Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue

March 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 18, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue (Audit # 200330041)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) could and should charge interest on taxpayer accounts containing accrued Failure to Pay (FTP) tax penalties.

In summary, the Congress established the FTP tax penalty to encourage taxpayers to pay their Federal income taxes timely and authorized the IRS to charge this penalty on tax accounts for which taxes are not paid when due. The FTP tax penalty generally accrues at a rate of one-half of 1 percent per month on the unpaid tax and continues to accrue until the penalty reaches a maximum of 25 percent. This penalty is charged only on the unpaid tax and not on unpaid penalties and interest.

Currently, most calculations and assessments for the FTP tax penalty are made by the IRS computer system. The computer makes an initial assessment of the penalty to the taxpayer's account on the IRS Master File[1] at the time the original tax liability is assessed. After this, the penalty continues to accrue (grow) each month but is usually not assessed[2] to the taxpayer's account until all other assessed liabilities (tax, penalties, and interest which have actually been posted to the account) are paid in full and there is

[1] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] An amount is not considered assessed until it is officially recorded as a liability on a taxpayer's account on the IRS Master File.

a credit available in the taxpayer's account.[3] In other words, the computer keeps track of how much FTP tax penalty the taxpayer owes, but most of the penalty is never officially assessed to the taxpayer's account on the Master File until there are funds in the account to pay all or part of the accrued penalty. Even then, only the portion of the accrued FTP tax penalty that can be paid with the credit available in the account is officially assessed. The rest remains accrued but not assessed.

This is significant for two reasons. First, IRS computers are not programmed to charge interest on accrued FTP tax penalties. By not assessing these penalties periodically, the IRS has foregone the interest associated with them. Internal Revenue Code (I.R.C.) Section (§) 6601(e)(2)(A) requires the IRS to charge interest on FTP tax penalties just as it does on other unpaid taxes and penalties. It states "interest shall be imposed" on these penalties. We estimate that, if the IRS had assessed all penalty accruals at least quarterly, it would have assessed over $817 million in interest on accrued penalties during Calendar Year (CY) 2002. Second, this practice results in inconsistent treatment of some taxpayers who have to pay interest on the penalties. These taxpayers, some in hardship situations such as victims of natural disasters or military personnel serving in combat zones, have accounts that have to be administered by the IRS manually (rather than by computer). The FTP tax penalties on these accounts are computed manually because certain variables associated with the accounts are not programmed into IRS computers. IRS personnel periodically calculate and manually assess the penalties. Because the manually computed FTP tax penalties are periodically assessed, interest is charged on the FTP tax penalties on these accounts. The IRS Mission Statement requires that it apply the tax law with integrity and fairness to all. However, we estimate for those accounts for which the computer did not administer the penalties in CYs 2000 and 2001, the IRS charged $8.7 million in interest through December 31, 2003, on 126,061 manually administered taxpayer accounts.

To ensure all taxpayers are treated equitably and all monies owed the Federal Government are correctly assessed, we recommended the Commissioner, Small Business/Self-Employed (SB/SE) Division, request programming changes that would cause accrued FTP tax penalties to be assessed on a periodic basis. We also recommended the Commissioner work with the Department of the Treasury Assistant Secretary for Tax Policy to request clarifying legislation regarding the need for separate notices to be issued to taxpayers each time FTP tax penalties are assessed and interest is charged on the penalties. Finally, we recommended the Commissioner ensure notices include the proper wording to inform taxpayers that interest is being charged on the FTP tax penalties until they are fully paid.

Management's Response: The Commissioner, SB/SE Division, agreed with our conclusion that IRS computers are not assessing interest on monthly FTP penalty accruals and that these accruals would have to be assessed for related interest to be charged. The Commissioner also acknowledged the inequity between interest

[3] Any balance due notice sent to the taxpayer contains the full amount of the FTP tax penalty (assessed and unassessed).

assessments on manually computed accounts and those accounts for which the penalty is systemically generated. Further, the Commissioner agreed to implement corrective actions for our three recommendations. The Commissioner also concurred with our estimate of the potential increase in revenue, while stating that it is not possible to separately track additional dollars collected based on additional interest assessed on FTP tax penalty accruals.

However, the Commissioner disagreed that legislative changes are needed due to conflicting legal interpretations or that such legislation would be clarifying. The Commissioner also stated that corrective action is significantly impaired by systemic limitations on account maintenance, retention, calculation, and overall capacity. In addition, the Commissioner noted that the monthly assessment of FTP tax penalties and related interest is made more difficult because a notice and demand for payment of tax, interest, and penalty must be mailed to the taxpayer for the interest on the penalty to be legally due and payable. In the Commissioner's opinion, the volume of notices required would compromise the IRS' notice issuance capacity and increase taxpayer call-ins, which would affect the IRS' ability to respond to general inquiries. Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment: Although the IRS generally agreed with our findings and recommendations, it disagreed that legislative changes are needed due to conflicting legal interpretations regarding I.R.C § 6601. We do not necessarily disagree with the IRS' legal interpretation that a notice must be issued on each FTP tax penalty before interest can be charged. However, we do recognize, as the IRS Chief Counsel stated in a May 3, 2001, memorandum, that an argument could be made for assessing interest on additional penalty amounts without sending additional notices each time the penalty is assessed. Regardless of the interpretation, the fact remains that the IRS' procedure is to charge interest on the penalty only after a notice has been issued. As long as the IRS does not have the capacity and resources to issue tax notices on FTP tax penalties as they become due each month, some taxpayers will be treated inconsistently and the IRS will not charge the proper amount of interest legally due on those accounts. Assessing the FTP penalty accruals once a year in coordination with the reminder notices is a start, but a stronger commitment is necessary to correct the problems outlined in our report. Because of this fact, we strongly emphasize that the IRS should work with the Department of the Treasury Assistant Secretary for Tax Policy to request legislation stating that an original notice and demand will suffice for putting taxpayers on notice for interest charges on future FTP tax penalty assessments. Without an amendment or change to the I.R.C., the IRS' ability to make periodic assessments, and thus charge interest on those assessments, will continue to be limited by the resources available to issue more notices. While we believe our recommendation is worthwhile, we do not intend to elevate our disagreement concerning it to the Department of the Treasury for resolution.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or

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Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue

Background

To encourage taxpayers to pay their Federal income taxes timely, the Congress established the Failure to Pay (FTP) tax penalty and authorized the Internal Revenue Service (IRS) to charge this penalty on tax accounts for which taxes are not paid when due. The FTP tax penalty is different from most other penalties in that it continues to accrue (grow) over time while other penalties are usually one-time assessments. The FTP tax penalty generally accrues at a rate of one-half of 1 percent per month on the unpaid tax and continues to accrue until the penalty reaches a maximum of 25 percent. This penalty is charged only on the unpaid tax and not on unpaid penalties and interest.

Currently, in administering the FTP tax penalty, most calculations and assessments are made by the IRS computer system. The computer makes an initial assessment of the penalty to the taxpayer's account on the IRS' Master File[1] at the time the original tax liability is assessed. After this, the penalty continues to accrue each month but is usually never assessed[2] to the taxpayer's account until all other assessed liabilities (tax, penalties, and interest that have actually been posted to the account) are paid in full and there is a credit available in the taxpayer's account.[3]

In other words, the computer keeps track of how much FTP tax penalty the taxpayer owes, but most of the penalty is never officially assessed to the taxpayer's account on the Master File until there are funds in the account to pay all or part of the accrued FTP tax penalty. Even then, only the portion of the accrued FTP tax penalty that can be paid with the credit available in the account is officially assessed. The rest remains accrued but not assessed. Appendix V shows a simulated transcript of a fictitious tax account for which the computer keeps track of the accruals and makes the assessments.

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[1] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] An amount is not considered assessed until it is officially recorded as a liability on a taxpayer's account on the IRS Master File.
[3] Any balance due notice sent to the taxpayer contains the full amount of the FTP tax penalty (assessed and unassessed).

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Table 1 reflects the volume and amount of accrued FTP tax penalties owed by taxpayers at the end of each quarter in Calendar Year (CY) 2002. The information was taken from IRS Tax Records Categorization (TRCAT) files.[4] As can be seen, the volumes and amounts of these penalties are very substantial and fairly consistent from quarter to quarter.

Table 1: FTP Tax Penalty Data (CY 2002)

Quarter Ending	Number of Taxpayer Accounts[5]	Accrued FTP Tax Penalties
March 2002	18,093,631	$14,178,035,126
June 2002	19,100,646	$14,170,433,175
September 2002	18,960,234	$14,173,436,864
December 2002	18,768,418	$14,351,786,404

Source: IRS TRCAT files.

This is significant for two reasons. First, IRS computers are not programmed to charge interest on accrued FTP tax penalties. By not assessing these penalties periodically, the IRS has foregone the interest associated with them. Second, there are some taxpayers whose accounts have to be manually administered by the IRS (rather than by computer). The FTP tax penalties on these accounts are computed manually because certain variables associated with the accounts are not programmed into IRS computers. IRS personnel periodically calculate and manually assess the penalties. Because the FTP tax penalties are periodically assessed on the manually administered accounts, interest is charged on the penalties from the time of their assessment. This report discusses these two issues in depth.

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[4] TRCAT files are created as part of the Accounts Receivable Dollar Inventory. These files are generated on a quarterly basis from both the Individual Master File (IMF) and Business Master File (BMF). The IMF is the IRS database that maintains transactions or records of individual tax accounts. The BMF is the IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

[5] This column represents 23,865,069 unique taxpayer accounts. Some taxpayer accounts can be duplicated from quarter to quarter if the penalties remain unpaid.

This review was performed at the Ogden, Utah, IRS Campus[6] during the period October 2003 through September 2004 using tax return information filed nationwide. The audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Internal Revenue Service Should Periodically Assess and Charge Interest on All Failure to Pay Tax Penalties

The IRS practice of accruing FTP tax penalties, rather than periodically assessing them, results in no interest charges for most of these penalties. IRS computers are programmed to charge interest on the penalties only after they are assessed. A credit must exist in an account before any accrued penalty is assessed.[7] Even then, the accrued penalty is only assessed to the extent of the credit in the account. Interest is never charged on the accrued penalty, even after assessment, because the penalty is basically fully paid at the time it is assessed.

Internal Revenue Code (I.R.C.) Section (§) 6601(e)(2)(A) requires the IRS to charge interest on FTP tax penalties just as it does on other unpaid taxes and penalties. It states that "interest <u>shall be imposed</u>" (emphasis added) on these penalties. In addition, the IRS Mission Statement requires that it apply the tax law with integrity and fairness to all. However, the current procedure of not assessing accrued FTP tax penalties on a periodic basis, and thus not charging interest on the penalties, creates an inequity for those taxpayers who do pay the penalties timely and an even greater inequity for taxpayers whose accounts have to be manually administered by the IRS.

Some reasons why the IRS has not periodically assessed and charged interest on FTP tax penalties include the following:

- The IRS has asserted that assessing the accrued penalties periodically would create a capacity problem for its

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[6] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[7] In addition to assessing the penalty when the module balance becomes negative, the computer will assess the penalty if a subsequent tax assessment posts to the specific account or module.

Master File computers. However, we were advised by an IRS Computer Specialist that the penalties could be periodically assessed as often as every 6 weeks.

- Even if the penalties are assessed periodically, there are still conflicting legal interpretations regarding whether interest can be charged without issuing new notices each time the penalties are assessed. For example, the IRS Chief Counsel stated in a memorandum dated May 3, 2001, that an argument could be made for assessing interest on additional penalty amounts without sending additional notices each time the penalty is assessed. There are also concerns regarding whether the IRS' notice issuance facilities could meet the demand to issue these additional notices.

  I.R.C. § 6601(e)(2)(A) states "interest shall be imposed" on FTP tax penalties from the date of notice and demand to the date of payment. However, it is not clear whether it was the Congress' intent for the penalties, and the interest on those penalties, to begin with the initial notices sent to taxpayers by the IRS or whether subsequent notices are required each time the accrued penalties are assessed.

  To ensure the IRS is in strict compliance with the law, the IRS Office of Chief Counsel has determined that, until clarifying legislation is provided, the IRS should send new notices each time the FTP tax penalties are assessed before interest can be charged on the penalties.

As a result of IRS procedures regarding FTP tax penalties, the Federal Government loses hundreds of millions of dollars in interest each year and thousands of taxpayers are treated inconsistently from other taxpayers.

Interest lost

Based on information we obtained from IRS TRCAT files, over $14 billion in accrued FTP tax penalties existed on taxpayer accounts at the end of CY 2002. The $14 billion figure was relatively constant at the end of each quarter in CY 2002. If the IRS changed its present procedures from assessing accrued FTP tax penalties when a credit exists in an account to assessing the accruals on a quarterly basis, we estimate the IRS would have charged over $817 million in interest on accrued penalties that would have been assessed during CY 2002 (see Table 2).

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Table 2: Potential Interest Charges (CY 2002)

Quarter Ending	Unassessed Accrued Penalties at Quarter's End	Interest Rate for Subsequent Quarter	Potential Interest Charges
March 2002	$14,178,035,126	1.50% (4/02-6/02)	$212,670,527
June 2002	$14,170,433,175	1.50% (7/02-9/02)	$212,556,498
September 2002	$14,173,436,864	1.50% (10/02-12/02)	$212,601,553
December 2002	$14,351,786,404	1.25% (1/03-3/03)	$179,397,330
Total			$817,225,908

Source: TRCAT files and IRS Interest Rate Tables.

Because our CY 2002 FTP tax penalty data may have contained some taxpayer liabilities that would never be collected, we selected a statistical sample of 385 tax accounts to determine how many taxpayer accounts had been fully paid or were still in an active collection status.[8] We found that 160 of the 385 accounts were fully paid, 17 were in current installment agreements, and 2 had at least 3 payments made in the last year. Based on our analysis, we estimate that the IRS could expect to collect almost one-half of the interest it charges by assessing FTP tax penalties on a periodic basis. Our margin of error for this estimate was $\pm$5 percent (41.5 to 51.5 percent).

As stated earlier, there are conflicting legal interpretations regarding whether new notices must be sent each time the FTP tax penalties are assessed to facilitate charging interest on the penalties. In addition, concerns have been raised regarding whether the IRS' notice issuance facilities could meet the demand to issue notices each time the accrued FTP

[8] We defined active collection status as those taxpayers in a current installment agreement or accounts having at least three payments made on the account during the last year.

tax penalties are assessed, if they are assessed periodically.[9] Currently, the IRS sends a number of balance due notices within the first few months of when a tax liability is established. After that, only one notice is sent per year. These notices now show the total FTP tax penalty amounts and do not distinguish between assessed and accrued amounts. Even if the IRS determines it does not have the capacity to issue more notices for assessed FTP tax penalties, the penalties could be assessed at the time each of these notices is generated.

Inconsistent treatment of taxpayers

Normally, IRS computer programs automatically calculate the FTP tax penalty amounts. However, there are situations in which penalties are prohibited or limited to specific periods and must be computed manually by IRS employees. In these situations, an IRS employee enters a code into the computer to "restrict" the computer from calculating the penalty amounts. For example, qualifying taxpayers affected by natural disasters or military personnel serving in combat zones receive an extension of time to file and pay their taxes, extending the FTP tax penalty start dates. Taxpayers in bankruptcy status have the FTP tax penalties suspended from computation. Appendices V and VI show simulated transcripts of fictitious tax accounts with FTP tax penalties accrued by the computer and manually assessed, respectively.

Because the FTP tax penalties on these restricted accounts are manually assessed and not computed by the IRS computers, there are no accrued penalties on the accounts. The penalties are periodically calculated and manually assessed, and interest is charged on the periodic assessments. This creates an inconsistency because these taxpayers are charged interest on the manually assessed penalties while taxpayers with computer accrued penalties are not charged interest.

We identified a population of 126,061 Individual Master File (IMF) and Business Master File (BMF) taxpayer

[9] If the Congress provides clarifying legislation regarding the need for new notices each time FTP tax penalties are assessed, the ability of the IRS to meet the demand for the notices may no longer be of concern.

accounts that contained FTP tax penalties manually assessed in CYs 2001 and 2002 for amounts more than $50. We selected and reviewed a statistically valid sample of 100 of these accounts and determined that $6,909 in interest was charged on the manually assessed FTP tax penalties through December 31, 2003. Based on these results, we estimate that the 126,061 taxpayer accounts contained over $8.7 million in interest charges through December 31, 2003. If these same accounts were not restricted, IRS computers would have accrued the FTP tax penalties, but interest would not have been charged on the penalties.

Recommendations

The Commissioner, Small Business/Self-Employed (SB/SE) Division, should:

1. Request programming changes that would cause accrued FTP tax penalties to be assessed on a periodic basis (as often as possible based upon the IRS' ability to issue additional notices). This would cause interest to be charged on the assessed FTP tax penalties during the time period in which they are not paid and would be consistent with the way interest is charged on other unpaid liabilities.

<u>Management's Response</u>: The Commissioner, SB/SE Division, will submit a system change request to have FTP tax penalties assessed on BMF and IMF annual reminder notices, effective January 2006.

<u>Office of Audit Comment</u>: Assessing the FTP tax penalty accruals once a year in coordination with the reminder notices is a start, but a stronger commitment is necessary to correct the problems outlined in our report.

2. Work with the Department of the Treasury Assistant Secretary for Tax Policy to request clarifying legislation regarding the need for separate notices to be issued to taxpayers each time FTP tax penalties are assessed and interest is charged on the penalties. If and when such legislation is enacted, request programming changes that would cause accrued FTP tax penalties to be assessed quarterly or more often, if possible.

Management's Response: The Commissioner, SB/SE Division, and Office of Chief Counsel will review the applicable statutory provisions and IRS procedures for assessing interest on the FTP tax penalty and providing notices to taxpayers. Following this review, they will discuss all available options, including possible statutory amendments, and proceed with a course that is in the best interest of sound tax administration.

Office of Audit Comment: Regardless of the results of this review, the fact remains that the IRS' procedure is to charge interest on the FTP tax penalty only after a notice has been issued. As long as the IRS does not have the capacity and resources to issue tax notices on FTP tax penalties as they become due each month, some taxpayers will be treated inconsistently and the IRS will not charge the proper amount of interest legally due on those accounts. We strongly emphasize that the IRS should work with the Department of the Treasury Assistant Secretary for Tax Policy to request legislation stating that an original notice and demand will suffice for putting taxpayers on notice for interest charges on future FTP tax penalty assessments. Without an amendment or change to the I.R.C., the IRS' ability to make periodic assessments, and thus charge interest on those assessments, will continue to be limited by the resources available to issue more notices.

3. Ensure notices containing FTP tax penalty assessments include information informing taxpayers that interest is being charged on the FTP tax penalties until they are fully paid. Currently, the stuffers (Information About Your Notice, Penalty and Interest, Notice 746; and Interest and Penalty Information, Notice 433) included with the notices do not inform the taxpayers that interest is charged on FTP tax penalties.

Management's Response: On the next scheduled revision, Notices 746 and 433 will be revised to indicate that interest is charged on assessed FTP tax penalties.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Internal Revenue Service (IRS) could and should charge interest on taxpayer accounts containing accrued Failure to Pay (FTP) tax penalties. To accomplish our objective, we:

I. Determined IRS policies and procedures for charging interest on FTP tax penalties and whether these procedures were consistent with applicable tax laws. This was done through interviews with IRS management, analysis of relevant tax law, and analysis of IRS policies, procedures, and training material.

II. Determined the amount of FTP tax penalties accrued on taxpayer accounts during the period January 1, 2002, through December 31, 2002. This information was obtained through analysis of IRS Tax Records Categorization (TRCAT)[1] files.

III. Determined the amount of interest not being charged on taxpayer accounts with accrued FTP tax penalties. This information was also obtained through analysis of IRS TRCAT files containing data during the period January 1, 2002, through December 31, 2002.

IV. Determined whether the additional revenues were greater than the associated costs to establish procedures for charging interest on accrued FTP tax penalties. We also estimated the collectibility of the additional revenues. This was done by selecting a statistical sample[2] of 385 taxpayer accounts from a population of 23,865,069 taxpayer accounts containing FTP tax penalties accrued during Calendar Year (CY) 2002. In selecting our sample, we used a confidence level of 95 percent, a precision rate of ±5 percent, and an expected error rate of 50 percent for the population of 23,865,069. We reviewed the 385 taxpayer accounts and determined whether they were fully paid or in active collection status.[3]

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[1] TRCAT files are created as part of the Accounts Receivable Dollar Inventory. These files are generated on a quarterly basis from both the Individual Master File (IMF) and Business Master File (BMF). The IMF is the IRS database that maintains transactions or records of individual tax accounts. The BMF is the IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

[2] We selected statistical samples because we wanted to project our results over the entire population of cases.

[3] We defined active collection status as those taxpayers in a current installment agreement or accounts having at least three payments made on the account during the last year.

V. Determined the number of taxpayer accounts for which the computer was restricted from assessing the FTP tax penalties during CY 2002. This information was obtained through analysis of IRS Master File[4] data for the period January 1, 2002, through December 31, 2002.

VI. Determined the amount of interest being charged on taxpayer accounts for which the FTP tax penalties were being manually assessed. We selected a statistical sample of 100 taxpayer accounts from a population of 126,061 accounts for which the FTP tax penalties were manually assessed during CYs 2001 and 2002. From this sample, we estimated that $8.7 million in interest was charged on manually assessed FTP tax penalties through December 31, 2003. Our computed precision for this estimate was between $5.4 and $12 million. In selecting our sample, we used a confidence level of 95 percent, a precision rate of $\pm$10 percent, and an expected error rate of 50 percent for the population of 126,061 accounts.

[4] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $1,873,454,946 in interest charges on 9,904,004 taxpayer accounts (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained Internal Revenue Service (IRS) Tax Records Categorization (TRCAT)[1] files for the 4 quarters in Calendar Year (CY) 2002. After analyzing this information, we determined the average quarterly accrued Failure to Pay (FTP) tax penalty amount was $14,218,422,892. We also determined the average interest rate for the last 20 quarters (5 years) was 1.5875 percent (6.35 percent annual rate). Multiplying the $14,218,422,892 by the 1.5875 percent interest rate for 20 quarters (5 years) equals $4,514,349,268. This is the estimated interest amount the IRS could charge on the accrued FTP tax penalties if the penalties were assessed quarterly over a 5-year period.

The CY 2002 data included accrued FTP tax penalties on 23,865,069 unique taxpayer accounts. Because at least some of these accounts might not be collectible, we selected a statistical sample of 385 of the 23,865,069 taxpayer accounts. We analyzed the 385 accounts to determine the numbers that were either fully paid or in an active collection status.[2] Of the 385[3] taxpayer accounts, 179 (46.5 percent) were fully paid or in an active collection status. Our margin of error for this estimate was ±5 percent (41.5 to 51.5 percent).

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[1] TRCAT files are created as part of the Accounts Receivable Dollar Inventory. These files are generated on a quarterly basis from both the Individual Master File and Business Master File. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

[2] We defined active collection status as those taxpayers in a current installment agreement or accounts having at least three payments made on the account during the last year.

[3] The computation size for our statistical sample included a confidence level of 95 percent, a precision rate of ±5 percent, and an expected error rate of 50 percent for the population of 23,865,069 taxpayer accounts.

To be conservative, we multiplied $4,514,349,268 by 41.5 percent to obtain a reduced figure of $1,873,454,946 in interest charges over a 5-year period.[4] We also reduced the 23,865,069 taxpayer accounts by the 41.5 percent figure to produce a new figure of 9,904,004 taxpayer accounts.

[4] It is possible that some of the additional revenue generated by periodically assessing and charging interest on the FTP tax penalty would be offset by the cost of issuing additional notices to taxpayers. We did not reduce our outcomes for the following reasons: a) we reduced our projections by the margin of error for our sample size and b) if the Congress provides clarifying legislation regarding the need for new notices each time FTP tax penalties are assessed, the cost of the notices may no longer be of concern.

Appendix V

Master File[1] Transcript for Computer Assessed Failure to Pay Tax Penalty

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ACCOUNT NO 123-45-6789
NAME CONT- ABCD
****************************************************************


**************************
* TAX PERIOD 30   200112 *
**************************


MF MOD BAL-                3,295.00
ACCRUED INTEREST-            400.00  02162004
ACCRUED PENALTY-             640.00  02162004


     150 06032002      8,000.00

     806 04152002      4,000.00-

     170 06032002         50.00

     166 06032002        175.00

     276 06032002         40.00

     196 06032002         30.00

     670 03312003      1,000.00-
```

This figure is the assessed module balance. It is the sum of the seven assessed transactions below. The transaction codes represent the following:

150 – Tax Liability
806 – Withholding Credit
170 – Estimated Tax Penalty
166 – Failure to File Penalty
276 – Computer Assessed Failure to Pay Tax Penalty
196 – Computer Assessed Interest
670 – Payment

This $640.00 figure is the Accrued Failure to Pay (FTP) tax penalty. It is shown separately from the seven assessed transactions to the left. No interest is charged on the accrued FTP tax penalties.

This specific $40 transaction is the initial assessed FTP tax penalty. As the penalty accrues (grows) after the initial assessment, it is reflected in the accrued penalty figure. Interest is charged on this initial assessment but is not charged on future accruals.

This is a simulated Internal Revenue Service (IRS) taxpayer account transcript. Although the taxpayer data are fictitious, the transcript illustrates how the IRS computer accrues and assesses Failure to Pay (FTP) tax penalties. In this example, the taxpayer filed late and did not pay the

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[1] The Master File is the Internal Revenue Service database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

amount due. The IRS computer assessed an FTP tax penalty of $40 at the time the return was processed on June 3, 2002. After that initial assessment, the FTP tax penalty amount grew to $640. This $640 amount is shown separately from the assessed transactions. The number 02162004 signifies that the $640 figure is computed to February 16, 2004. The $640 figure will continue to accrue (grow) until the tax is fully paid or the 25 percent maximum penalty is reached. The accrued amount will not be assessed until the module balance becomes negative.[2] For example, if a payment of $3,395.00 were made, $100.00 ($3,295 - $3,395 = -$100) in FTP tax penalty would be assessed and the accrued amount would be reduced to $540. Interest is charged on the initial $40 assessment but is not charged after that point. This is true because the IRS computer is not programmed to charge interest on penalties in an accrued status. When the accrued penalties are assessed, they are only assessed to the extent that a credit exists in the account. When the accrued penalty is assessed, it is basically already fully paid and is not subject to interest.

[2] In addition to assessing the penalty when the module balance becomes negative, the computer will assess the penalty if a subsequent tax assessment posts to the specific account or module.

Appendix VI

Master File[1] Transcript for Manually Assessed Failure to Pay Tax Penalty

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ACCOUNT NO 123-45-6789
NAME CONT- ABCD
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* TAX PERIOD 30   200112 *
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MF MOD BAL-                 3,935.00
ACCRUED INTEREST-             400.00 02162004
ACCRUED PENALTY-                 .00 02162004


     150 06032002      8,000.00

     806 04152002      4,000.00-

     170 06032002         50.00

     166 06032002        175.00

     270 06032002         40.00

     196 06032002         30.00

     270 07082002         20.00

     270 08122002         20.00

     670 03312003      1,000.00-

     270 02162004        600.00
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This figure is the assessed module balance. It is the sum of the 10 assessed transactions below. The transaction codes represent the following:

150 – Tax Liability
806 – Withholding Credit
170 – Estimated Tax Penalty
166 – Failure to File Penalty
270 – Manually Assessed Failure to Pay Tax Penalty
196 – Computer Assessed Interest
670 – Payment

The accrued Failure to Pay tax penalty amount is $.00 on this account because the Internal Revenue Service (IRS) computer is not computing the penalty. The penalty amounts are periodically being manually assessed.

The initial $40 Failure to Pay tax penalty on this account was assessed with a special restricting transaction (transaction code 270) that takes the computation of the penalty away from the computer. The penalty must now be manually computed and assessed by an IRS employee.

[1] The Master File is the Internal Revenue Service database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

This is a simulated Internal Revenue Service taxpayer account transcript. Although the taxpayer data are fictitious, the transcript illustrates how the Failure to Pay (FTP) tax penalty is assessed when an account has been restricted from the computer. In this example, the taxpayer filed late and did not pay the amount due. Because it was determined the computer could not accurately compute the penalty on this account, the initial FTP tax penalty of $40 was manually assessed. As the penalty accrues (grows), further manual computations and assessments must be made. Because the amounts are being assessed periodically and not accrued by the computer, the computer is charging interest on the assessments from the time they are assessed until they are paid. For example, interest is being charged on the $40 assessment from June 3, 2002, on the first $20 assessment from July 8, 2002, on the second $20 assessment from August 12, 2002, and on the $600 assessment from February 16, 2004.

Appendix VII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

February 22, 2005

RECEIVED
FEB 2 5 2005

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT
(SMALL BUSINESS AND CORPORATE PROGRAMS)

FROM: Kevin M. Brown KMB
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions in Lost Revenue (Audit # 200330041)

I reviewed your report and appreciate the information on how assessable interest applies to the Failure to Pay (FTP) penalty. We agree with your conclusion that our computers are not assessing interest on monthly FTP penalty accruals and that these accruals would first have to be assessed in order to charge related interest. However, as your report recognizes, there are numerous difficulties in addressing this issue.

First, corrective action is significantly impaired by systemic limitations on account maintenance, retention, calculation and overall capacity. Second, monthly assessment of FTP penalties and related interest is further hindered by the fact that a notice and demand for payment of tax, interest and penalty must be mailed to the taxpayer in order to consider interest on the penalty legally due and payable. Our notice issuance capacity would be prohibitively compromised by the volume of correspondence required to meet this condition, and the increase in related taxpayer call-ins would impact our ability to fulfill routine public contact requirements in response to general inquiries. There would also be an additional burden placed upon taxpayers (small businesses and individuals) who would receive notices.

We disagree that the need for legislative changes is due to "conflicting legal interpretations," or that such legislation would be "clarifying," as the report states. Interest on the penalty is imposed under Internal Revenue Code section 6601(e)(2), which clearly requires a notice of assessment of a penalty before interest can be charged on the penalty. Accordingly, our interpretation of this provision requires the assessment of, and new notice and demand for, payment of each new FTP accrual before interest can be charged. Our published guidance to taxpayers states that interest is charged according to this interpretation. A legislative change would be necessary to allow the Service to charge interest on accruals of the FTP penalty, based only on the initial assessment of, and notice and demand for, the penalty.

We concur with the estimate of the potential increase in revenue. However, while we can track the amounts of additional interest assessed on FTP penalty accruals, we are not able to separately track the additional dollars collected based on these additional assessments.

Finally, we acknowledge the inequity you observed in comparing the vast majority of systemically generated FTP penalty accounts with the relatively small number of accounts that require manual calculations. The latter cannot be completed without assessments that, unlike systemically generated updates, include a charge for interest on the penalty. This creates inconsistency as taxpayers in similar circumstances are not treated identically and is a condition we especially wish to correct.

In the last three years we have addressed seven TIGTA reviews on the failure-to-pay / failure-to-file penalty provisions under Internal Revenue Code section 6651 and implemented numerous recommendations. In response to previous reviews, we administratively extended the timeframe for applying the one-quarter percent FTP penalty rate on installment agreements. We also clarified when the FTP penalty begins to apply on adjustments to withholding and the earned income credit. During this time period, we independently completed a system change request to discontinue FTP penalty charges on erroneous refunds and perfected our substitute-for-return procedures to ensure FTP penalties are sustained in court.

Our comments on your recommendations follow:

RECOMMENDATION 1

The Commissioner, Small Business/Self-Employed Division, should request programming changes that would cause accrued FTP tax penalties to be assessed on a periodic basis (as often as possible based upon the IRS' ability to issue additional notices). This would cause interest to be charged on the assessed FTP tax penalties during the time period in which they are not paid and would be consistent with the way interest is charged on other unpaid liabilities.

CORRECTIVE ACTION

We will submit a system change request to have FTP penalties assessed on Business Master File (BMF) and Individual Master File (IMF) annual reminder notices effective January, 2006.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Examination Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
Program Manager, Penalties and Interest, will advise the Director, Examination Policy, of any delays.

RECOMMENDATION 2
The Commissioner, Small Business/Self-Employed Division, should work with the Department of the Treasury's Assistant Secretary for Tax Policy to request clarifying legislation regarding the need for separate notices to be issued to taxpayers each time FTP tax penalties are assessed and interest is charged on the penalties. If and when such legislation is enacted, request programming changes that would cause accrued FTP tax penalties to be assessed quarterly or more often if possible.

CORRECTIVE ACTION
SB/SE and Chief Counsel will review the applicable statutory provisions, our procedures for assessing interest on the FTP penalty, and providing notice to taxpayers. Following this review, we will discuss all available options, including possible statutory amendments, and proceed with a course in the best interest of sound tax administration.

IMPLEMENTATION DATE
January 15, 2006

RESPONSIBLE OFFICIAL(S)
Director, Examination Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
Program Manager, Penalties and Interest, will advise the Director, Examination Policy, of any delays.

RECOMMENDATION 3
The Commissioner, Small Business/Self-Employed Division, should ensure that notices containing FTP tax penalty assessments include information informing taxpayers that interest is being charged on the FTP tax penalties until they are full paid. Currently the stuffers (Information About Your Notice, Penalty and Interest, Notice 746; and Interest and Penalty Information, Notice 433) included with the notices do not inform the taxpayers that interest is charged on FTP tax penalties.

CORRECTIVE ACTION
On the next scheduled revision, Notices 746 and 433 will be revised to indicate that interest is charged on assessed FTP penalties.

IMPLEMENTATION DATE
January 15, 2006

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RESPONSIBLE OFFICIAL(S)
Director, Examination Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
Program Manager, Penalties and Interest, will advise the Director, Examination Policy, of any delays.

If you have any questions, please call me at (202) 622-0600 or Steve Burgess, Director, Examination, Small Business/Self-Employed Division at (202) 283-2170.