TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Actions Are Planned to Extend the Grace Period Before Assessing the Failure to Pay Tax Penalty; However, Computer Programming Needs to Be Corrected

March 2006

Reference Number: 2006-30-057

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

March 14, 2006

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Actions Are Planned to Extend the Grace Period
Before Assessing the Failure to Pay Tax Penalty; However, Computer
Programming Needs to Be Corrected (Audit # 200530010)

This report presents the results of our review to determine whether the Internal Revenue Service
(IRS) properly implemented the provision of The Taxpayer Bill of Rights 2 (TBOR2),[1] which
increased the period of time that taxpayers were given to pay an additional tax assessment[2]
before being assessed the Failure to Pay (FTP) tax penalty.

Synopsis

A provision of TBOR2 increased the period of time that taxpayers were given to pay an
additional tax assessment before the IRS could assess the FTP tax penalty. Before the law was
enacted, taxpayers had 10 calendar days to pay an additional tax assessment and avoid paying the
FTP tax penalty.[3] TBOR2 changed this grace period from 10 to 21 calendar days for additional
tax assessments less than $100,000. For additional tax assessments of $100,000 or more, the
grace period was changed from 10 calendar days to 10 *business* days.

In March 2003, we issued a report[4] addressing IRS administration of the FTP tax penalty. The
report identified several instances in which the IRS computation of the FTP tax penalty did not

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[1] Pub. L. No. 104-168, 110 Stat. 1452 (1996) (codified as amended in scattered sections of 26 U.S.C.).
[2] Tax required to be shown on a return which is not shown. See Internal Revenue Code Section 6651(a)(1) and (3).
[3] The FTP tax penalty is calculated at 0.5 percent of the unpaid tax for each month that payment is overdue, until a
maximum penalty of 25 percent of the tax due is reached.
[4] *The Failure to Pay Penalty Is Not Always Calculated or Assessed Correctly* (Reference Number 2003-10-077,
dated March 2003).

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allow taxpayers the appropriate grace period for payment after an additional tax assessment was made. The IRS agreed to correct the problem by January 1, 2005.

Consequently, in December 2004, we initiated this audit. We then learned the IRS was planning to cancel the corrective actions that had been agreed upon in the prior report.

During this audit, the IRS initiated a Request for Information Services[5] that is intended to provide the appropriate grace period to all taxpayers. During our evaluation of IRS computer programs, we discovered a programming error that could prevent certain taxpayers from receiving the appropriate grace period. In our opinion, the law allows taxpayers 21 calendar days from the date of notice to pay additional tax assessments of less than $100,000 and 10 business days from the date of notice to pay additional tax assessments of $100,000 or more without incurring any penalty. Contrary to this, IRS computers are programmed to use the total amount of tax, penalty, and interest the taxpayer owes on the tax module[6] to compute the grace period rather than only the additional tax assessment amount. Fortunately, our analysis of 2004 data determined that few taxpayers would have been affected by the incorrect programming. Nonetheless, computer programs should be correct and in accordance with the law.

We notified personnel in the Office of Penalty and Interest about our concern that the grace period was not being determined correctly. The Office of Penalty and Interest agreed that the grace period should be determined in accordance with the law. A formal opinion from the Office of Chief Counsel regarding this issue has not been requested to date.

Recommendations

We recommended the Commissioner, Small Business/Self-Employed Division, request an opinion from the Office of Chief Counsel regarding whether the length of the grace period should be determined by the additional tax assessment amount or the total tax module balance amount and change computer programming if warranted. We recognize the extent of the problem is not widespread. However, the automatic computation of the FTP tax penalty should comply with the law.

Response

IRS management agreed with our recommendation. The Program Manager, Office of Penalties and Interest, will request an opinion from the Office of Chief Counsel to establish the correct

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[5] A Request for Information Services is a formal written request for a change in computer systems programming.
[6] A tax module refers to a specific year and type of return within a taxpayer's account and all tax modules combined comprise a taxpayer's account.

interpretation of the grace period in Internal Revenue Code Section 6651(a)(3). If the grace period is determined with reference to the amount of additional tax assessment instead of the total tax module balance, the Program Manager will request an internal system change and issue interim guidelines for employees to identify the miscalculations and manually correct them. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Curtis W. Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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***Actions Are Planned to Extend the Grace Period Before
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Background

Congress established the Failure to Pay (FTP) tax penalty to encourage taxpayers to pay their Federal income taxes timely. The Internal Revenue Service (IRS) is authorized to charge this penalty on tax modules[1] if taxes are not paid when due. The penalty is charged on only the unpaid tax and not on unpaid penalties and interest. In general, the FTP tax penalty is assessed at a rate of one-half of 1 percent (.005) per month on the unpaid tax until the penalty reaches a maximum of 25 percent.

The Taxpayer Bill of Rights 2 (TBOR2)[2] was enacted in 1996 to amend the Internal Revenue Code (I.R.C.). Portions of TBOR2[3] amended the I.R.C.[4] to increase the period of time that taxpayers were given to pay an additional tax assessment before the IRS could assess the FTP tax penalty. Before the law was enacted, taxpayers had 10 calendar days from the date the IRS issued a notice informing them of an additional tax assessment[5] to pay the tax with no FTP tax penalty. Beginning in 1997, the new law allows taxpayers 21 calendar days from the date of the notice to pay additional tax assessments of less than $100,000 and 10 business days to pay additional tax assessments of $100,000 or more without incurring the FTP tax penalty.

Most FTP tax penalty calculations and assessments are automatically made by the IRS computer system. When a tax liability on a filed tax return has not been fully paid, the computer makes an initial assessment of the FTP tax penalty to the taxpayer's tax module on the IRS Master File.[6] If additional tax assessments are not fully paid within the allotted grace period, then additional FTP tax penalties may also accrue or be assessed.

In March 2003, we issued a report[7] addressing IRS administration of the FTP tax penalty. One of the issues discussed in that report, which the IRS agreed to correct, was a problem with the grace period taxpayers were allowed. In October 2004, we found this issue had not been corrected. Consequently, we initiated this audit.

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[1] A tax module refers to a specific year and type of return within a taxpayer's account, and all tax modules combined comprise a taxpayer's account.
[2] Pub. L. No. 104-168, 110 Stat. 1452 (1996) (codified as amended in scattered sections of 26 U.S.C.).
[3] Title III, Section 303.
[4] Title 26, Subtitle F, Chapter 68, Subchapter A, Part I, Section 6651(a)(3).
[5] Tax required to be shown on a return which is not shown. See I.R.C. Section 6651(a)(1) and (3).
[6] The Master File is the IRS database that stores various types of taxpayer account information. This database contains individual, business, employee plans and exempt organization data.
[7] *The Failure to Pay Penalty Is Not Always Calculated or Assessed Correctly* (Reference Number 2003-10-077, dated March 2003).

This review was performed at the Ogden, Utah, IRS Campus[8] during the period December 2004 through October 2005. The audit was conducted 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.

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[8] 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.

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Results of Review

The Internal Revenue Service Delayed Actions Necessary to Correct Failure to Pay Inequalities

Our report issued in March 2003 concluded, in part, that the IRS did not always start the FTP tax penalty at the proper time after an additional tax assessment was made. The auditors identified several cases in which the FTP tax penalty was started too early due to "computer programming limitations." We recommended that this be corrected, and the IRS agreed to submit a Request for Information Services (RIS)[9] and have it implemented by January 1, 2005.
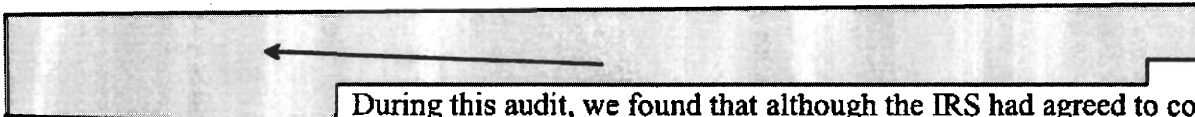
During this audit, we found that although the IRS had agreed to correct the problem in response to our March 2003 report, the IRS was making preparations in February 2005 to cancel the planned corrective action. This was based on the IRS opinion that the cases we identified were isolated exceptions that would have been corrected manually at a subsequent time. However, the IRS had been unable to establish that these were systemic errors.

Our follow up discussions with IRS personnel to re-address this issue led to the discovery that IRS computers are programmed to allow the proper grace period only to taxpayers whose tax modules are in Collection Status Code 21 (Status 21)[10] at the time of the additional tax assessment. All other non-Status 21 tax modules do not receive the appropriate amount of time to pay the assessment. As a result, IRS management reevaluated their plans to cancel the corrective action. On February 23, 2005, the IRS issued a RIS intended to remedy the problem identified in the 2003 audit report.

Our review confirmed, except in those cases discussed later in the report, that taxpayers whose tax modules are in Status 21 receive the proper grace period for the timely payment of an additional tax assessment while those tax modules not in Status 21 are not afforded the appropriate length of time to make payments. We found that in 2004, there would have been more than 18,000 non-Status 21 tax modules possibly affected. Some of these taxpayers may have paid penalties they did not owe.

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[9] A RIS is a formal written request for a change in computer systems programming.
[10] Collection Status Codes are computer generated to designate the current collection status of a tax module. Status Code 21 may indicate a tax return has been filed and assessed and the first collection notice has been issued. It may also indicate a subsequent assessment has been made and notice and demand for payment for such assessment has been issued.

For example, if a taxpayer whose tax module was not in Status 21 was assessed an additional tax assessment of $90,000, that taxpayer would receive only a 10 calendar day grace period rather than the full 21 calendar days. As a result, the taxpayer could still pay within 21 days but be erroneously assessed an FTP tax penalty[11] of $450 (.005 x $90,000). A taxpayer with an additional tax assessment greater than $100,000 would have had only 10 calendar days to pay the assessment rather than the required 10 business days. As a result, the taxpayer would have been allowed from 4 to 8 fewer days to pay the assessment before the FTP tax penalty could be assessed.

Although Programming Changes Have Been Requested to Extend the Proper Grace Period to Taxpayers, the Computer Program Will Still Contain an Error

To determine whether the RIS developed by the IRS would successfully grant all taxpayers the appropriate grace period, we obtained a copy and evaluated it to ensure it would achieve its intended purpose. We found the RIS, if implemented as written, should resolve the disparate treatment of taxpayers whose tax modules are not in Status 21.

The proposed changes outlined in the RIS will extend the computer programming currently being used to calculate the FTP tax penalty on tax modules in Status 21 to those tax modules currently not in Status 21. This will be accomplished by programming the computer system to place non-Status 21 tax modules temporarily into Status 21 so the computer can calculate the total balance due on the tax module. Once the calculation has occurred, the computer system will automatically put the tax module back into its original status. Since the computer is already programmed to look for tax modules with Status 21, generating Status 21 on these tax modules will allow the computer to "see" the balance due, compare that amount to $100,000, determine the corresponding grace period, and make any subsequent FTP tax penalty and interest calculations. The RIS is scheduled to be implemented by January 13, 2006.

During our evaluation of the IRS computer programs designed to calculate the FTP tax penalty, we discovered another error in computer programming for the FTP tax penalty. This programming error could prevent certain taxpayers from receiving the proper grace period and could ultimately result in an incorrect FTP tax penalty amount. As previously mentioned, the law allows taxpayers 21 calendar days from the date of notice to pay additional tax assessments of less than $100,000 and 10 business days to pay additional tax assessments of $100,000 or more without incurring any penalty. However, rather than using the amount of the additional tax assessment to make that determination, IRS computers are erroneously programmed to use the total amount of tax, penalty, and interest the taxpayer owes on the tax module. This total not

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[11] The FTP tax penalty is calculated at 0.5 percent of the unpaid tax for each month that payment is overdue, until a maximum penalty of 25 percent of the tax due is reached.

only includes the additional tax assessment, but also any unpaid balance already on the tax module.

This condition could affect taxpayers depending on their tax module balance at the time of the additional tax assessment. Taxpayers could be granted a different grace period than that to which they are entitled which may result in the assessment of more or less FTP tax penalty than should be assessed. For example, if a taxpayer owed $75,000 prior to an additional tax assessment of $50,000, that taxpayer should be entitled to a 21 calendar day grace period because the additional tax assessment is less than $100,000. However, because the prior tax module balance and additional tax assessment total more than $100,000, that taxpayer would be granted only a 10 business day grace period. As a result, the taxpayer could be charged an FTP tax penalty of $250 (.005 x $50,000) even though payment may have been timely.

To determine the effect of this programming error, we reviewed several small judgmental samples of 2004 tax modules that could have been affected by the programming error. Although we know that taxpayer accounts meeting criteria similar to that described above would be adversely affected, we were unable to identify any examples of taxpayers who had been assessed erroneous FTP tax penalties nor were we able to identify any examples where the IRS was adversely affected. We believe that the number of taxpayers affected would be small. However, IRS computer programming should be correct and in accordance with the law. Taxpayers have a right to be treated with fairness and equity.

We notified personnel in the Office of Penalty and Interest about our concern that the grace period was not being determined correctly. The Office of Penalty and Interest agreed that the grace period should be determined in accordance with the law. A formal opinion from the Office of Chief Counsel regarding this issue has not been requested to date.

Recommendation

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, should request an opinion from the Office of Chief Counsel regarding whether the length of the grace period to pay an assessment without incurring the FTP penalty is determined by the tax assessment amount or the total tax module balance amount. If the Office of Chief Counsel agrees with our opinion that the grace period is determined by the additional tax assessment amount, we recommend the Commissioner, Small Business/Self-Employed Division, ensure the computer program is corrected. We recognize the extent of the problem is not widespread. However, the automatic computation of the FTP tax penalty should comply with the law. In the interim, employees should be informed of the condition so individual tax modules that are handled manually can be reviewed and corrected if needed.

> **Management's Response**: The Program Manager, Office of Penalties and Interest, will request an opinion from the Office of Chief Counsel to establish the correct interpretation of the grace period in I.R.C Section 6651(a)(3). If the grace period is

determined with reference to the amount of additional tax assessment instead of the total tax module balance, the Program Manager will request an internal system change and issue interim guidelines for employees to identify the miscalculations and manually correct them.

Actions Are Planned to Extend the Grace Period Before
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Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to determine whether the Internal Revenue Service (IRS) properly implemented the provision of The Taxpayer Bill of Rights 2,[1] which increased the period of time that taxpayers were given to pay an additional tax assessment[2] before being assessed the Failure to Pay (FTP) tax penalty. To perform our objective, we:

I.   Reviewed Internal Revenue Code Section 6651(a)(3), which defines the grace period for payment of an additional tax assessment, and interviewed IRS personnel for clarification on the statute and how the grace period has been implemented by the IRS.

II.   Obtained a copy of the Request for Information Services (RIS)[3] and confirmed that it was received and recorded by the appropriate RIS Coordinator. We accessed the RIS Tracking and Reporting System on the intranet to confirm that the RIS was in the system, that it had been approved, and that it was scheduled to be implemented.

III.   Evaluated the RIS to verify whether it will, if implemented as written, extend the grace period for payment of an additional tax assessment to taxpayers with tax modules[4] not in Collection Status Code 21 (Status 21)[5] and thereby treat them the same as taxpayers with tax modules in Status 21 which are currently allowed the 10 business day (for additional tax assessments of $100,000 or more) or 21 calendar day (for additional tax assessments less than $100,000) grace period to pay an additional tax assessment without incurring the FTP tax penalty. We also evaluated the RIS to determine if the computer program would properly calculate the number of days for the 10 business day and 21 calendar day grace periods, and use the correct amount (additional tax assessment versus total tax module balance) to determine the length of the grace period.

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[1] Pub. L. No. 104-168, 110 Stat. 1452 (1996) (codified as amended in scattered sections of 26 U.S.C.).
[2] Tax required to be shown on a return which is not shown. See Internal Revenue Code Section 6651(a)(1) and (3).
[3] A RIS is a formal written request for a change in computer systems programming.
[4] A tax module refers to a specific year and type of return within a taxpayer's account, and all tax modules combined comprise a taxpayer's account.
[5] Collection Status Codes are computer generated to designate the current collection status of a tax module. Status Code 21 may indicate a tax return has been filed and assessed and the first collection notice has been issued. It may also indicate a subsequent assessment has been made and notice and demand for payment for such assessment has been issued.

IV.   Determined if the RIS will also correct the problem with the Integrated Data Retrieval System (IDRS)[6] Command Code INTST[7] so it will use the correct amounts and dates when determining the grace period for restricted tax modules[8] which do not have the penalty automatically calculated and assessed by the Master File[9] computer.

V.   Requested all individual and business taxpayer tax modules that had an additional tax assessment of any amount greater than zero posted in Calendar Year 2004 and that also had a subsequent payment posted within 21 calendar days of the additional tax assessment. We requested separate databases for those tax modules that were in Status 21 when the additional tax assessment posted and those tax modules that were not in Status 21 when the additional tax assessment posted. We validated the data received from the Information Technology function by tracing data from accounts in each sample to the corresponding tax module on the Master File using the IDRS.

VI.   Selected and reviewed a judgmental sample of 19 cases from a population of 537,031 combined individual and business taxpayer tax modules in Status 21 to determine if the IRS computer programming is properly applying the new law to those cases. We also selected and reviewed a judgmental sample of 21 cases from a population of 18,351 combined individual and business taxpayer tax modules not in Status 21 to determine if the IRS computer programming is improperly applying the old law to those cases.

VII. Selected and reviewed a judgmental sample of 40 from the population of 537,031 combined individual and business taxpayer tax modules in Status 21 to determine if the IRS computer programming is using the total tax module balance amount instead of the additional tax assessment amount to determine the length of the grace period (10 business days for assessments of $100,000 or more and 21 calendar days for assessments of less than $100,000).[10]

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[6] The IDRS is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

[7] IDRS Command Code INTST is used to calculate the amount of penalty or interest to assess manually.

[8] Restricted tax modules are those that the computer is restricted from automatically calculating and assessing penalty and/or interest. These tax modules have the penalty and interest computed and assessed manually.

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

[10] We used judgmental samples in steps VI and VII because preliminary sample results indicated that the number of exception cases would be very low and would not justify the time and resources needed to complete a statistical sample.

Major Contributors to This Report

Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs)
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Actions Are Planned to Extend the Grace Period Before
Assessing the Failure to Pay Tax Penalty; However, Computer
Programming Needs to Be Corrected

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 23, 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Actions Are Planned to Extend the
               Grace Period Before Assessing the Failure to Pay Tax
               Penalty; However, Computer Programming Needs to
               Be Corrected (Audit # 200530010)

We have reviewed your report and agree with the recommendation. We appreciate your acknowledgement that the number of affected taxpayers is very small, and the amounts involved in distinguishing between 10-day and 21-day grace periods for the assessment of failure-to-pay penalties are most often not materially significant. Even so, we are committed to having Master File programming conform with the applicable statutes.

The Small Business/Self-Employed (SB/SE) Examination Division identified many of the same concerns identified in your report. As a result, we are initiating action that will expand the scope of our review of the 10/21-day grace period for failure-to-pay penalty assessments. This will include how the computer system is programmed to determine the 10/21-day grace period for interest charges.

Our comments on your recommendation follow:

RECOMMENDATION 1
The Commissioner, Small Business/Self-Employed (SB/SE) Division, should request an opinion from the office of Chief Counsel regarding whether the length of the grace period to pay an assessment without incurring the FTP penalty is determined by the tax assessment amount or the total tax module balance amount. If Chief Counsel agrees with our opinion that the grace period is determined by the additional tax assessment amount, we recommend the Commissioner, SB/SE Division, ensure the computer program is corrected. We recognize the extent of the problem is not widespread. However, the automatic computation of the FTP tax penalty should comply with the law. In the interim, employees should be informed of the condition so individual tax modules that are handled manually can be reviewed and corrected, if needed.

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CORRECTIVE ACTION
The Program Manager, Office of Penalties and Interest, will request an opinion from Chief Counsel to establish the correct interpretation of the grace period in IRC section 6651(a)(3). If the grace period is determined with reference to the amount of additional tax assessment instead of the total tax module balance, the Program Manager will request an internal system change and issue interim guidelines for employees to identify the miscalculations and manually correct them.

IMPLEMENTATION DATE
July 31, 2007

RESPONSIBLE OFFICIAL(S)
Director, Examination Policy, SB/SE Division.

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

If you have any questions, please contact me at (202) 622-0600, or Steve Burgess, Director, SB/SE Examination Division, at (904) 665-0503.