
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign
Operations and Transactions Shows Promise,
but More Work Is Needed***

May 2006

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- 2b = Law Enforcement Guideline(s)
- 2c = Law Enforcement Tolerance(s)
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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 10, 2006

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and Transactions
Shows Promise, but More Work Is Needed (Audit # 200530017)

This report presents the results of our review of the Internal Revenue Service's (IRS) penalty-setting process for information returns related to foreign operations and transactions. The overall objective of this review was to evaluate whether the IRS sufficiently uses penalties to encourage filing compliance for entities with Forms 5471 and 5472¹ reporting requirements. In general, Forms 5471 and 5472 are information documents that are attached to income tax returns of individuals and businesses to report results of foreign operations and amounts from certain transactions with foreign-related parties. With American businesses expanding to overseas markets and more foreign entities doing business in the United States, the IRS increasingly needs and uses the information provided on these Forms ^{2(b),2(d)}

Synopsis

Forms 5471 and 5472 play an important role in promoting compliance in the international tax arena. Their importance is reflected in the severity of the penalties that can be imposed for not

¹ The Form 5471 is an Information Return of U.S. Persons With Respect To Certain Foreign Corporations, while the Form 5472 is an Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S Trade or Business. As indicated in the title, the requirement for filing Form 5472 extends only to corporations.



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

filing them timely. The penalty for not filing a required Form 5471 or 5472, or for not filing it timely, is \$10,000. The \$10,000 penalty can also be applied if a Form was filed timely but was substantially incomplete when filed.

The IRS is missing opportunities to promote better compliance with the filing requirements for Forms 5471 and 5472 by not assessing the late-filing penalties more often. We analyzed statistically valid samples of Forms 5471 and 5472 filed for Tax Year 2002 to estimate how many of the Forms were filed late yet avoided the late-filing penalty. We found 3 percent of the Forms in our samples were late (i.e., attached to income tax returns that were filed late), but not 1 return had a penalty assessed for the late filing of the Forms 5471 or 5472. Projecting the results of our samples to the total of 245,419 Forms 5471 and 5472 that were processed for Tax Year 2002, we estimate 7,929 Forms were filed late but were not assessed a late-filing penalty. The late-filing penalties on these 7,929 Forms, at \$10,000 per Form, would have totaled approximately \$79.2 million if these taxpayers did not have a reasonable cause for filing late.

The missed opportunities for assessing late-filing penalties are due to the IRS' reliance on its examiners to manually detect and address filing noncompliance. This conclusion is consistent with the results of an earlier IRS study in which automation of the penalty-setting process was simulated. A team from the IRS Small Business/Self-Employed (SB/SE) Division² reported results from a test in August 2004 that, among other things, simulated automating the penalty-setting process for delinquent Forms 5471. The test showed 38 (76 percent) of the 50 taxpayers could not establish reasonable cause for filing 1 or more Forms 5471 late and were assessed \$1.12 million in penalties that they would have otherwise avoided.

We compared the team's methodologies, which were documented in the team's report, with some best practice concepts for changing work processes outlined in the Government Accountability Office *Business Process Reengineering Assessment Guide*. As a result, we offer three observations the IRS may find useful in its efforts to better administer penalties for late-filed Forms 5471 and 5472.

First, the IRS team's test results, and the results of our analysis, show the current process of relying on examiners to manually detect and address filing noncompliance with Forms 5471 and 5472 is leaving gaps between the number of penalties assessed and the number that should have been assessed. These performance gaps, according to the *Business Process Reengineering Assessment Guide*, make the process an excellent candidate for improvement because the process may be fundamentally inefficient.

² The SB/SE Division is one of the IRS' operating divisions; the taxpayers it serves include small businesses and self-employed individuals.



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

Second, the initial results presented by the IRS team for automating the penalty-setting process for delinquent Forms 5471 need to be updated and expanded into a business case³ that includes a comparison of the various costs associated with automating the process to the expected benefits to be returned. This additional work is needed to provide IRS executives with supporting information for use in deciding whether to pursue a more detailed pilot study that will be needed before automating the process agency-wide.

Third, if a decision is made to implement an automated penalty-setting process, a thorough pilot program will need to be designed and executed. The IRS has successfully used pilot programs to evaluate the soundness of other process changes and pinpoint trouble spots so necessary adjustments can be made before full implementation. A well-designed pilot program will provide opportunities to delve into details not previously covered, such as testing the changes needed to automate the penalty-setting process for delinquent Forms 5472 and addressing potential nonfilers of both Forms 5471 and 5472.

Recommendations

To better promote filing compliance with Forms 5471 and 5472, we recommended the Commissioner, SB/SE Division, convene a study group to develop a business case for deciding whether or not to pursue automating the penalty-setting process for Forms 5471 and 5472. We also recommended the Commissioner, SB/SE Division, coordinate with other IRS decision makers and use the business case to document the reasons for deciding whether or not to initiate a pilot program to implement an automated penalty-setting process for Forms 5471 and 5472 agency-wide.

Response

IRS management agreed with our recommendations and indicated that a cross-functional study group will be formed to develop a business case for deciding whether or not to pursue automating the penalty-setting process for Form 5471 and 5472. In addition, the group's business case will be used to document the reasons for deciding whether or not to initiate a pilot program that will implement an automated penalty-setting process.

Although IRS management agreed to act on our recommendations, they expressed two concerns about our outcome measure. First, they suggested that, in computing the outcome measure, we used the duplicate filings of Forms 5471 and 5472 and may not have considered if the original Forms 5471 and 5472 were filed timely as attachments to related timely filed income tax returns.

³ The Government Accountability Office *Business Process Reengineering Assessment Guide* defines a business case as a structural proposal for business improvement that functions as a decision package for organizational decision makers.



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

Second, IRS management is concerned with the 76 percent figure we used to estimate the number of Forms 5471 and 5472 that were filed late and had no reasonable cause. Specifically, the concern is that the 76 percent figure comes from a very small study conducted by the IRS and may not accurately reflect conditions in the universe of Forms 5471 and 5472 that are filed. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

With regard to IRS management's two concerns about our outcome measure, we believe some clarification is needed. First, we acknowledge using samples of duplicate filings of Forms 5471 and 5472 in computing the outcome. However, we also verified through the IRS Master File⁴ that the original Forms 5471 and 5472 were, in fact, filed late because they were attached to late-filed income tax returns. Second, we agree with IRS management that the 76 percent "no reasonable cause" figure may not be accurate and believe this shortcoming is fully disclosed in Appendix IV.

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

⁴ The Master File contains postings of all tax data and related information pertaining to taxpayers so the file reflects a continuous updated and current record of each taxpayer's account. All settlements with taxpayers are effected through computer processing of the Master File account. The Master File data are also used for accounting records; issuance of refund checks, bills, or notices; answering inquiries; classifying returns for audit; preparing reports; and other matters concerned with the processing and enforcement activities of the IRS.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

Table of Contents

Background	Page 1
Results of Review	Page 3
Management Controls Guide Examiners in the Penalty-Setting Process for Taxpayers Who Do Not Comply With Forms 5471 and 5472 Reporting Requirements.....	Page 3
Thousands of Delinquent Forms 5471 and 5472 Are Not Investigated.....	Page 5
<u>Recommendation 1:</u>	Page 7
<u>Recommendation 2:</u>	Page 8
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 9
Appendix II – Major Contributors to This Report	Page 11
Appendix III – Report Distribution List	Page 12
Appendix IV – Outcome Measure.....	Page 13
Appendix V – Management’s Response to the Draft Report.....	Page 15



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

Background

In general, Forms 5471 and 5472¹ are information documents that individuals, partnerships, corporations, and trusts attach to their income tax returns to report results of foreign operations and amounts from certain transactions with foreign-related parties. To avoid penalties, the documents need to be completed and filed with the Internal Revenue Service (IRS) by the due date, including extension, of the related income tax returns. Unless the related income tax returns are filed electronically, taxpayers are also required to file duplicate Forms 5471 and 5472 with the IRS Philadelphia Submission Processing Site in Philadelphia, Pennsylvania,² where the

[REDACTED]

With American businesses expanding to overseas markets and more foreign entities doing business in the United States, the IRS increasingly needs and uses the information provided on these Forms^{2(b),2(d)}

[REDACTED]

The Forms, among other things, disclose international intercompany transactions.^{2(d)}

[REDACTED]

Forms 5471 and 5472 play an important role in promoting compliance in the international tax arena. Their importance is reflected in the severity of the penalties that can be imposed for not filing them timely. The penalty for not filing a required Form 5471 or 5472, or for not filing it timely, is \$10,000. The \$10,000 penalty can also be applied if a Form was filed timely but was substantially incomplete when filed. Also, the IRS is authorized under the Internal Revenue Code to assess additional \$10,000 penalties in certain delinquency situations that are not corrected after the IRS provides required notification.

¹ The Form 5471 is an Information Return of U.S. Persons With Respect To Certain Foreign Corporations, while Form 5472 is an Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S Trade or Business. As indicated in the title, the requirement for filing Form 5472 extends only to corporations.

² The Philadelphia Submission Processing Site is a location at which individuals and businesses may file their tax returns.

[REDACTED]



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

This review was performed in the IRS Large and Mid-Size Business and the Small Business/Self-Employed (SB/SE)⁴ Divisions, which are respectively headquartered in Washington, D.C., and New Carrollton, Maryland, during the period August through November 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.

⁴ The taxpayers served by the SB/SE Division include small businesses and self-employed individuals, while taxpayers served by the Large and Mid-Size Business Division include businesses with assets of more than \$10 million.



**Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed**

Results of Review

Management Controls Guide Examiners in the Penalty-Setting Process for Taxpayers Who Do Not Comply With Forms 5471 and 5472 Reporting Requirements

IRS examiners have the primary responsibility for detecting and addressing noncompliance with requirements to file Forms 5471 and 5472. To assist examiners in meeting this responsibility, the IRS has an array of policies, mechanisms, procedures, and techniques (management controls) that are in line with the Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government*. At the agency level, there is a broad policy statement on penalties that was revised in June 2004 to provide guidance for examiners, as well as other IRS personnel, and included overall goals⁵ for implementing the policy. The policy statement underscores the role penalties play in promoting compliance with and fairness in the tax system by imposing an economic cost on those who do not voluntarily comply with the tax laws. In implementing the revised policy, the IRS provided an agency-wide training session on penalty administration and augmented the training by developing and making available to examiners agency-wide a comprehensive audit technique guide. Figure 1 provides an overview of the goals reflected in the IRS' new penalty policy.

Figure 1: IRS Penalty Policy Goals	
Goals	Overview
Enhance and encourage compliance.	Penalties provide an important tool to promote compliance and fairness in the tax system by increasing the costs for those who do not comply with the tax laws.
Curb the use of abusive tax transactions.	Accuracy-related penalties combat the undermining effect abusive transactions have on the tax system.
Promote sound and efficient tax administration.	Penalties may occasionally be waived as part of a strategy to encourage prompt resolution of tax issues.
Promote consistency in applying penalties.	The IRS Office of Penalty and Interest Administration reviews and approves changes to its Penalty Handbook, which all agency employees are to use and follow.
Demonstrate fairness of the tax system.	Provide taxpayers with opportunities to provide reasons why penalties should not be assessed by considering evidence in favor of not assessing penalties.

Source: Treasury Inspector General for Tax Administration analysis of IRS Policy Statement 20-1.

⁵ According to the United States Office of Management and Budget Circular A-11, *Preparing, Submitting, and Executing the Budget*, goals are broad statements of desired outcomes that should reflect the agency's priorities and provide a clear direction for future action.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

At the divisional level, Quality Assurance staffs review samples of examination cases and assess the degree to which examiners comply with standards, including those related to Forms 5471 and 5472 penalties. The reviews serve as a mechanism for measuring and evaluating the quality of examinations and penalty determinations, communicating areas of concern up the chain of command, identifying potential training needs, and improving work processes. In addition to reviews by Quality Assurance staffs, mid-level managers may evaluate how well examiners are developing penalty issues during their operational reviews. Operational reviews are required to be performed at least annually to ensure work is being done in conformance with procedures.

At the examiner level, the Internal Revenue Manual serves as the official compilation of procedures and detailed instructions that govern examinations and the penalty-setting process. Although an examiner's primary responsibility is determining the correct income tax liability during an examination, the Internal Revenue Manual requires examiners to complete compliance checks for Forms 5471 and 5472 as well as for other information returns. This is done to ensure all required information returns are timely and correctly filed. As summarized in Figure 2, examiners' compliance checks generally consist of a four-step process that involves inspecting copies of an entity's Forms 5471 and 5472 filed with the IRS and comparing them to what is reported on the tax return to assist in determining if a more detailed examination is warranted. If an examiner detects noncompliance, he or she is to obtain the delinquent Form(s) and consider assessing penalties if warranted.

***Figure 2: Compliance Checks for Forms 5471 and 5472
During Income Tax Examinations***

Required Steps	Purpose
1. Compare data residing on IRS automated information systems to line items on the tax return.	Evaluate the taxpayer's Forms 5471 and 5472 potential reporting requirements before initiating contact to start the examination.
2. Interview the taxpayer or his or her designated representative about the accounting procedures and system of records.	Identify potential strengths and weaknesses in the taxpayer's procedures used to ensure Forms 5471 and 5472 are timely and correctly filed.
3. Document steps taken in analyzing records that ensured Forms 5471 and 5472 were timely and correctly filed.	Analysis and documentation provides support information for determining if a taxpayer met his or her reporting requirements and is used in management reviews designed to ensure examiners are analyzing the proper records and making correct decisions.
4. Expand examination as appropriate to include Forms 5471 and 5472.	Secure delinquent Forms 5471 and 5472 and assess penalties as warranted.

Source: Treasury Inspector General for Tax Administration analysis of the Internal Revenue Manual.

Additionally, front-line managers are an important control component in the penalty-setting process at the examiner level because they are responsible for the quality of work performed by



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

the examiners they supervise. To ensure examiners' work is meeting acceptable quality standards, including penalty considerations for Forms 5471 and 5472, managers use a variety of techniques. These techniques, as we have previously reported,⁶ include observations and discussions with examiners and reviews of work during examinations and after they are closed. Through these observations, discussions, and reviews, front-line managers attempt to identify problems so examiners can take prompt corrective actions.

Thousands of Delinquent Forms 5471 and 5472 Are Not Investigated

Despite having authority under the Internal Revenue Code to impose penalties and layers of management controls to guide the penalty-setting process, the IRS is missing opportunities to better promote filing compliance with Forms 5471 and 5472 by relying on its examiners to manually detect and address filing noncompliance. By nature, the examination process is highly selective given that less than 1 percent of all income tax returns filed annually are examined. In addition, even when the IRS conducts an income tax examination, procedures are not always followed in considering and making correct penalty determinations. In Fiscal Year 2005, we reported⁷ that, in 78 percent of the cases we reviewed, examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that applicable penalties were considered. Our results from this review were similar to conclusions that continue to be reached by the IRS Quality Assurance staffs as well as those reported previously by the former IRS Internal Audit function⁸ and the GAO.⁹

To illustrate the missed opportunities, we analyzed statistically valid samples of 925 Forms 5471 and 5472 from a population of 245,419 that had been processed for Tax Year 2002. We found 3 percent of the Forms in our sample were filed late (i.e., attached to income tax returns that were filed late). However, while IRS computers had assessed delinquency penalties for most of the applicable late-filed tax returns, not one penalty had been assessed for late-filed Forms 5471 or 5472 in our sample. Projecting the results of our samples to the total of 245,419 Forms 5471 and 5472 that were processed for Tax Year 2002, we estimate 7,929 Forms were filed late but were not assessed a late-filing penalty. The late-filing penalties on these 7,929 Forms, at \$10,000 per Form, would have totaled approximately \$79.2 million if these taxpayers did not have a reasonable cause for filing late. Comparatively, IRS records show that, on average, examiners annually assess a total of 69 Forms 5471 and 5472 delinquency penalties.

⁶ *Consistent and Effective Manager Involvement Is Needed in Examinations of Large Businesses* (Reference Number 2004-30-054, dated February 2004).

⁷ *The Strategy to Reemphasize Penalties in Corporate Examinations Could Be Enhanced* (Reference Number 2005-30-123, dated August 2005).

⁸ Now the Treasury Inspector General for Tax Administration Office of Audit.

⁹ *Tax Administration: Negligence and Substantial Understatement Penalties Poorly Administered* (GAO/GGD-91-91, dated July 1991).



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

2(c)

Similar concerns were previously identified by IRS personnel

Recognizing the penalty-setting process for Forms 5471 and 5472 could be strengthened, a team from the IRS SB/SE Division reported results from a test in August 2004 that, among other things, simulated automating the penalty-setting process for delinquent Forms 5471. Although the IRS test had some shortcomings that included using a nonstatistically valid sample of 50 taxpayers who filed delinquent Forms 5471, the findings nevertheless support our conclusion that opportunities to better promote filing compliance in this area are being missed. The test showed 38 (76 percent) of the 50 taxpayers could not establish reasonable cause for filing 1 or more Forms 5471 late and were assessed \$1.12 million in penalties they would have otherwise avoided. 2(c) at the Philadelphia Submission Processing Site, which are highlighted in Figure 3.

2(c)

Due to time constraints, we did not validate, in detail, the results of the IRS team's feasibility test. However, we did compare the team's methodologies documented in the team's report to some best practice concepts for changing work processes that are outlined in the GAO *Business Process Reengineering Assessment Guide (BPRAG)*. As a result, we have some observations the IRS may find useful in its effort to better administer penalties for late-filed Forms 5471 and 5472. First, the IRS team's test results, especially when combined with our analysis, show the current process of relying on examiners to detect and address filing noncompliance with Forms 5471 and 5472 is leaving gaps between the number of penalties assessed and the number that should have been assessed. These gaps between desired and actual outcomes make the process an excellent candidate for improvement, according to the *BPRAG*, because it may be fundamentally inefficient.



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

Second, the initial results presented by the IRS team for automating the penalty-setting process for delinquent Forms 5471 need to be updated and expanded into a business case¹⁰ that includes a comparison of the various costs associated with automating the process to the expected benefits to be returned. This additional work is needed to provide IRS executives with supporting information for use in deciding whether to pursue a more detailed pilot study that will be needed before automating the process agency-wide. According to the *BPRAG*, the business case will need to show the cost savings involved with implementing the change and the potential burdens that could be imposed on compliant taxpayers by having to respond to inquiry notices. Consideration will also be needed to determine whether the IRS currently has the organizational capacity, in terms of personnel and resources, to implement the change given that it is involved in an agency-wide effort to update computer systems and other business practices under the Business Systems Modernization program. Since its inception in 1998, the Business Systems Modernization program has been a top priority for the IRS due in part to its size, complexity, and importance for improving performance and accountability agency-wide.

Third, a thorough pilot program will need to be designed and executed once the decision is made to pursue implementation. As we have previously reported,¹¹ the IRS has successfully designed and used pilot programs to evaluate the soundness of other process changes in actual practice, secure the support of the employee union, and pinpoint trouble spots so necessary adjustments can be made before full implementation. A well-designed pilot program will provide opportunities to delve into details not previously covered in our work or the work done by the IRS team, such as testing the changes needed to automate the penalty-setting process for delinquent Forms 5472 and addressing potential nonfilers of both Forms 5471 and 5472.

Recommendations

Recommendation 1: The Commissioner, SB/SE Division, should convene a study group to develop a business case for deciding whether or not to pursue automating the penalty-setting process for Forms 5471 and 5472. The business case should include a comparison of the various costs associated with automating the process to the potential benefits that could be returned. It should also determine if the IRS currently has the organizational capacity to automate the process given the priority the Business Systems Modernization program has on personnel and resources.

¹⁰ The GAO *BPRAG* defines a business case as a structural proposal for business improvement that functions as a decision package for organizational decision makers.

¹¹ One example is *The Fast Track Dispute Resolution Pilot Program Was Successful, but Some Challenges Remain* (Reference Number 2004-30-119, dated July 2004).



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

Management's Response: IRS management agreed with this recommendation. The Director, Specialty Programs, SB/SE Division, will convene a cross-functional study group to develop a business case that will help the IRS determine whether or not to pursue an automated system for the penalty-setting process.

Recommendation 2: The Commissioner, SB/SE Division, should coordinate with other IRS decision makers and use the business case to document the reasons for deciding whether or not to initiate a pilot program to implement an automated penalty-setting process for Forms 5471 and 5472.

Management's Response: IRS management agreed with this recommendation. The Director, Specialty Programs, SB/SE Division, will coordinate with other IRS decision makers and use the business case to document the reasons for deciding whether or not to initiate a pilot program for automating the penalty-setting process for Forms 5471 and 5472.

Although IRS management agreed to act on our recommendations, they expressed two concerns about our outcome measure. First, they suggested that, in computing the outcome measure, we used the duplicate filings of Forms 5471 and 5472 and may not have considered if the original Forms 5471 and 5472 were filed timely as attachments to related timely filed income tax returns. Second, IRS management is concerned with the 76 percent figure we used to estimate the number of Forms 5471 and 5472 that were filed late and had no reasonable cause. Specifically, the concern is that the 76 percent figure comes from a very small study conducted by the IRS and may not accurately reflect conditions in the universe of Forms 5471 and 5472 that are filed.

Office of Audit Comment: With regard to IRS management's two concerns about our outcome measure, we believe some clarification is needed. First, we acknowledge using samples of duplicate filings of Forms 5471 and 5472 in computing the outcome. However, we also verified through the IRS Master File¹² that the original Forms 5471 and 5472 were, in fact, filed late because they were attached to late-filed income tax returns. Second, we agree with IRS management that the 76 percent "no reasonable cause" figure may not be accurate and believe this shortcoming is fully disclosed in Appendix IV.

¹² The Master File contains postings of all tax data and related information pertaining to taxpayers so the file reflects a continuous updated and current record of each taxpayer's account. All settlements with taxpayers are effected through computer processing of the Master File account. The Master File data are also used for accounting records; issuance of refund checks, bills, or notices; answering inquiries; classifying returns for audit; preparing reports; and other matters concerned with the processing and enforcement activities of the IRS.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate whether the Internal Revenue Service (IRS) sufficiently uses penalties to encourage filing compliance for entities with Forms 5471 and 5472¹ reporting requirements. During the review, we relied on databases provided to us by the IRS. Although we did not audit to determine the accuracy and reliability of the information in any of the databases, we checked the reasonableness of our results against the IRS Master File.² Our checks are described below and did not identify any material errors in the information used from the databases. Except as noted otherwise, we used judgmental sampling techniques due to time and resource constraints. To accomplish the objective, we:

- I. Used the Government Accountability Office *Standards for Internal Control in the Federal Government* to identify the policies, mechanisms, procedures, and techniques (management controls) the IRS established to assist examiners in meeting their responsibility for detecting and addressing filing noncompliance with Forms 5471 and 5472.
- II. Interviewed IRS officials in the Philadelphia Submission Processing Site in Philadelphia, Pennsylvania,³ responsible for processing Forms 5471 and 5472 to determine how documents are received, controlled, processed, and used in tax administration.
- III. Analyzed statistically valid samples of 925 Forms 5471 and 5472 from a population of 245,419 Forms 5471 and 5472 that had been processed for Tax Year 2002 to determine the number of documents filed late that avoided a delinquency penalty and the potential impact on revenues. The statistically valid samples were based on a 95 percent confidence level. The final precision rates for the samples ranged from ± 4.8 percent to ± 5.49 percent. The expected error rate was based on pilot samples of either 30 or

¹ The Form 5471 is an Information Return of U.S. Persons With Respect To Certain Foreign Corporations, while Form 5472 is an Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S Trade or Business. As indicated in the title, the requirement for filing Form 5472 extends only to corporations.

² The Master File contains postings of all tax data and related information pertaining to taxpayers so the file reflects a continuous updated and current record of each taxpayer's account. All settlements with taxpayers are effected through computer processing of the Master File account. The Master File data are also used for accounting records; issuance of refund checks, bills, or notices; answering inquiries; classifying returns for audit; preparing reports; and other matters concerned with the processing and enforcement activities of the IRS.

³ The Philadelphia Submission Processing Site is a location at which individuals and businesses may file their tax returns.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

- 60 Forms 5471 or 5472, and the final samples' expected error rates ranged from 3.3 percent to 65 percent. The accuracy of the projection from the samples into the population was verified with IRS Statistics of Income Division⁴ staff.
- IV. Compared a judgmental sample of 21 Forms 5471 and 5472 from our statistically valid samples of 925 Forms 5471 and 5472 to source tax returns to verify whether documents were filed and posted to the proper taxpayer accounts.
 - V. Analyzed extracts from the IRS Master File for Fiscal Years 1999 to 2005 to determine the number of penalties assessed against taxpayers who did not comply with Forms 5471 and 5472 reporting requirements.
 - VI. Reconciled a judgmental sample of 19 transactions included in our Fiscal Years 1999 to 2005 Master File extracts to the source Master File to identify missing accounts or accounts with inaccurate information in our extracts.
 - VII. Used the Government Accountability Office *Business Process Reengineering Assessment Guide* in assessing how well the project team applied best practices concepts outlined in the *Guide* to the team's feasibility study that recommended automating the penalty-setting process for Forms 5471.

⁴ The IRS Statistics of Income Division collects, analyzes, and disseminates information on Federal taxation for the Department of the Treasury Office of Tax Analysis, Congressional Committees, the IRS in its administration of tax laws, other organizations engaged in economic and financial analysis, and the general public.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

Appendix II

Major Contributors to This Report

Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs)
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Stanley Pinkston, Senior Auditor
Dorothy Richter, Information Technology Specialist



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
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Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Pre-Filing and Technical Guidance, Large and Mid-Size Business Division
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Chief Counsel CC
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***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

Appendix IV

Outcome Measure

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 Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$60.3 million per year; \$301 million over 5 years. This represents the additional revenue associated with using automation to close the gaps between the number of penalties assessed and the number that should be assessed when Forms 5471 and 5472¹ are filed late (see page 5).

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with closing the gaps between the number of penalties assessed and the number that should be assessed when Forms 5471 and 5472 are filed late, we:

1. Analyzed statistically valid samples of 925 Forms 5471 and 5472 from a population of 245,419 Forms 5471 and 5472 that had been processed for Tax Year 2002 to determine the number of documents that were filed late and avoided a delinquency penalty.
2. Used the results from our samples to project that as many as 7,929 of the Forms were filed late because they were attached to income tax returns that were filed late.
3. Shared our sampling methodology with IRS Statistics of Income Division² staff who confirmed the accuracy of our methodology and projection.
4. Assumed that there was no reasonable cause for the delinquency in 6,026 (76 percent) of the 7,929 documents we projected were filed late and that a \$10,000 penalty was warranted. The 76 percent figure was obtained from the test conducted by the IRS team

¹ The Form 5471 is an Information Return of U.S. Persons With Respect To Certain Foreign Corporations, while Form 5472 is an Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S Trade or Business. As indicated in the title, the requirement for filing Form 5472 extends only to corporations.

² The IRS Statistics of Income Division collects, analyzes, and disseminates information on Federal taxation for the Department of the Treasury Office of Tax Analysis, Congressional Committees, the IRS in its administration of tax laws, other organizations engaged in economic and financial analysis, and the general public.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

described earlier in the report. The IRS test was conducted using a nonstatistical sample of 50 taxpayers who filed delinquent Forms 5471 and, therefore, may not be representative of the entire population. However, it was the only information available on the potential percentage of Forms 5471 and 5472 filed late without a reasonable cause. The IRS team's test showed 38 (76 percent) of the 50 taxpayers could not establish reasonable cause for filing Forms 5471 late and were assessed \$1.12 million in penalties.


5. Multiplied the 6,026 Forms 5471 and 5472 that were file late without a reasonable cause by the \$10,000 penalty to estimate the annual potential increase in revenue associated with closing the gaps between the number of penalties assessed and the number that should be assessed.



**Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed**

Appendix V

Management's Response to the Draft Report

 COMMISSIONER SMALL BUSINESS/SELF-EMPLOYED DIVISION	DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224	RECEIVED APR 24 2006
April 24, 2006		
MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT		
FROM:	Kevin M. Brown <i>KMB</i> Commissioner, Small Business/Self-Employed Division	
SUBJECT:	Draft Audit Report – Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed (Audit # 200530017)	
<p>We have reviewed your report and agree with the recommendations. We appreciate your recognizing the IRS is increasingly using information gathered from taxpayers via the Forms 5471 and 5472 for important work 2(b),2(d)</p>		
<p>The IRS Small Business/Self-Employed (SB/SE) Operating Division is committed to convening a cross-functional study group that would include executive level support from the Large and Mid-Size Business (LMSB) and Wage and Investment (W&I) Operating Divisions, and the Chief Information Officer (CIO). The LMSB taxpayers file the majority of Forms 5471 and the CIO manages the IRS automation priorities.</p>		
<p>It is important to note that the likelihood of the IRS amending its current priorities for automation to include the Forms 5471 and 5472 within any immediate timeframe is remote. Therefore, before preparing a "strong business case", we would prepare an initial analysis that presents the most favorable situation to justify a change in automation priorities. If this is not adequate to warrant a change in our priorities, there may be little value in investing further resources into preparing a more complete business case.</p>		
<p>We do have concerns about the Outcome Measures stated in this report.</p>		
<ol style="list-style-type: none">1. It appears that the number of late filed Forms 5471 and 5472 for 2002 was based on a physical count of duplicate copies of these forms that taxpayers who do not file electronically are required to file. While the requirement to file a duplicate is stated on the instructions to Forms 5471 and 5472, we are unaware of any research conducted to determine if, in fact, the original Forms 5471 and 5472 were filed timely as an attachment to the relevant income tax return. It is unclear, but doubtful, that we could		



Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work is Needed

2

assert a penalty for late filing of the duplicate copy if the original was filed timely.

2. 2(c)

3. The assumption that there was no reasonable cause for delinquency in 76% of the cases sampled was based on the results of the very small study done by SB/SE International. This SB/SE International sample included forms filed by 50 handpicked SB/SE taxpayers, including 25 individual and 25 corporate taxpayers. In reality, the vast majority of Forms 5471 are filed by LMSB medium and large corporate taxpayers. There has been no study conducted on this universe of taxpayers.

2(c)

Our comments on your recommendations follow:

RECOMMENDATION 1

We recommend the Commissioner, SB/SE Division, convene a study group to develop a business case for deciding whether or not to pursue automating the penalty-setting process for Forms 5471 and 5472. The business case should include a comparison of the various costs associated with automating the process with the potential benefits that could be returned. It should also



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

3

determine if the IRS currently has the organizational capacity to automate the process given the priority the Business System Modernization has on personnel and resources.

CORRECTIVE ACTION

We agree with this recommendation. The Director, Specialty Programs, SB/SE will convene a cross-functional study group including executive level support from LMSB, W&I, and CIO to develop a business case that will help IRS determine whether or not to pursue an automated system for the penalty-setting process for Forms 5471 and 5472. The study will determine if IRS can automate the process given the constraints on CIO Business Systems Modernization personnel and resources.

IMPLEMENTATION DATE

July 15, 2007

RESPONSIBLE OFFICIAL(S)

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

Director, Specialty Programs, will advise the Commissioner, SB/SE Division, of any delays.

RECOMMENDATION 2

We recommend the Commissioner, SB/SE Division, coordinate with other IRS decision makers and use the business case to document the reasons for deciding whether or not to initiate a pilot program to implement automating the penalty-setting process for Forms 5471 and 5472.

CORRECTIVE ACTION

We agree with this recommendation. The Director, Specialty Programs, SB/SE will coordinate with LMSB, W&I, and CIO and will use the study group's business case to document the reasons for deciding whether or not to initiate an automated pilot program.

IMPLEMENTATION DATE

July 15, 2007

RESPONSIBLE OFFICIAL(S)

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

Director, Specialty Programs, will advise the Commissioner, SB/SE Division, of any delays.



***Automating the Penalty-Setting Process for
Information Returns Related to Foreign Operations and
Transactions Shows Promise, but More Work is Needed***

4

If you have any questions, please contact me at (202) 622-0600 or Bill Conlon,
Director, Specialty Programs, SB/SE Division, at (202) 283-6874.