses for income tax purposes.

--Systematically test the practices followed by various industry groups in the area of advertising and lobbying expenses to determine the extent of noncompliance that exists and what corrective action, if any, is warranted.

--Provide more specific audit criteria for IRS agents to follow in deciding whether to select corporate accounts relating to political advertising and lobbying expenses for examination.

--Develop additional guidance, such as a listing of advertising themes, for auditors to follow in separating grassroots lobbying and advertising expenses from allowable deductions in computing taxable income. (This letter is attachment I.)

On December 23, 1977, the Commissioner responded by indicating that he was taking steps to determine the extent to which abuses exist, to clarify criteria for differentiating deductible from non-deductible expenditures, and to improve the guidance to examiners.

Specifically, he stated that:

--the Chief Counsel had started a study project to review existing regulations in this area. One study objective is to clarify the distinctions between deductible and nondeductible advertising expenditures.

--The Exempt Organizations Division audit program for 1978 will include examination of about 50 percent of the returns filed by the larger trade associations. The Division is developing an audit checksheet for use in determining whether the treatment of lobbying expenditures is an area of substantial noncompliance and whether it is adequately covered during the audit process. A similar project is also being considered to test compliance in the large case corporate audit program.

--IRS will prepare an information notice to emphasize to field personnel the substantive tax rules and auditing techniques used to determine the deductibility of these expenditures. IRS also will re-examine its guidance to the field to determine whether changes are needed, and will encourage examiners to ask for technical advice in gray areas.

--IRS will identify examples of advertisements with a view to publishing rulings to help clarify gray areas both for taxpayers and examiners. (The Commissioner's response is attachment II.)

IRS' proposed actions are an important step in the right direction. They should provide taxpayers and IRS examiners with better guidance on how to properly account for political lobbying expenses. In addition, the proposed actions indicate a willingness on IRS' part to recognize its obligation to better enforce section 162(e)(2) of the Code.

As part of the Service's commitment to action in this area, on February 3, 1978, it issued a manual supplement relating to an audit survey of grassroots lobbying and certain other activities conducted by 501(c)(5) and (6) tax-exempt organizations. IRS also intends to audit a sample of large corporations to analyze the extent of compliance with the provisions of section 162(e)(2). In addition, on March 20, 1978, IRS issued four revenue rulings concerning the deductibility of political lobbying expenses. These steps are consistent with the actions the Service said it would take. They should help the Service determine the extent of compliance by corporations and tax-exempt organizations and provide better guidance to taxpayers.

Although we intend to closely monitor IRS' actions, we do not anticipate undertaking any detailed work until IRS has completed its studies because IRS may change its approach

to auditing for compliance with section 162(e)(2) depending on the outcome.

But another critical issue is whether taxpayers provide IRS enough information for the Service to adequately determine whether political lobbying expenses are properly accounted for. In most cases, we do not think they do.

ADEQUATE TAX RETURN INFORMATION CONCERNING POLITICAL LOBBYING IS LACKING

In January 1978, the Subcommittee asked us to determine whether tax returns and other taxpayer-supplied data provide sufficient information concerning the amount of grassroots lobbying by a tax-exempt organization or by a corporation to enable IRS to properly administer the Code's provisions relating to political lobbying.

Tax Exempt Organizations

Tax exempt organizations file an annual information report, Form 990, to report receipts and expenses and to answer specific questions about the organization's activities. The information reported on Form 990 along with related attachments is generally available for public inspection in accordance with Section 6104(b) of the Internal Revenue Code.

Our review of the Form 990 indicated that nowhere is the filing organization required to separately identify either direct lobbying expenses or those expenses incurred in connection

with any attempts to influence the general public. Only private foundations which file another form and certain charities filing in 1977 and later are required to provide a detailed description of their lobbying activities.

The only line items which would show expenditures for political purposes are:

--Part I, line 21(a) which calls for the amount spent directly or indirectly for political purposes, but primarily limited, according to the instructions, to expenditures which influence the selection of individuals to political office.

--Part II, line 19 which calls for an attached schedule of "Other" expenses and disbursements.

In either case the amount of detail shown on a line other than a dollar figure is left to the filer's discretion; the filer is not required to specifically identify those costs attributed to grassroots lobbying.

Corporations

In the corporate area we first wanted to determine the extent to which corporate tax form schedule M-1 provides information on political lobbying expenses incurred by a corporation but not deducted on the return. (IRS requires corporations to file a schedule M-1 with their tax return. A copy of the M-1 is attachment III.) Second, we wanted to know whether natural gas and electric power companies report similar information on the schedule M-1 and the schedule 223 which they file annually with the Federal Power Commission. Both the M-1 and the 223 provide for reconciling book income with taxable income.

We analyzed the schedule M-1s filed by 46 of the 180 largest corporations filing in IRS' Manhattan district. Using the most current return available at the district office we compiled the following profile.

--Of the 46 corporations, 5 were involved in mineral extraction, 4 were utilities, 3 were oil and gas companies, 9 were banking and financial institutions, 13 were manufacturing concerns, and 12 were in other fields.

--Assets of the 46 corporations ranged from $216 million to $75 billion.

--The 46 companies had from 2 to 593 domestic subsidiaries and from 0 to 538 foreign subsidiaries.

In analyzing the schedule M-1, we noted that no standard format is used to prepare the schedule and its attachments. Some corporations entered total figures for line item entries directly on the Schedule M-1. However, they all referred to an attached schedule which provides some additional information.

The M-1 attachments we examined ranged from a one page typed summary to a 44 page computer printout. Some of the attachments were consolidated for all corporate entities while others had supporting schedules broken into columns representing each subsidiary company. Many companies used handwritten accounting spread sheets.

While all supporting schedules basically followed the M-1 outline of 10 line item entries, the extent of detail, clarity, and format varied by company without any uniformity by industry type or size.

In examining the 46 schedule M-1s and related attachments, we paid particular attention to entries on line 5. It is on this line that the corporation would include expenses, like non-deductible lobbying expenses, that were recorded on the books but not deducted on the tax return. Only one of the 46 returns examined showed non-deductible lobbying expenses as an entry on line 5. The amount was less that $800. No explanation was given concerning the nature of the lobbying efforts. Twenty-four of the corporations listed line item entries which could involve non-deductible lobbying expenses. These entries bore such titles as "disallowance of questionable deductions", "miscellaneous", "non-deductible expenses", "other", "unallowable expenses", "special payments", and "amounts charged as expense not claimed". We could not determine whether lobbying expenses made up part of these line item categories however, without examining the corporation's books and records.

In no case did we see any schedule M-1 adjustments for non-deductible trade association dues or assessments used for grassroots lobbying. Here again, this type of adjustment may have been included as part of a miscellaneous entry, if at all.

From our analysis of corporate tax returns we believe that the schedule M-1 does not provide sufficient detail in most instances to determine whether corporate taxpayers

have appropriately adjusted their accounting records to insure that non-deductible political lobbying expenses have not been included on the tax return. Although many of the M-1 supporting schedules contain line item entries such as "other" or "miscellaneous" which could include lobbying expenses, the lack of a standardized reporting format requires direct access to the taxpayer's books and records for verification.

Our second analysis involved 24 randomly selected electric power and natural gas companies required to file detailed reports with the FPC. These reports, including the schedule 223, are to be filed by April 1st of each year based on the previous year's activity. (Attachment IV shows the schedule 223.)

Using calendar year 1975 as our test period, we obtained copies of the schedule 223 and the schedule M-1 filed by each of the 24 utilities in our sample. Tax year 1975 was used because corporate tax returns for that year were readily available at the IRS district offices having audit responsibility.

Our analysis of the 24 utility schedule M-1s reaffirmed our earlier observation that no standard format is followed. Despite the lack of a standard format, however, all but 2 of the 24 returns contained

--a reference to attachments on the schedule M-1,

--a typed or written attachment showing the consolidated tax return adjustments (usually broken down by subsidiary company), and

--the basic 10 line format of additions and subtractions from book income.

The two exceptions involved one company that made adjustments on a line-by-line basis following the basic line format on the corporate tax return, and another company that used a financial statement format to adjust its book income.

All 24 utilities filled out their schedule 223s following the same basic outline as used in preparing the M-1. Some of the 24 included all their information on the basic schedule 223; others used attachments. The only other difference was in the number and description of detailed line item entries.

In comparing the reported figures on both schedules, we found that the similarity ended after line 1 -- net income per books. Twenty-one of the utilities reported identical book income on both schedules. We cannot explain why the amount reported by the other three utilities differed between schedules.

Other than line 1, no line totals agreed between the two schedules. Differences in the amount shown as taxable income (line 10) ranged from $56.3 million more reported on the M-1 of one utility to $33.7 million more reported on the schedule 223 of another utility. One utility came within four dollars

of reporting the same taxable income on both schedules. This appeared to be a coincidence, however, since the various amounts added and subtracted to arrive at taxable income fluctuated widely between the two forms.

We were able to identify only a limited number of supporting entries making up the totals for lines 2 through 10 that were similar, in terms of dollars and/or description, on both the M-1 and the 223. In most instances the M-1 contained more detailed supporting entries than the schedule 223. However, both the 223 and the M-1 contained entries which could not be traced to the other schedule.

We discussed the lack of similarity between the figures on the 223 with those on the M-1 with two officials in the Energy Information Administration, the group now responsible for securing reports from utilities. They noted that companies use estimates in preparing the 223 because of the short time between the end of the calendar year and the April 1 filing deadline. On the other hand, most large corporations apply for and receive extensions from IRS to file their tax returns 6 months late -- in September rather than March. This gives the corporation time to review and categorize its figures to more accurately reflect taxable income.

Whereas each schedule 223 we reviewed was filed by April 1976, only 1 of the 24 tax returns was filed before September 1976, and that was filed in June.

We asked Energy Department officials about the usefulness of the 223. They said they know the schedule does not accurately reflect tax return information and that no analyses are being made using data on the schedule. They also stated that the 223 is going to be eliminated as part of the department's forms revision process.

Our examination of the 24 M-1s and schedule 223s revealed 6 entries by 5 companies that specifically identified one or more types of non-deductible political lobbying expenses. All six entries were clearly reported on the M-1 or on the attachments thereto while only one was shown on the 223. These entries included

--political contributions,

--non-deductible lobbying expenses,

--expenditures for civil, political and related activities,

--cost to influence legislation, and

--section 162(e) expense.

The amounts listed ranged from $1,000 to over $52,000.

Other M-1s and 223s contained entries which would require an audit of the corporation's books and records to determine if they involved non-deductible lobbying expenses. We noted that a total of 12 out of 24 utilities had such entries. These entries bore such titles as "Miscellaneous adjustments", "Other non-deductible expenses", "Other", and "Contributions".

Although we did not solicit information from IRS about audits of any of the 24 tax returns in our sample, IRS provided such data on two returns. Neither return identifies specific lobbying expenditures on the M-1. During its audits, however, IRS determined that certain trade association dues were used for non-deductible lobbying purposes and proposed adjustments of about $16,000 and $21,000 respectively.

Based on our comparisons, the 223 is not a reliable indicator of a corporation's taxable income or of the adjustments made by a corporation to reconcile its book income with its taxable income as shown on its tax return. The 5 to 6 months difference in filing dates between the 223 and the tax return probably contributes to the unreliability of the schedule 223 in this regard.

CONCLUSION

Our work in the area of political lobbying has shown that generally taxpayers do not provide IRS with sufficient information to assure proper treatment of political lobbying expenses in accordance with Internal Revenue Code provisions. To insure the continued success of one of the basic principles underlying our tax system, self-assessment, it is essential that IRS make the regulations which taxpayers must follow as clear as possible. It is also essential that IRS require taxpayers to file sufficient information to enable it to adequately enforce section 162(e)(2) of the Code.

Without sufficiently detailed reporting, it is not clear from reviewing tax returns whether corporations or tax-exempt organizations engaged in and properly accounted for non-deductible lobbying activities. Since grassroots lobbying can be done through many different types of activities -- such as mass mailings, media advertising, contributions to or contracts with outside parties, and travel and entertainment expenses -- the taxpayers' books and records could reflect these expenses in various account titles. Without some type of standardized reporting which would highlight such expenditures, IRS will have to make more detailed audits of taxpayers' books and records to determine the extent of compliance in this area.

Therefore, in addition to the steps IRS already has underway in this area, it should assess what changes in reporting requirements will facilitate proper compliance and enable it to carry out audits in the most cost-efficient manner.

This concludes my prepared statement. We would be pleased to respond to questions.

Attachment I

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT DIVISION

B-137762

November 9, 1977

The Honorable Jerome Kurtz, Commissioner
Internal Revenue Service
Department of the Treasury

Dear Mr. Kurtz:

As you know, the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Government Operations Committee, plans to hold hearings on the proper accounting for corporate expenditures made for political advertising. While preparing for these hearings, we noted that the Internal Revenue Service (IRS) has done little, if anything, to address apparent problems in this area which were surfaced as early as 3 years ago.

In May and June 1974, the Senate Commerce Committee held hearings on the deductability of political lobbying expenses under section 162 of the Internal Revenue Code. Testimony presented indicated that public utilities as well as other energy related industries may be improperly treating costs associated with certain political advertising and that utilities may be passing these costs along to consumers in the form of increased rates. The testimony also pointed out that questionable tax deductions may be occurring and that clarification of both the Federal Power Commission (FPC) and IRS regulations may be required.

After these hearings, we issued, at the request of Senator Stevenson, a report entitled, "Auditing of Political Advertising by Electric Utilities and Gas and Oil Companies" (EMD-76-2, July 16, 1976). The report, released by the Senator on October 3, 1977, presented, in part, our concerns over the lack of clear criteria for public utilities and FPC auditors to use in classifying and auditing political advertising expenses. The report also expressed our opinion that the instructions IRS has furnished its auditors contain little guidance to aid them in making judgments about the political nature of advertisements claimed as deductions by corporations.

FPC agreed to implement our recommendations to:

--Clarify the description of advertising transactions to be recorded in its prescribed accounts.

--Furnish its auditors with additional guidelines on controversial subjects relating to political advertising, including the identification of certain themes of such advertising to help auditors make judgments on classifications.

--Revise its examination program to expand audit coverage.

Conversely, IRS has taken little, if any, action to improve its guidance to taxpayers and its own auditors. For example, the "Audit Technique Handbook for Internal Revenue Agents" still merely advises the auditor:

"Advertising charges are relatively simple to check. The principal things for which an examiner should look are: * * * Nondeductible expenditures claimed in connection with campaigns of political candidates or for the promotion or defeat of legislation."

We reviewed several other IRS documents which instruct auditors regarding the way possible grass-roots lobbying expenses should be detected and analyzed. These documents included pertinent regulations, the "Field Audit Case Managers' Handbook," basic revenue agent training material on lobbying expenses, and various audit technique handbooks for specialized industries. In general, the instructions in these documents are no more specific or helpful to the auditor than the instructions contained in the revenue agent audit technique handbook.

For example, the specialized audit technique handbook for public utilities contains two sections which deal with determining the proper allocation of advertising expenses. Those sections are appropriately entitled, "Advertising Expense," and "Lobbying Expense." Under the section dealing with advertising expense the handbook says:

"Certain charges to advertising expense are nondeductible under section 1.162(c)(1) of the Regulations. This would relate to expenses such as certain outside advertising expenditures which could be considered as being of a propaganda or political nature. If the utility is Federally regulated and has followed the Commission's instructions (e.g. the Federal Power Commission), a detail of such questionable items can generally be found in the annual report. * * * "

The section on lobbying expenses is a little more detailed. It notes that in the course of auditing utility tax returns the auditor should be aware of deductions claimed for lobbying expenses involving

attempts to influence legislation or aid political candidates. It further notes that these nondeductible expenditures may be found in various utility accounts. The section also defines properly deductible expenses--institutional or good will advertising--as those which keep the company's name before the public, such as sponsoring news and weather reports or encouraging contributions to charitable organizations.

It goes on to point out that after tax year 1962 the companies may deduct expenses involved in the submission of information to and appearances before the legislature of Federal, State, and local governments. It also provides a broad explanation that certain other expenses pertaining to the general area of lobbying which are not deductible include political campaigns at all levels, influencing the public to support or reject a measure in referendum or law, and support or defeat of legislation.

These definitions are no more specific than the regulations defining section 162 of the Internal Revenue Code. They do not provide any specific guidance to the auditor as to how he or she should exercise judgment in determining whether or not advertising is for grass-roots lobbying purposes and therefore nondeductible.

Except for a limited survey done to prepare for the pending hearings, IRS has not systematically reviewed the advertising or grass-roots lobbying practices of various industries, identified any potential pockets of noncompliance that may exist regarding the classification of related expenditures, and determined what, if any, appropriate audit action is needed. Moreover, IRS apparently has not researched the problem sufficiently to determine why taxpayers might improperly classify advertising expenses and, consequently, not developed the information needed to rewrite regulations or instructions to make more accurate the taxpayers' initial determinations regarding the allowability of deducting certain advertising expenses. We believe that IRS should do so.

To insure the continued success of one of the basic principles underlying our tax system, self-assessment, it is essential that IRS make the regulations which the taxpayers must follow as clear as possible. It is also essential that IRS auditors have definitive criteria for measuring the extent to which proper self-assessment is being achieved.

We recognize that there are many specific corporate accounts. Given IRS' primary mission of protecting the revenues, it would seem natural for the Service to focus on those accounts that have the most

potential for tax adjustment. Thus, in the absence of specific National Office instructions, it would not be surprising to find that auditors devote relatively less effort to accounts that, although important from a public policy standpoint, lack significant adjustment potential.

The extent to which public policy concerns about possible areas of noncompliance should override cost/benefit concerns in determining the emphasis IRS should give to auditing accounts that may not generate substantial tax adjustments is a decision which should be made at the national level. A recent example of a National Office determination that a public policy concern was overriding is the issuance of detailed audit instructions to be followed and specific compliance checks to be performed in detecting corporate slush funds.

We see nothing to indicate that similar IRS action is not warranted to clarify for taxpayers and its own auditors the provisions of Code section 162 as they relate to political advertising. FPC acted to correct the related confusion, misunderstanding and noncompliance which existed within its own jurisdiction and it seems that IRS should take similar action.

Acccordingly, we recommend that IRS:

—Clarify existing regulations in the area of political advertising and grass-roots lobbying to provide taxpayers and auditors with better definitions for classifying such expenses for income tax purposes.

—Systematically test the practices followed by various industry groups in the area of advertising and lobbying expenses to determine the extent of noncompliance that exists and what corrective action, if any, is warranted.

—Provide more specific audit criteria for IRS agents to follow in deciding whether to select corporate accounts relating to political advertising and lobbying expenses for examination.

—Develop additional guidance, such as a listing of advertising themes, for auditors to follow in separating grass-roots lobbying and advertising expenses from allowable deductions in computing taxable income.

We would appreciate your comments on these recommendations by December 9, 1977. If you or your staff want to discuss these matters further, feel free to call me on 566-6503.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Associate Director

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

DEC 2 ? 1977

Mr. Richard L. Fogel
Associate Director
General Government Division
Tax Group
General Accounting Office
Washington, D. C. 20224

Dear Mr. Fogel:

The Subcommittee on Commerce, Consumer and Monetary Affairs, Committee on Government Operations, and your letter of November 9, 1977, have expressed concern regarding the important and difficult issue involved in the Service's administration of the tax laws dealing with lobbying expenses.

We are seeking to improve our administration in this area by taking steps to determine the extent to which there are abuses, by clarifying criteria for differentiating deductible from nondeductible expenditures, and by improving the guidance to our revenue agents in the field.

With specific regard to each of your four recommendations:

1. Chief Counsel has opened a study project to review existing regulations in this area. The aims of the study include clarification of the distinctions between deductible and nondeductible advertising expenditures.

2. Our Exempt Organizations Division audit program for 1978 will include examination of about 50% of returns filed by the larger trade associations. The Division is developing an audit checksheet to attempt quantification of treatment of lobbying expenditures to determine whether this is an area of substantial noncompliance and whether this issue is adequately covered on audit. We are also considering the

feasibility of developing a method to test compliance in the large case program. We would welcome your review of our audits described in the Comptroller General's letter of December 12, 1977 as a constructive aid to our own decisions regarding future tax administration decisions.

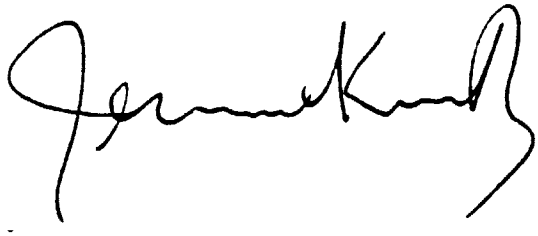
3. We will prepare an information notice to emphasize to our field personnel the substantive tax rules and auditing techniques used to determine the deductibility of these expenditures. We will also reexamine our current guidance to the field to determine whether changes are needed. We will encourage our agents to ask for technical advice in grey area cases.

4. We will identify actual examples of these advertisements with a view to publishing rulings to help clarify grey areas both for taxpayers and our revenue agents.

Our aim is to afford this issue appropriate attention in a balanced tax administration program. We recognize our responsibility to audit this area because of its public policy implications even though its revenue producing potential may be less than other issues. If this is shown to be an area of high noncompliance, we will seek to apply our general policy in other high noncompliance areas of devoting additional resources overriding cost/benefit concerns. I am confident that we can and will improve our administration of the tax laws dealing with lobbying expenditures by the steps we have outlined.

With kind regards,

Sincerely,



Schedule L Balance Sheets

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash				
2 Trade notes and accounts receivable				
(a) Less allowance for bad debts				
3 Inventories				
4 Gov't obligations: (a) U.S. and instrumentalities				
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other fixed depreciable assets				
(a) Less accumulated depreciation				
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)				
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable				
16 Mtges., notes, bonds payable in less than 1 yr.				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more				
20 Other liabilities (attach schedule)				
21 Capital stock: (a) Preferred stock				
(b) Common stock				
22 Paid-in or capital surplus				
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated				
25 Less cost of treasury stock		( )		( )
26 Total liabilities and stockholders' equity				

Schedule M-1 Reconciliation of Income Per Books With Income Per Return

1 Net income per books		7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax		(a) Tax-exempt interest $	
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)		8 Deductions in this tax return not charged against book income this year (itemize)	
		(a) Depreciation $	
5 Expenses recorded on books this year not deducted in this return (itemize)		(b) Depletion $	
(a) Depreciation $			
(b) Depletion $			
6 Total of lines 1 through 5		9 Total of lines 7 and 8	
		10 Income (line 28, page 1)—line 6 less 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings Per Books (line 24 above)

1 Balance at beginning of year		5 Distributions: (a) Cash	
2 Net income per books		(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
4 Total of lines 1, 2, and 3		7 Total of lines 5 and 6	
		8 Balance at end of year (line 4 less 7)	

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RECONCILIATION OF REPORTED NET INCOME WITH TAXABLE INCOME FOR FEDERAL INCOME TAXES

1. Report hereunder a reconciliation of reported net income for the year with taxable income used in computing Federal income tax accruals and show computation of such tax accruals. The reconciliation should include as far as practicable the same detail as furnished on Schedule M-1 of the tax return for the year. The reconciliation shall be submitted even though there is no taxable income for the year. Descriptions should clearly indicate the nature of each reconciling amount.

2. If the utility is a member of a group which files consolidated Federal tax return, reconcile reported net income with taxable net income as if a separate return were to be filed, indicating, however, intercompany amounts to be eliminated in such consolidated return. State names of group members, tax assigned to each group member, and basis of allocation, assignment, or sharing of the consolidated tax among the group members.

Line No.	Particulars (a)	Amount (b)
		$
1	Net income for the year per Statement C, page 116A	
2	Reconciling items for the year:	
3		
4	Taxable income not reported on books:	
5		
6		
7		
8		
9	Deductions recorded on books not deducted for return:	
10		
11		
12		
13		
14	Income recorded on books not included in return:	
15		
16		
17		
18		
19	Deductions on return not charged against book income:	
20		
21		
22		
23		
24		
25		
26		
27	Federal tax net income	
28		
29	Computation of tax:	
30		
31		
32		
33		
34		
35		
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40		
41		
42		
43		