



*Significant Revenue Continues to
Be Lost Because of Unassessed
Failure to Pay Tax Penalties*

March 24, 2009

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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.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 24, 2009

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Significant Revenue Continues to Be Lost
Because of Unassessed Failure to Pay Tax Penalties
(Audit # 200830010)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) implemented corrective actions necessary to ensure that interest was charged on the Failure to Pay (FTP) tax penalty. This audit was a followup review to our report *Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue*.¹

Impact on the Taxpayer

Congress established the FTP penalty to encourage taxpayers to pay their Federal income taxes on time and authorized the IRS to charge this penalty on tax accounts when taxes are not paid when due. Interest should also be charged on the penalty until it has been paid in full. However, because of the procedures used by the IRS to administer the penalty, interest is being fully assessed on the penalty for only some accounts while on most accounts it is not assessed. As a result, hundreds of millions of dollars in revenue owed to the Federal Government is lost every year, and taxpayers are not treated equitably.

¹ Reference Number 2005-30-052, dated March 2005.



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Synopsis

In general, the IRS' practice is to accrue FTP penalties but not assess² them until all other assessed liabilities (tax, penalties, and interest which have actually posted to the account) are paid in full and there is a credit available in the taxpayer's account. In other words, the computer keeps track of how much penalty the taxpayer owes, but most of the penalty is not officially assessed to the taxpayer's account until there are funds in the account to pay all or part of the accrued penalty. Even then, the IRS assesses only the portion of the accrued penalty that can be paid with the credit available in the account, while the rest remains accrued but not assessed.

IRS computers are programmed to charge interest only on assessed FTP penalties, not on accrued penalties. Therefore, by not assessing these penalties, the IRS is forgoing the associated interest. In addition, the IRS is not administering the tax law equitably because it charges certain taxpayers interest on these 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). IRS personnel periodically calculate and assess the penalties on these accounts because certain variables associated with the accounts are not programmed into IRS computers. Because the manually computed penalties are periodically assessed, interest is charged on the penalties on these accounts.

In response to our prior report, the IRS agreed to take steps to assess the accrued FTP tax penalty more frequently, which would enable it to assess interest on the penalty for all taxpayers. The IRS is operating in line with an interpretation of the Internal Revenue Code that it can only charge interest on the penalty if the taxpayer receives a notice informing him or her of the specific amount of the penalty assessed. Because of this interpretation and the problems associated with issuing new notices each time the penalty is assessed, the IRS decided to make a computer programming change to have the accrued FTP penalties assessed on individual and business accounts in conjunction with the ongoing issuance of annual balance-due reminder notices.

Although the IRS had made programming changes to assess the accrued FTP penalties in conjunction with the annual reminder notices, we found that 257 (92 percent) of 278 balance-due accounts included in our samples still did not have the penalty accruals assessed. We estimate the IRS is still forgoing more than \$171 million in interest assessments annually. In addition, some taxpayers are being treated inequitably because they are charged interest on their penalties.

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. 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.



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In our previous report, we discussed differing legal interpretations regarding whether new notices must be sent to taxpayers each time the FTP penalties are assessed to facilitate charging interest on the penalties. Contrary to our recommendation, IRS management did not seek clarifying legislation on this issue. They concluded no clarification or modification to an existing statute could ever be implemented due to a perceived inability of its computer system to assess the penalty accruals more than once a year. However, IRS programmers believe that, absent the requirement to issue a notice each time, penalty accruals could be assessed as often as quarterly without encountering any considerable programming problems.

Without an amendment or change to the Internal Revenue Code, the IRS' ability to make regular assessments, and thus charge interest on those assessments, will continue to be limited by the resources available to issue more notices.

Recommendations

To ensure all taxpayers are treated equitably and all monies owed the Federal Government are correctly assessed, we recommended the Deputy Commissioner for Services and Enforcement develop and follow consistent procedures for assessing accrued FTP penalties on a regular basis on all balance-due accounts where such an assessment is not prohibited by statute. We also recommended the Commissioner, Small Business/Self-Employed Division, work with the Assistant Secretary of the Treasury for Tax Policy to request clarifying legislation to address whether or not separate notices must be issued to taxpayers each time penalties are assessed and interest is charged on the penalties. If it is determined that notices are not needed each time the penalties are assessed, assessment of these penalties should be made on a quarterly basis.

Response

IRS management partially agreed with both of our recommendations. They stated that in response to our prior report, the IRS updated computer systems to include the accrued FTP penalty on the annual notices issued for all accounts except those prohibited by statute. This change, which was effective in 2005 for individual taxpayer accounts and in 2006 for business taxpayer accounts, resulted in the issuance of annual reminder notices in weekly intervals throughout the year. IRS management stated that our sampling methodology did not take into account the staggered timing of the notices and the fact that many cases were statutorily barred from notice and demand for payment. IRS management made no plans to address our second recommendation other than to work closely with the Office of Chief Counsel to review the options for addressing the issue and determine appropriate actions. No implementation date or monitoring plan was given.

Management's complete response to the draft report is included as Appendix V.



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Office of Audit Comment

We are concerned with IRS management's analysis and its conclusions. Notwithstanding management's assertion to the contrary, our methodology took into consideration accounts barred by statute from receiving notice and demand for payment and accounts that were no longer in active collection status. Moreover, the lack of effective corrective action by management allows for continued inconsistent treatment of taxpayers. As such, there will continue to be significant disparities in the amount of interest charged on FTP penalties and a revenue loss on accounts in which the accrued penalties are not regularly assessed.

In its response to the first recommendation, IRS management states that it updated its computer systems to include the accrued FTP penalty on the annual notices issued for all accounts except those prohibited by statute. However, this does not address whether the penalty was actually assessed on the taxpayer accounts for these cases so that the interest required by law would begin to accrue. As such, management's response did not effectively address the recommendation.

With regard to our second recommendation, we are concerned with the lack of specific corrective action, especially in light of the IRS' previous inaction on this issue. We will provide a copy of our report to the Assistant Secretary of the Treasury for Tax Policy for consideration of a legislative proposal to clarify the law. If the law regarding this issue is clarified to state that the original notice and demand issued to taxpayers at the time the penalty is first assessed suffices for future assessments, the IRS should ensure that the FTP penalty is assessed regularly and applicable interest is charged on all taxpayer accounts except those prohibited by statute. If the law is clarified to state that a new notice must be issued each time the penalty is assessed, then the IRS should address the selective and inconsistent manner in which the penalty is now being assessed. In either case, clarification is needed and should result in further action by the IRS.

The IRS has stated that it remains committed to continuing to search for additional ways to improve its ability to assess and recover the FTP penalties and interest. We plan to follow up on this issue to assess the IRS' actions. We also plan to communicate our concerns about these issues to the Assistant Secretary of the Treasury for Management and Chief Financial Officer.

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 Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at 202-622-5916.



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Abbreviations

CY	Calendar Year
FTP	Failure to Pay
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
TRCAT	Transaction Category



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Background

To encourage taxpayers to pay their Federal income taxes on time, Congress established the Failure to Pay (FTP) penalty and authorized the Internal Revenue Service (IRS) to charge this penalty on tax accounts when taxes are not paid when due. The penalty is different from most other penalties because it continues to accrue (grow) over time while other penalties are usually one-time assessments. The 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 of the total unpaid tax due. This penalty is charged only on the unpaid tax and not on unpaid penalties and interest.

Most calculations and assessments for the FTP 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 File¹ at the time the original tax liability is assessed. Subsequently, the penalty continues to accrue each month but is usually not assessed² to the taxpayer's account until all other assessed liabilities (tax, penalties, and interest which have actually posted to the account) are paid in full and a credit is available in the taxpayer's account. In other words, the computer keeps track of how much penalty the taxpayer owes, but most of the penalty is not officially assessed to the taxpayer's account until there are funds in the account to pay all or part of the accrued penalty. Even then, the IRS assesses only the portion of the accrued penalty that can be paid with the credit available in the account, while the rest remains accrued but not assessed.

This is significant for two reasons. First, despite the fact that Internal Revenue Code (I.R.C.) Section (§) 6601(e)(2)(A) requires the IRS to charge interest on FTP penalties (just as it does on other unpaid taxes and penalties), IRS computers are programmed to charge interest **only** on assessed penalties, not on accrued penalties. The IRS is operating in line with an interpretation of the I.R.C. that it can only charge interest on the penalty if the taxpayer receives a notice informing him or her of the specific amount of each penalty assessment. By not assessing these penalties regularly, the IRS has failed to abide by this regulation and has forgone the interest associated with the penalties accruing without a notice having been issued. Second, the IRS is not administering the tax law equitably because it charges certain taxpayers 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). IRS personnel calculate and assess the penalties on these accounts because certain variables associated with the accounts are not programmed into

¹ 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.



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IRS computers. Because the manually computed penalties are periodically assessed, interest is charged on the penalties on these accounts.

We brought these concerns to the IRS' attention in a previous report.³ In response to that report, the IRS agreed to make programming changes that would cause accrued FTP penalties to be assessed more frequently and ensure notices include the proper wording to inform taxpayers that interest is being charged on the penalties until they are fully paid.

This followup review of the IRS' corrective actions was performed during the period November 2007 through July 2008. Our audit included a review of tax return information filed nationwide, as well as discussions and interviews with personnel from the IRS' Servicewide Penalty and Interest offices, Small Business/Self-Employed Division. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ *Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue* (Reference Number 2005-30-052, dated March 2005).



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Results of Review

***Actions Taken by the Internal Revenue Service Had Minimal Impact on
Interest Assessments***

In response to our prior report, the IRS agreed to take steps to assess the accrued FTP penalty more frequently, which would enable the IRS to assess interest on the penalty for all taxpayers who owe it. The IRS is operating under the premise that it can only charge interest on the penalty if the taxpayer receives a notice informing him or her of the specific amount of the penalty assessed. Because of this, the IRS decided to make a computer programming change to have the accrued penalties assessed on individual and business accounts in conjunction with the ongoing issuance of annual balance-due reminder notices.

We reviewed and analyzed a statistically valid sample of 278 taxpayer accounts (139 individual taxpayer accounts and 139 business taxpayer accounts)⁴ to determine whether the accrued FTP penalty was being assessed so that interest could be charged on the penalty. From our sample of individual taxpayer accounts, we found that only 5 (3.6 percent) had the penalty accruals assessed. From our sample of business taxpayer accounts, we found that 16 (11.5 percent) had the penalty accruals assessed. Overall, 257 (92 percent) of the 278 accounts we reviewed still did not have the penalty accruals assessed.

Although the IRS had made programming changes to assess the accrued FTP penalties in conjunction with the annual reminder notices, we found that 182 accounts in our sample never received an annual reminder notice⁵ and, therefore, never had the accrued penalty assessed. For the remaining 75 accounts, the programming simply did not work as expected. For example, the programming changes did not properly address accounts residing on the IRS' Automated Collection System⁶ and accounts set up to make monthly installment payments. As a result, the IRS' corrective programming had no effect on these accounts.

⁴ See Appendix I for details concerning sample information.

⁵ The IRS' Master File computers evaluate an account and determine if certain conditions exist in order to generate the annual reminder notice. For example, the IRS assigns collection status codes to accounts to define where they are in the collection process. In order to receive an annual reminder notice, an account must have been in the same collection status for a specific amount of time. The computer analyzes an account a minimum of once per year at a specific time of the year to determine if a notice should be issued. Also, certain accounts are prohibited by statute from receiving notices from the IRS. These include those taxpayers identified by the IRS as deceased, bankrupt, provided disaster relief, defunct, no requirement to file a tax return, or unable to be located.

⁶ This system accepts balance-due cases requiring telephone contact for resolution. IRS employees use the system's case management abilities to contact taxpayers, review their case histories, issue liens or levies, and to issue balance-due reminder notices.



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The fact that the FTP penalties are still not being assessed on most taxpayer accounts creates the following two problems.

Lost interest

The Federal Government continues to lose hundreds of millions of dollars in interest each year because the FTP penalties are being accrued versus assessed. Based on information we obtained from the IRS Transaction Category (TRCAT)⁷ files, more than \$10 billion in accrued penalties existed on taxpayer accounts at the end of Calendar Year (CY) 2007. The \$10 billion figure was relatively constant at the end of each quarter in CY 2007. If the IRS changed its present procedures and assessed the accruals on a quarterly basis, forgone interest charges would be substantially reduced. For example, if accruals had been assessed quarterly during CY 2007, we estimate the IRS could have charged almost \$800 million more in interest.

Table 1: Potential Interest Charges (CY 2007)

Quarter Ending Date	Accrued FTP Tax Penalties at Quarter's End	Interest Rate for Subsequent Quarter	Potential Interest Charges
March 2007	\$10,324,708,895	2% (4/07-6/07)	\$206,494,178
June 2007	\$10,370,522,462	2% (7/07-9/07)	\$207,410,449
September 2007	\$10,444,825,128	2% (10/07-12/07)	\$208,896,503
December 2007	\$10,100,337,383	1.75% (1/08-3/08)	\$176,755,904
Total			\$799,557,034

Source: IRS TRCAT files and IRS Interest Rate Tables.

It is unlikely that the IRS would be able to collect the entire \$800 million. We analyzed our statistical sample of 278 taxpayer accounts to determine how many taxpayer accounts were in an active or inactive collection status.⁸ We found 196 of 278 that were currently in active collection status where the IRS was performing actions to collect the balance due. Based on our analysis,

⁷ IRS TRCAT files are created as part of the Accounts Receivable Dollar Inventory. These files are generated on a monthly basis from both the Individual Master File and Business Master File. The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts. The Business Master File 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.

⁸ We defined active collection status as those taxpayers in a current installment agreement, fully paid, or in a collection status assigned by the IRS indicating current actions are being performed to obtain the balance due. We defined inactive collection status as those taxpayers identified by the IRS with no requirement to file a tax return, provided disaster relief, or currently not collectible accounts such as unable to be located, deceased, bankrupt, defunct, or other.



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we conservatively estimate that the IRS could potentially expect to collect over \$171 million in interest it would have charged on accrued penalties that would have been assessed during CY 2007. Over 5 years, we estimate the IRS could collect over \$855 million in interest (see Appendix IV).

Inconsistent treatment of taxpayers

As mentioned earlier in this report, there are situations where penalties 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 to file and pay their taxes, extending the FTP penalty start dates. Also, taxpayers in bankruptcy status have the penalties suspended from computation.

Because the FTP penalties on these restricted accounts are manually assessed and are 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 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. Based on information we obtained from the IRS TRCAT files, we identified a population of 546,724 taxpayer accounts that were restricted from having the computer calculate the penalties as of the end of CY 2007. Not all of these accounts are being charged interest on the penalty because it might have been determined on some of the accounts that the penalty may not be applicable due to reasonable cause demonstrated by the taxpayer. However, for those restricted accounts where the penalty has not been abated, interest is being charged on the assessed portion of the penalties. If these same accounts were not restricted, IRS computers would have accrued, but not assessed, the penalties and not charged interest on the penalties.

Recommendation

Recommendation 1: The Deputy Commissioner for Services and Enforcement should develop and follow consistent procedures for assessing accrued FTP penalties on a regular basis on all balance-due accounts where such an assessment is not prohibited by statute. If the IRS decides to continue to associate this assessment with the issuance of an annual reminder notice, programming changes should be made to ensure that these notices are issued on all accounts except where prohibited by statute.

Management’s Response: IRS management partially agreed with this recommendation. They stated that in response to our prior report, the IRS updated its computer systems to include the accrued FTP penalty on the annual notices issued for all accounts except those prohibited by statute. This change, which was effective in 2005 for individual taxpayer accounts and in 2006 for business taxpayer accounts, resulted in the issuance of annual reminder notices in weekly intervals throughout the year. IRS



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management stated that our sampling methodology did not take into account the staggered timing of the notices and the fact that many cases were statutorily barred from notice and demand for payment. They reexamined our sample cases and concluded that, at most, 25 (9 percent) out of the 278 modules should have received a notice but did not. They are in the process of researching why the notice was not sent in these cases and will develop a corrective action plan.

Office of Audit Comment: We do not believe that IRS management's corrective action is adequate and are concerned with management's analysis and its conclusions. IRS management states that it updated its computer systems to include the accrued FTP penalty on the annual notices issued for all accounts except those prohibited by statute. However, this did not address whether the penalty was actually assessed on the taxpayer accounts for these cases so that the interest required by law would begin to accrue. As such, management's response did not effectively address the recommendation.

Our review focused on whether the accrued FTP penalties had been assessed to allow for the accrual of interest. Notwithstanding management's assertion to the contrary, our methodology took into consideration accounts barred by statute from receiving notice and demand for payment and accounts that were no longer in active collection status.

The IRS' procedure of associating the assessment of the FTP penalty with the issuance of an annual reminder notice is not effective. In its response, the IRS focuses on whether taxpayers received annual reminder notices rather than on whether the penalty was assessed on these accounts so that the interest required by law would begin to accrue. As a result, its conclusions upon reexamination of the cases are flawed.

In response to our prior audit, the IRS made the decision to tie the assessment of the FTP penalty to the annual reminder notice issued from the IRS' Master File. The IRS did not follow the recommendation that it seek clarification in the law regarding the need for additional notices when assessing the penalty despite the fact that its own Counsel had stated that the law regarding the requirement to issue an additional notice each time the penalty was assessed could be considered ambiguous. The specific criteria the IRS uses for issuing an annual reminder notice from its Master File have little to do with whether or not assessment of the penalty is appropriate in a given case. For example, taxpayers on installment agreement plans with the IRS do not receive annual reminder notices generated from the IRS' Master File, and the accrued penalty and associated interest is not assessed on their accounts. However, the law does not exempt these taxpayers from paying the same interest on the penalty as all other taxpayers.

The IRS puts forth inconsistent arguments in its response. For example, in discussions with us, the IRS acknowledged that in its previous corrective action it had not taken into consideration taxpayers receiving their annual reminder notices from the Automated Collection System. Taxpayer accounts residing on this system do receive reminder



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notices, but do not have the FTP penalty assessed. In its reexamination of our sample cases, the IRS included cases residing on the system as part of its 25 which should have had the penalty assessed. However, it excluded many more cases recently released from the Automated Collection System even though no penalty was assessed on these cases when they resided on that system. These cases should not have been excluded.

Further, based on their own review of our sample cases, the IRS acknowledges other cases for which taxpayers who should have received annual reminder notices from the Master File (and had the FTP penalty assessed) did not. Yet their response shows all corrective actions completed.

Moreover, taxpayers are being treated inconsistently. The IRS states there is some inequity between taxpayers because interest is assessed for different taxpayers at different times of the year, but the inequity does not disproportionately affect taxpayers in combat zones or disaster areas. However, this argument does not consider that its process creates a large inconsistency which results in hundreds of thousands of taxpayers whose accounts must be computed manually (such as taxpayers affected by natural disasters or military personnel serving in combat zones) paying interest on the penalty that many other taxpayers are not required to pay.

Although there are obstacles associated with charging interest on these penalties, the law is clear when it says that interest should be charged. Selective enforcement of the tax law based on convenience should not be an option. The IRS should ensure that it charges interest on the penalty fairly to all taxpayers.

Clarifying Legislation Was Never Requested by the Internal Revenue Service

In our previous report, we discussed the differing legal interpretations regarding whether new notices must be sent to taxpayers each time the FTP penalties are assessed to facilitate charging interest on the penalties. I.R.C. § 6601(e)(2)(A) states “interest shall be imposed” on FTP penalties from the date of notice and demand to the date of payment.

There are two possible interpretations of the I.R.C. sections pertaining to whether interest might be charged on the penalties for which taxpayers have not received additional and specific notices and demand for payment. The first interpretation is the IRS’ current practice, which is that no interest can be charged on FTP penalties until and unless notice and demand is sent on the specific penalty amount. The IRS Office of Chief Counsel stated that this practice is based upon a strict interpretation of the I.R.C. The other possible interpretation is that once a notice and demand for the tax liability plus interest and penalty is originally sent, the taxpayer has been notified that the penalty is running. Subsequent accruals are automatic pursuant to I.R.C. §§ 6651(a)(2) and (a)(3). Therefore, no further notice and demand of such accruals should be required to charge interest. The IRS Office of Chief Counsel stated that this interpretation



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appears logical and would follow the cases in which the courts have held that taxpayers are liable for penalties that continue to accrue but were not assessed. However, the IRS Office of Chief Counsel also stated that this interpretation would require a more expansive reading of the statute and regulation and would be taxpayer unfavorable.

Based on the language of the statute and legislative history, we were unable to determine definitively the intent of Congress regarding this issue. However, because of the unique nature of the FTP penalty, in that it continues to accrue until the balance is paid, we believe the second interpretation to be the most reasonable. Penalties, by their nature, are unfavorable to some taxpayers, but we believe this interpretation would facilitate a more equitable treatment of taxpayers overall (as discussed in the previous section of this report) and would be consistent with the intent of the penalty.

To address this issue, we recommended in our previous report that the IRS 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 penalties are assessed and interest is charged on the penalties. In their response, the IRS disagreed that a legislative change was needed. They raised concerns that any clarification or modification could never be implemented due to significant systemic limitations in its Master File computers. However, IRS programmers believe that, absent the requirement to issue a notice each time, penalty accruals could be assessed as often as quarterly, without encountering any considerable computer problems.

The Government Accountability Office's *Standards for Internal Control in the Federal Government* recommend that managers take prompt action to correct problems identified by auditors. Specifically, Federal managers are to: 1) evaluate findings and recommendations reported by auditors; 2) determine the actions to take in response to the findings and recommendations; and 3) complete actions that correct the problem brought to their attention.

Without a change to the I.R.C. or Revenue Procedures, 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.

Recommendation

Recommendation 2: The Commissioner, Small Business/Self-Employed Division, should work with the Assistant Secretary of the Treasury for Tax Policy to request clarifying legislation to address whether or not separate notices must be issued to taxpayers each time FTP penalties are assessed and interest is charged on the penalties. If it is determined that notices are not needed each time the penalties are assessed, assessment of the penalties should be made at least on a quarterly basis.



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Management's Response: IRS management expressed no disagreement with this recommendation but made no plans to address it other than to work closely with the Office of Chief Counsel to review the options for addressing this issue and determine appropriate actions. No implementation date or monitoring plan was given.

Office of Audit Comment: We are concerned with the lack of specific corrective action, especially in light of the IRS' previous inaction on this issue. We will provide a copy of our report to the Assistant Secretary of the Treasury for Tax Policy for consideration of a legislative proposal to clarify the law. If the law regarding this issue is clarified to state that the original notice and demand issued to taxpayers at the time the penalty is first assessed suffices for future assessments, the IRS should ensure that the FTP penalty is assessed regularly and applicable interest is charged on all taxpayer accounts. If the law is clarified to state that a new notice must be issued each time the penalty is assessed, then the IRS should address the selective and inconsistent manner in which the penalty is now being assessed. In either case, clarification is needed and should result in further action by the IRS.

Taxpayers Are Now Being Informed That Interest Is Charged on Failure to Pay Penalties Until They Are Fully Paid

In our prior report, we identified that stuffers [Information About Your Notice, Penalty and Interest (Notice 746) and Interest and Penalty Information (Notice 433)] included with notices did not inform the taxpayers that interest was being charged on FTP penalties. We recommended that the IRS ensure that these stuffers include information informing taxpayers that interest will be charged on the penalties until they are fully paid.

The IRS committed to and took action by revising and adding additional wording to the stuffers included with taxpayer notices. These stuffers make it clear to taxpayers that interest is being charged on any unpaid FTP penalties.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS implemented corrective actions necessary to ensure that interest was charged on the FTP penalty. To accomplish this objective, we:

- I. Obtained and reviewed a copy of the Joint Audit Management Enterprise System Corrective Action Form to determine the status of IRS corrective actions on our prior audit report.¹
- II. Reviewed IRS corrective actions to determine if:
 - A. Requested programming changes to have accrued FTP penalties assessed on Individual Master File and Business Master File accounts receiving notices.²
 - B. Reviewed the applicable statutory provisions and IRS procedures for assessing interest on the FTP penalty and providing notices to taxpayers; discussed all available options, including a possible statutory amendment to the I.R.C.; and pursued a course of action that is in the best interest of tax administration.
 - C. Requested clarifying legislation to change the I.R.C. stating that an original notice and demand, instead of a separate notice each time the FTP penalties are assessed, will suffice for putting taxpayers on notice for interest charges on future penalty assessments.
 - D. Revised Information About Your Notice, Penalty and Interest (Notice 746) and Interest and Penalty Information (Notice 433), which are sent to taxpayers along with the FTP penalty assessment notices, to include information to inform taxpayers that interest is charged on assessed penalties until they are fully paid.
- III. Determined if interest was being assessed on taxpayer accounts with accrued FTP penalties according to programming changes as specified in IRS' corrective actions.
 - A. Used a computer program to identify individual taxpayer and business accounts with an accrued FTP penalty existing as of December 31, 2007. This information was obtained through analysis of IRS TRCAT files.

¹ *Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue* (Reference Number 2005-30-052, dated March 2005).

² The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts. The Business Master File 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.



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- B. Validated, verified, and assessed the reliability of the computer-processed data received in Step III.A. by comparing the data from the computer request to information from the IRS' Master File³ and found the data to be valid and reliable.
 - C. From the computer extract, selected statistically valid samples⁴ of 139 individual taxpayer accounts from a population of 12,239,760 taxpayer accounts and 139 business taxpayer accounts from a population of 3,389,381 taxpayer accounts containing accrued FTP penalties. In selecting our samples, we used a confidence level of 95 percent, a precision rate of ± 5 percent, and an expected error rate of 10 percent. We reviewed the 278 taxpayer accounts and determined whether interest was being assessed timely on the penalty.
- IV. Determined the revenues associated with assessing the FTP penalty on a quarterly basis rather than a yearly basis.
- A. Used a computer program to identify taxpayer accounts with an accrued FTP penalty existing between January 1, 2007, and December 31, 2007. This information was obtained through analysis of IRS TRCAT files. We determined the number of accounts and the amount of accrued penalty on the accounts for each quarter (3 month period) of 2007.
 - B. Determined the amount of interest that could be assessed on the accounts if the FTP penalty was assessed on a quarterly basis rather than a yearly basis.
- V. Determined how interest was being charged on restricted FTP penalty accounts versus penalty accounts where interest was assessed by the computer.
- A. Used a computer program to identify taxpayer accounts with a restricted FTP penalty existing between January 1, 2007, and December 31, 2007. This information was obtained through analysis of IRS TRCAT files.

³ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁴ We selected statistical samples because we wanted to project our results over the entire population of accounts.



*Significant Revenue Continues to Be Lost Because
of Unassessed Failure to Pay Tax Penalties*

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Kyle R. Andersen, Director

Larry Madsen, Audit Manager

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W. George Burleigh, Senior Auditor



*Significant Revenue Continues to Be Lost Because
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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Chief Technology Officer OS:CTO
Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Accounts Management, Customer Account Services, Wage and Investment Division
SE:W:CAS:AM
Director, Payment Compliance, Small Business/Self-Employed Division SE:S:C:CP:PC
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Commissioner, Large and Mid-Size Business Division SE:LM
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Wage and Investment Division SE:W



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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; \$855,451,550 in interest charges on 13,054,132 accounts over a 5-year period (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained IRS TRCAT files for the quarter ending December 31, 2007. We identified 15,629,141 taxpayer accounts with accrued FTP penalties totaling \$10,100,337,383. This included 12,239,760 individual taxpayer accounts with \$4,860,911,173 in accrued penalties and 3,389,381 business taxpayer accounts with \$5,239,426,210 in accrued penalties. Because at least some of these accounts might not be collectible, we reviewed a statistically valid sample of 278 taxpayer accounts (139 individual taxpayer accounts and 139 business taxpayer accounts). Our sample size was determined based on a 95 percent confidence level, an expected error rate of 10 percent, and a precision of ± 5 percent.

We analyzed the 278 accounts to determine those that were in an active or inactive collection status.¹ We found 93.5 percent (130 of 139) of the individual taxpayer accounts and 47.5 percent (66 of 139) of the business taxpayer accounts were in an active collection status. By multiplying 12,239,760 by .935, we estimate the IRS could expect to collect additional assessments of the FTP penalty and applicable interest on 11,444,176 individual taxpayer accounts. By multiplying 3,389,381 by .475, we estimate the IRS could expect to collect additional assessments of the penalty and applicable interest on 1,609,956 business taxpayer accounts. Overall, we estimate the IRS could expect to collect additional assessments of the penalty and applicable interest on 13,054,132 taxpayer accounts.

Accrued FTP penalty for the 130 active individual taxpayer accounts totaled \$36,250, or an average of \$278.85. By multiplying \$278.85 by 11,444,176, we estimate \$3,191,208,478 of the accrued penalties could be assessed and collected. Accrued penalty for the 66 active business

¹ We defined active collection status as those taxpayers in a current installment agreement, fully paid, or in a collection status assigned by the IRS indicating current actions are being performed to obtain the balance due. We defined inactive collection status as those taxpayers identified by the IRS as deceased, bankrupt, provided disaster relief, defunct, no requirement to file a tax return, or unable to be located.



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taxpayer accounts totaled, \$30,368, or an average of \$460.12. By multiplying \$460.12 by 1,609,956, we estimate \$740,772,955 of the accrued penalties could be assessed and collected. Overall, we estimate the IRS could expect to collect additional assessments of the accrued penalty of \$3,931,981,433. Our precision for this estimate was \pm \$1,487,834,153 (\pm \$1,049,159,995 for individual taxpayers and \pm \$438,674,158 for business taxpayers).

To be conservative, we used the smallest precision point of our estimate to obtain a reduced figure of \$2,444,147,280 (\$3,931,981,433 minus \$1,487,834,153). Multiplying the \$2,444,147,280 by the 7 percent annual interest rate applicable for these accounts equals \$171,090,310. This is the estimated interest amount the IRS would have charged on accrued penalties that would have been assessed during CY 2007. This would equal \$855,451,550 in additional interest charges over a 5-year period.



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Appendix V

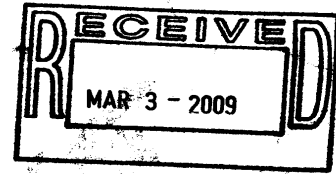
Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

February 23, 2009



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Significant Revenue Continues to Be Lost
Because of Unassessed Failure to Pay Tax Penalties
(Audit # 200830010)

Thank you for the opportunity to review the draft report titled "Significant Revenue Continues to Be Lost Because of Unassessed Failure to Pay Tax Penalties."

Current law requires that we issue notice and demand for payment to the taxpayer before interest can begin to accrue on penalty on these accounts. Therefore, the IRS is using the annual reminder notice as notice and demand for payment on all balance due accounts for taxpayers where notice and demand may be made. Due to system limitations, we schedule the mailing of these annual notices in weekly intervals throughout the year. The sampling methodology discussed in this report does not take into account the staggered timing of the notices and the fact that many of the cases within the sample were statutorily barred from notice and demand for payment. Therefore, we believe, the study significantly overstates the amount of additional interest that could be assessed. The IRS remains committed to continuing to search for additional ways to improve our ability to assess and recover Failure to Pay Tax penalties and interest.

We acknowledge that the current system results in some inequity between taxpayers because interest is assessed for different taxpayers at different times of the year. It should be noted that this inequity does not disproportionately affect taxpayers in combat zones or disaster areas. We will continue to examine our systems and look for ways to make additional improvements to minimize this inequity.

Responses to your specific recommendations are enclosed. If you have questions, please call me at (202) 622-0600 or Alain Dubois, Director, Examination Policy, Small Business/Self Employed Division, at (202) 283-2513.

Attachment



*Significant Revenue Continues to Be Lost Because
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Attachment

RECOMMENDATION 1:

The Deputy Commissioner for Services and Enforcement should develop and follow consistent procedures for assessing accrued FTP tax penalties on a regular basis on all balance-due accounts where such an assessment is not prohibited by statute. If the IRS decides to continue to associate this assessment with the issuance of an Annual reminder notice, programming changes should be made to ensure that these notices are issued on all accounts except where prohibited by statute.

CORRECTIVE ACTIONS:

In response to this recommendation in your prior audit report on this subject matter (2005-30-052), we updated our computer systems for individual taxpayer accounts to include the accrued FTP tax penalty on the Annual notices issued for all accounts except those prohibited by statute. This change, which was effective in 2005 for individual taxpayer accounts and in 2006 for business taxpayer accounts, resulted in the issuance of annual reminder notices in weekly intervals throughout the year.

We have reexamined the sample cases, and find that at most 25 out of the 278 modules, or 9%, should have received a notice but did not. We are in the process of researching why the notice was not sent in these cases and will develop a corrective action plan.

IMPLEMENTATION DATE:

Completed

RESPONSIBLE OFFICIAL:

Director, Exam Policy (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

Not applicable

RECOMMENDATION 2:

The Commissioner, Small Business/Self-Employed Division, should work with the Department of the Treasury Assistant Secretary for Tax Policy to request clarifying legislation to address whether or not separate notices must be issued to taxpayers each time FTP tax penalties are assessed and interest is charged on the penalties. If it is determined that notices are not needed each time the FTP tax penalties are assessed, assessment of the FTP tax penalties should be made at least on a quarterly basis.

CORRECTIVE ACTIONS:

We will work closely with the office of Chief Counsel to review the options for addressing this issue and determine appropriate actions.

IMPLEMENTATION DATE:

Not applicable



*Significant Revenue Continues to Be Lost Because
of Unassessed Failure to Pay Tax Penalties*

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RESPONSIBLE OFFICIAL:
Director, Exam Policy (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:
Not applicable