

**The Internal Revenue Service Can Help Small
Businesses Save Millions of Dollars in Failure
to Deposit Penalties**

September 2000

Reference Number: 2000-30-163

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



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 28, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Can Help
Small Businesses Save Millions of Dollars in Failure to Deposit
Penalties

This report presents the results of our review of how the Internal Revenue Service (IRS) administers its "tolerance" policy when assessing the penalty for failure to make proper Federal Tax Deposits. In summary, the IRS has not increased the minimum amount at which the failure to deposit penalty will be charged to keep pace with increased IRS costs. This minimum amount, or "tolerance," has not been increased since 1986. Consequently, taxpayers are paying penalties based on a tolerance amount that is no longer appropriate.

We also found that the IRS does not send educational notices explaining how to comply with complex Federal Tax Deposit requirements to taxpayers who are not penalized due to the tolerance amount. This type of notice could help improve compliance. In addition, the IRS has not changed its tolerance policy statement since 1960. This policy views setting tolerance amounts from the IRS perspective and does not acknowledge taxpayer costs and other burdens in dealing with relatively small dollar cases.

We recommended that the IRS immediately increase the tolerance amount, educate taxpayers who were not penalized due to the tolerance amount on how to comply, and revise the tolerance policy statement to include the taxpayer's point of view.

Management's response was due on September 27, 2000. As of September 28, 2000, management had not responded to the draft report.

Copies of this report are being sent to the IRS managers who are affected by the report recommendations in accordance with this requirement. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**The Internal Revenue Service Can Help Small Businesses Save Millions of
Dollars in Failure to Deposit Penalties**

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Executive Summary

The Internal Revenue Service (IRS) can immediately help thousands of small businesses and other taxpayers save an estimated \$76.6 million a year in relatively low-dollar penalties. In addition, the IRS can reduce the paperwork burden for these taxpayers by eliminating an estimated 1.1 million notices and letters annually that result from these penalties. The savings and reductions can be realized by increasing the “tolerance” amount that the IRS uses to help administer the penalty charged to taxpayers who have not followed Federal Tax Deposit requirements.

The IRS’ tolerance policy provides that IRS functions should not work on smaller, less productive cases where the revenue involved would not warrant the handling costs and the interests of the government would not be jeopardized. In accordance with this policy, the IRS established a dollar amount under which a taxpayer would not be charged a penalty for failing to meet Federal Tax Deposit requirements.

The IRS’ penalty administration and understanding of the complicated Federal Tax Deposit requirements are among the most serious problems facing taxpayers, especially small businesses. Our objective was to determine whether the IRS’ dollar tolerance under which a failure to deposit penalty is not assessed should be changed to conform to IRS policy and contribute to more effective and efficient tax administration.

Results

The current tolerance amount was established in 1986, and the IRS has not increased it to keep pace with changes in the value of the dollar. Businesses that did not make proper deposits may have fallen under the penalty tolerance amount in 1986 (and thus would not have had to pay the penalty) but would likely be penalized with the same practices in 2000. This represents an increase in taxpayer burden. The IRS’ handling costs have increased over the last 14 years. However, the tolerance amount for charging a failure to deposit penalty has remained the same. This has resulted in the IRS assessing hundreds of thousands of relatively low-dollar penalties each year for not making proper deposits. Sixty-nine percent of the taxpayers included in our analysis fully paid their taxes and were billed for the penalty charge only. Over 90 percent of the taxpayers penalized were small businesses.

These penalties would not have been charged had the tolerance amount kept up with the value of the dollar. Consequently, the tolerance amount established in 1986 is no longer at an appropriate level.

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The IRS has an opportunity to expand its educational efforts to those taxpayers who have not met the complex Federal Tax Deposit requirements. The educational efforts would further implement IRS initiatives to help taxpayers understand their tax responsibilities. In addition, the IRS also has the opportunity to update its policy on tolerances to consider taxpayer costs and other burdens when determining the appropriate tolerance amount for all types of penalties.

Subsequent to our review, the Commissioner approved sending to the Department of the Treasury a separate proposal affecting Federal Tax Deposits. A by-product of this proposal is raising the tolerance amount above the amount we recommend. The IRS' proposal could be implemented as early as January 2001. However, independent of this proposal, the IRS has the opportunity to immediately change the tolerance to the amount we recommend. This action would benefit tax administration for taxes due through the remainder of Calendar Year 2000.

The Tolerance Amount Is No Longer at an Appropriate Level for Small Businesses and Other Taxpayers

The IRS is not following its tolerance policy. The tolerance policy states that IRS functions should not work on smaller, less productive cases where the revenue involved would not warrant the handling costs and the interests of the government would not be jeopardized. Yet, the IRS has not increased the tolerance amount for charging a failure to deposit penalty to keep pace with increased IRS costs. In fact, the last change was in 1986. The tolerance amount has not changed because the IRS does not have a process for periodically evaluating the tolerance amount in comparison with costs.

Consequently, an estimated 142,000 taxpayers paid to the government approximately \$19.1 million in failure to deposit penalties for Employer's Quarterly Federal Tax Returns (Form 941) filed for the quarter ending March 31, 1999.¹ These penalties would not have been charged had the tolerance amount risen with increased costs. Therefore, the penalty tolerance amount is no longer at the appropriate level. If the quarter included in our audit is typical of other quarters, taxpayers may have paid an estimated \$76.6 million a year in unnecessary penalties.² Our estimates are based solely on increased IRS costs since 1986 and do not consider economic changes beyond those costs.

Consistent with the Paperwork Reduction Act of 1995,³ the Office of Management and Budget has an initiative to reduce the paperwork burden on small businesses. For our

¹ All estimates presented in this report are subject to percentage variances, and the actual figures may be more or less than the number or dollar amount presented. Appendix VII includes those variances.

² Annualized total does not equal 4 x \$19.1 million due to rounding.

³ Paperwork Reduction Act of 1995, Pub. L. No. 104-13, 109 Stat. 163.

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sampled quarter, the IRS' outdated tolerance amount caused the generation of an estimated 269,000 notices and subsequent letters that resulted in taxpayer paperwork, costs, and other burdens falling largely on small businesses. The IRS spent an estimated \$249,000 to mail the correspondence, receive responses, and resolve the issues raised in the responses. If the quarter included in our audit is typical of other quarters, taxpayers may have handled an estimated 1.1 million notices and letters a year. At the same time, this correspondence cost the IRS approximately \$996,000 annually to process.

Educational Efforts Should Be Directed at Taxpayers Who Were Not Compliant But Were Not Penalized Due to the Tolerance

The IRS mission, in part, is to help taxpayers understand and meet their tax responsibilities. However, when taxpayers are not penalized due to the tolerance, the IRS does not notify them that they did not comply and the reason for the noncompliance. The IRS computer system is not programmed to identify these taxpayers. As a result, the IRS is not able to use this direct channel to improve these taxpayers' abilities to follow Federal Tax Deposit requirements.

The Tolerance Policy Statement Does Not Consider the Taxpayer's Point of View

One of the IRS' guiding principles is to understand the customer's point of view and use this understanding to prevent and solve problems and provide quality service. The IRS' tolerance policy focuses on costs to the IRS for handling small, less productive cases. However, the policy does not recognize costs and burdens incurred by taxpayers for handling the same cases. The tolerance policy statement may unintentionally misinform the public and misguide IRS employees responsible for administering the policy that the taxpayer's viewpoint is not to be considered along with the interest of the government. The IRS adopted the tolerance policy in 1960, 38 years before it began to emphasize customer needs.

Summary of Recommendations

The Chief Operations Officer can immediately provide to small businesses and other taxpayers relief from relatively small dollar failure to deposit penalties and the related paperwork, while reducing its own administrative costs. This can be accomplished by increasing the tolerance amount for charging a failure to deposit penalty in line with changes in the value of the dollar. To minimize the impact on taxpayers of future cost increases, the tolerance amount should be re-evaluated periodically.

The Chief Operations Officer should also explore a new educational opportunity by notifying taxpayers who were not penalized due to the tolerance amount that they did not

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comply and the reason for the non-compliance. The success of these notices for improving compliance should be monitored.

The issues in this report also affect one aspect of overall administration. The Chief Operations Officer should revise the tolerance policy statement to include the taxpayer's point of view. This action would enhance consistency with one of the IRS' guiding principles.

Management's Response: Management's response was due on September 27, 2000. As of September 28, 2000, management had not responded to the draft report.

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Objective and Scope

Our objective was to determine whether the IRS' dollar tolerance should be changed.

Our objective was to determine whether the Internal Revenue Service's (IRS) dollar tolerance under which a failure to deposit penalty is not assessed should be changed to conform to IRS policy and contribute to more effective and efficient tax administration.

To identify records for review, we used data from the Masterfile (the IRS' primary computer system) showing Employer's Quarterly Federal Tax Returns (Form 941) filed for the quarter ending March 31, 1999. We identified separate populations and samples for evaluating penalty assessments and abatements. To help us apply statistical sampling techniques, we consulted and validated our work with the IRS' Statistics of Income Division.

We conducted our review in accordance with *Government Auditing Standards* between December 1999 and July 2000. We conducted our work at the National Headquarters. Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II. A Glossary of Terms appears in Appendix V.

Background

The administration of the failure to deposit penalty is based on the requirements found in I.R.C. § 6302.

The administration of the failure to deposit penalty is based on the requirements found in Internal Revenue Code (I.R.C.) § 6302¹ and the related regulations.² The law requires employers to make Federal Tax Deposits for income tax withheld from employees³ and social

¹ 26 United States Code (U.S.C.) § 6302 (1999).

² Treasury Regulation § 31.6302.

³ 26 U.S.C. § 3402 (1999).

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security taxes.⁴ Federal Tax Deposits for withheld income tax and social security accounted for over \$1.2 trillion in government revenue in Fiscal Year (FY) 1999.

Employers who withhold income tax on wages, or who must pay social security or Medicare tax, must file Form 941. The form should be filed by the end of the month following the close of each calendar quarter. For example, the Form 941 reporting taxes due for the quarter that includes January, February, and March should be filed by April 30. Form 941 shows the Federal Tax Deposits made for the quarter.

The I.R.C. provides a failure to deposit penalty if a taxpayer does not meet deposit requirements.

I.R.C. § 6656⁵ provides a failure to deposit penalty if a taxpayer does not meet deposit requirements. Penalties are charged for not making a deposit timely, in the right amount, or in the right manner.⁶ In 1998, the IRS assessed 3.8 million deposit penalties for \$3.1 billion. The penalty can be abated if the failure is due to reasonable cause and not due to willful neglect.

The IRS does not charge a failure to deposit penalty when it is equal to or less than a "tolerance" amount.

As a matter of policy, the IRS does not charge a failure to deposit penalty when it is equal to or less than a "tolerance" amount.⁷

The Federal Tax Deposit requirements are complex from both the taxpayer and administrative viewpoints. The National Taxpayer Advocate reported to the Congress that penalty administration is the fifth most serious problem facing taxpayers and that understanding Federal Tax Deposits is the eighteenth most serious problem. The IRS Taxpayer Advocate Service (TAS) advised us that failure to deposit penalties remain a chronic source

⁴ 26 U.S.C. § 3102 (1999).

⁵ 26 U.S.C. § 6656 (1999).

⁶ Appendix VI includes additional information on Federal Tax Deposits.

⁷ The tolerance amount is included in an IRS Law Enforcement Manual (LEM). The LEM includes those materials that are not available to the public and are classified as "Official Use Only." The LEM protects information of a procedural nature whose release to the public would hinder the law enforcement process.

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of undue negative impact and burden, especially to taxpayers operating small businesses.

Concerns about penalties have received significant attention. The Congress has studied penalties assessed against businesses and has passed legislation providing relief from the failure to deposit penalty.⁸ The Department of the Treasury and the IRS have also studied penalties and made numerous recommendations to help minimize the burdens of penalties and paperwork and to improve taxpayer education. The IRS has ongoing initiatives for implementing these recommendations.

Results

The current tolerance amount was established in 1986, and the IRS has not increased it to keep pace with changes in the value of the dollar.

The current tolerance amount was established in 1986, and the IRS has not increased it to keep pace with changes in the value of the dollar. Businesses that did not make proper deposits may have fallen under the penalty tolerance in 1986 (and thus would not have had to pay the penalty) but would likely be penalized with the same practices in 2000. This represents an increase in tax burden.

The IRS' handling costs have increased over the 14-year period since the current tolerance amount was established. However, the tolerance amount for charging a failure to deposit penalty has remained the same. This has resulted in the IRS assessing hundreds of thousands of relatively low-dollar penalties a year for not making a deposit timely, in the right amount, or in the right manner. Sixty-nine percent of the taxpayers included in our analysis fully paid their taxes and were billed for the penalty charge only. Over 90 percent of the taxpayers penalized were small businesses.

⁸ For example, the IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685, § 3304.

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These penalties would not have been charged had the tolerance amount kept up with the value of the dollar. Consequently, the tolerance amount established in 1986 is no longer at an appropriate level.

The IRS has an opportunity to expand its educational efforts to those taxpayers who have not met the complex Federal Tax Deposit requirements. The educational efforts would further implement IRS initiatives to help taxpayers understand their tax responsibilities. Additionally, the IRS has the opportunity to update its policy on tolerances to consider taxpayer costs and other burdens when determining the appropriate tolerance amount for all types of penalties.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

Subsequent to our review, the Commissioner approved sending to the Department of the Treasury a separate proposal affecting Federal Tax Deposits. A by-product of this proposal is raising the tolerance to [redacted] [redacted] we recommend. The IRS' proposal could be implemented as early as January 2001. However, independent of this proposal, the IRS has the opportunity to immediately change the tolerance amount to the level we recommend.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

The Tolerance Amount Is No Longer at an Appropriate Level for Small Businesses and Other Taxpayers

The IRS' tolerance policy provides that production time should not be devoted to smaller cases where the revenue involved would not warrant the handling costs.

The IRS' tolerance policy states that, in the interest of efficient and economical operation, IRS functions should not devote production time to smaller, less productive cases where the revenue involved would not warrant the handling costs and the interests of the government would not be jeopardized. To this end, the IRS prescribes tolerances to be used for screening off the cases where it would not be worthwhile to follow the normal procedure.

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The tolerance amount has not changed since 1986, yet IRS costs have risen up to 70 percent since that time.

The IRS is not following its tolerance policy because it has not increased the dollar tolerance for charging a failure to deposit penalty in line with increased IRS costs. The IRS established the current tolerance amount in 1986, at which time it raised the tolerance fivefold. However, the IRS' costs have increased substantially since then. For example, between 1986 and 1999:

- Salaries and benefits increased 70 percent. A typical IRS employee received salary and benefits of \$27,925 in 1986. The same employee received \$47,463 in 1999.
- Costs for billing taxpayers for a failure to deposit penalty increased 65 percent. The IRS spent about \$249 for every thousand bills sent to taxpayers in 1986. This cost had risen to over \$411 in 1998.⁹

The tolerance amount was not changed because the IRS does not have a process to periodically evaluate the dollar tolerance in comparison to costs.

The tolerance amount was not changed because the IRS does not have a process to periodically evaluate the dollar tolerance in comparison to costs. The General Accounting Office's "Standards for Internal Control in the Federal Government" states that internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations.

Taxpayers are burdened by relatively small penalty charges.

The IRS defines Taxpayer Compliance Burden as the time and money spent by individuals and businesses to comply with the Federal tax system. Under this definition, taxpayers face the burden of paying small failure to deposit penalties to the government and incurring costs for the time spent handling those penalties. Beyond this definition, taxpayers may experience other burdens, such as frustration and annoyance, when contacting the IRS about the penalties.

⁹ Appendix IV includes a description of the data used to derive these figures. We used the most recent data available from the IRS (FY 1998).

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We estimate that over 90 percent of the taxpayers affected by the relatively small penalties are small businesses.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

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(b)(3):26 U.S.C. 6103,(b)(7)(E)

The IRS may have charged taxpayers almost \$93 million in 1999 in small penalties. The majority of the penalized taxpayers had fully paid their taxes.

These burdens fall on small businesses the vast majority of the time.¹⁰ In fact, we estimate that over 90 percent of the taxpayers affected by the relatively small penalties are small businesses. These taxpayers would not have been penalized had the IRS raised the tolerance amount for charging a failure to deposit penalty to keep pace with the rate of inflation since 1986.

The following sections present our estimates of the impact on taxpayers and the IRS if the tolerance amount was raised to [redacted]. This amount approximates increases in IRS costs. Our estimates are based solely on increased IRS costs since 1986, when the IRS established the tolerance amount at [redacted] and do not consider economic changes beyond those costs.

The IRS charged taxpayers relatively low-dollar penalties

An estimated 170,000 taxpayers would not have been penalized approximately \$23.2 million for Forms 941 filed for the quarter ending March 31, 1999, if the IRS had increased its tolerance amount to [redacted]. If our sampled quarter is typical of the other 3 quarters in 1999, the IRS may have assessed approximately 680,000 low-dollar penalties involving almost \$93 million in 1999.

The majority of those taxpayers had fully paid their taxes. In fact, an estimated 69 percent of the taxpayers in our sample were charged only for the failure to deposit penalty. The following hypothetical examples are based on the composite experience of taxpayers included in our samples who did not precisely comply with deposit requirements.

- Assume that a small business filed Form 941 timely and reported a tax due of \$13,000. The business made the 6 required Federal Tax Deposit payments,

¹⁰ The IRS defines small businesses as persons who are self-employed and corporations and partnerships with assets less than or equal to \$5 million.

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(b)(3):26 U.S.C. 6103,(b)(7)(E)

paying \$15,600, an overpayment of 20 percent. However, we will also assume that the IRS deemed several of the deposits to be late. The IRS would have credited the business' Masterfile account with a \$2,440 overpayment, after deducting [REDACTED] for a failure to deposit penalty.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

- Assume that a small business filed Form 941 timely and reported a tax due of \$3,500. The business made the 3 required Federal Tax Deposit payments. However, we will also assume that the first deposit was less than the required amount. The IRS would have billed the business for a [REDACTED] failure to deposit penalty.

Taxpayers paid millions in penalty charges

The penalized taxpayers may have paid to the government an estimated \$76.6 million in relatively small penalties in 1999.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

An estimated 142,000 taxpayers paid to the government approximately \$19.1 million in failure to deposit penalties for Forms 941 for the quarter ending March 31, 1999. The average payment was [REDACTED]. If our sampled quarter is typical of the other 3 quarters in 1999, taxpayers may have paid to the government an estimated \$76.6 million in relatively small failure to deposit penalties in 1999.¹¹

While we did not study payments, the IRS TAS provided some insight. The TAS indicated that some taxpayers feel it is more cost-effective to simply pay rather than contest penalty charges, even when the taxpayer deems a penalty incorrect. The TAS considers this bad customer service.

¹¹ Annualized total does not equal 4 x \$19.1 million due to rounding.

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Penalty charges were removed for reasonable cause

The failure to deposit penalty can be abated (removed) if the failure to deposit was due to reasonable cause and not to willful neglect. There are a number of circumstances under which reasonable cause can be considered. For example, a business may have a reasonable cause for making a late deposit if the person having sole authority to make the deposit was seriously ill. A taxpayer needs to contact the IRS to obtain this waiver.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

The IRS granted an estimated 79.2 percent of taxpayer requests for abatement of a small failure to deposit penalty for reasonable cause.

Taxpayers requested an estimated 12,500 abatements of a failure to deposit penalty of [redacted] or less for reasonable cause for Forms 941 filed for the quarter ending March 31, 1999. Of these requests, an estimated 9,900 (79.2 percent) were granted and approximately 2,600 (20.8 percent) were denied.

We did not review the accuracy of the IRS' determinations of reasonable cause. However, an IRS study in 1995 showed that the reasonable cause criteria were applied accurately less than half the time.¹² Likewise, the American Institute of Certified Public Accountants (AICPA) stated that:

... the reasonable cause standard, which by its nature is a very subjective standard, oftentimes is applied inconsistently by the Service.... As a result, similarly situated taxpayers are treated differently. Such disparate treatment does not encourage voluntary compliance. The experience of our members shows that typically, the effect of inconsistent treatment is misunderstanding and resentment on the part of taxpayers. These sentiments often have a negative effect on compliance.¹³

¹² Test data, from an IRS study in 1995, were cited in the IRS' 1998 Penalty Task Group Report. The IRS has ongoing initiatives to improve the accuracy of the application of reasonable cause criteria.

¹³ "Penalty and Interest System-Comments and Recommendations to the Joint Committee on Taxation and the IRS," March 2, 1999.

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Raising the tolerance amount would reduce the number of taxpayer contacts for abatement.

Raising the tolerance amount would reduce the number of taxpayer requests for abatement, a significant majority of which were subsequently granted. An increase in the tolerance amount could also lower the risk of inconsistent treatment of taxpayers, which should have a positive effect on meeting tax responsibilities.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

Taxpayers fully paid their liabilities

An estimated 93.5 percent of the penalized taxpayers fully paid all their liabilities.

Of the estimated 170,000 taxpayers penalized for [REDACTED] or less, approximately 159,000 (93.5 percent) had fully paid all their liabilities at the time of our audit.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

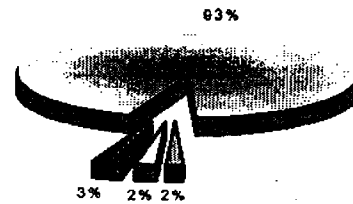
The estimates are based on a sample of 108 taxpayers who were penalized for [REDACTED] or less. Of the 108 taxpayers, only 7 were delinquent at the time of our review (see Figure 1).

Of the seven taxpayers:

- Two had been billed only for the failure to deposit penalty. These taxpayers would have had no liability and, therefore, would not have been in delinquent status had the tolerance been increased.
- Two had balances due too low for the IRS to take active collection action.
- Three had balances due high enough for the IRS to take collection action.

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Taxpayers Fully Paid Their Liabilities



(b)(3);26 U.S.C. 6103,(b)(7)(E)

- Full Paid Liability 93%
- Penalty Assessed for [redacted] or Less 2%
- Collection Action not Warranted 2%
- Collection Action Warranted 3%

Figure 1. Taxpayers fully paid their liability. These taxpayers are a large percentage of all taxpayers included in our sample. Source: IRS Masterfile.

Taxpayers incurred paperwork, costs, and other burdens when handling IRS correspondence generated by the relatively low-dollar penalties

In addition to paying small penalties, taxpayers are also burdened with actions needed to handle these penalties.

The IRS does not consider the taxpayer burdens, such as paperwork, costs, and frustration, when determining the tolerance amount. A taxpayer incurs these burdens when the owner, an employee, or an accountant reads an IRS notice or letter, determines a course of action in response, takes that action, and then deals with the outcome of the action. The IRS' outdated tolerance amount caused the generation of penalty notices and subsequent letters that resulted in taxpayer paperwork, cost, and other burdens falling largely on small businesses.

Paperwork Burden Consistent with the Paperwork Reduction Act of 1995,¹⁴ the Office of Management and Budget (OMB) has an initiative to reduce the paperwork burden on small businesses. In conjunction with this initiative, the Commissioner of the IRS stated that the impact of this paperwork burden is particularly felt by

¹⁴ Paperwork Reduction Act of 1995, Pub. L. No. 104-13, 109 Stat. 163.

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(b)(3):26 U.S.C. 6103,(b)(7)(E)

There were an estimated 269,000 written contacts between the IRS and taxpayers because of relatively small failure to deposit penalty charges.

small businesses whose proprietors' most precious asset is time.

There were an estimated 269,000 written contacts between the IRS and taxpayers because of a failure to deposit penalty of up to [REDACTED] from Forms 941 filed for the quarter ending March 31, 1999.¹⁵ These taxpayers fully paid their taxes and were billed for the failure to deposit penalty only. Had the tolerance amount been increased, the burdensome contacts would not have been necessary. These 269,000 contacts consisted of:

- 115,000 IRS first notices sent to inform the taxpayer of the penalty.
- 34,700 subsequent IRS notices sent when the penalty may not have been resolved before this notice was sent.
- 97,800 taxpayer payments for the penalty.
- 9,000 taxpayer requests for an abatement of the penalty for reasonable cause.¹⁶
- 12,500 IRS letters informing the taxpayer of the IRS' decision on the request for abatement of the penalty.

If our sampled quarter is typical of the other 3 quarters in 1999, taxpayers may have handled an estimated 1.1 million notices and other correspondence on this topic in 1999.

Cost Burden The IRS does not have comprehensive data on the cost of the taxpayer paperwork burden. As an alternative, we used publicly available data to provide examples of: (1) how costs to taxpayers have increased over time, and (2) possible taxpayer costs today.

While IRS costs for processing small penalties have risen, so have taxpayer costs for handling these penalties.

¹⁵ The total was derived from separate populations and samples for evaluating penalty assessments and abatements.

¹⁶ Taxpayers also requested 3,500 abatements by telephone.

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Costs to Taxpayers Have Increased Over Time

Both the CPI and the ECI have risen over 50 percent since 1986.

Both the Consumer Price Index (CPI) and the Employment Cost Index (ECI) have risen over 50 percent since 1986. The CPI is the most widely used measure of inflation. It measures the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The CPI can be used as a measure of inflation as experienced by consumers in their day-to-day living expenses. As shown in Figure 2, the CPI increased from 110 points in 1986 to 167 points in 1999, an increase of 52 percent.

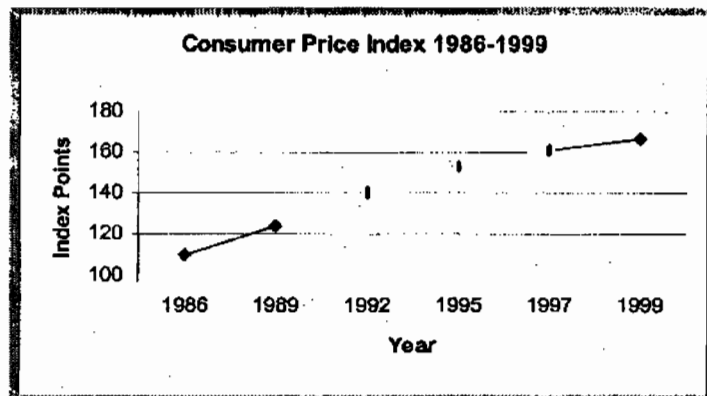


Figure 2. Increases in the CPI between 1986 and 1999. The CPI showed a 52% inflation rate. Source: Bureau of Labor Statistics.

Another measure of economic change is the ECI, which measures the change over time in the cost of labor. An analysis of the ECI illustrates the potential cost increase since 1986 that a business taxpayer must incur to pay an employee to handle a relatively small IRS penalty charge. The overall ECI rose 54 percent between 1986 and 1999. Figure 3 shows the difference between the ECI in 1986 and 1999 for various segments of employers.

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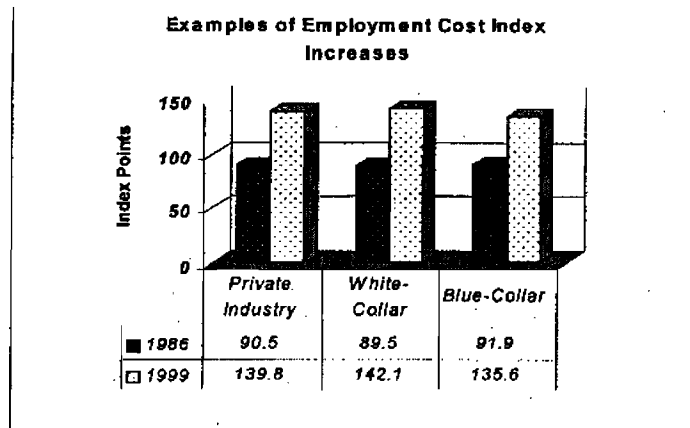


Figure 3. Increases in the ECI between 1986 and 1999. The cost of overall private industry employment increased 54%, the white-collar cost increased 59%, and the blue-collar cost increased 48%. Source: Bureau of Labor Statistics.

Possible Taxpayer Costs Today

The AICPA has stated that too many taxpayers must contact their tax advisers to understand and respond to IRS penalty notices. This resulted in an additional economic burden on either the taxpayers or the advisers.¹⁷

A taxpayer's cost for contact with the IRS could range from \$3.21 to \$51.16 depending on who handles the contact and how long the actions take.

We selected four occupations representative of taxpayers who responded to IRS failure to deposit notices and estimated the amount of time it may have taken to complete all actions necessary to resolve the notice. In our hypothetical scenarios, this cost could range from \$3.21 to \$51.16, depending on who handles the IRS contact and how long the actions take. For example, a small business would incur an estimated cost of \$18.00 if a Certified Public Accountant (CPA) handled the penalty notice and if this action took 45 minutes. The CPA and other typical occupations that could handle the IRS notices are shown in Table 1.

¹⁷“Penalty and Interest System-Comments and Recommendations to the Joint Committee on Taxation and the IRS,” March 2, 1999.

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Occupation	Estimated costs per 15 minute increments			
	15 minutes	30 minutes	45 minutes	1 hour
Secretary	\$ 3.21	\$ 6.42	\$ 9.62	\$12.83
Construction Supervisor	\$ 4.48	\$ 8.95	\$13.43	\$17.90
CPA	\$ 6.00	\$12.00	\$18.00	\$24.00
Executive	\$12.79	\$25.58	\$38.37	\$51.16

Table 1. Scenarios of the cost to small businesses for handling IRS penalty charges. The costs could vary widely depending on occupation and time. Sources: Bureau of Labor Statistics, National Compensation Survey for 1997 and *The Wall Street Journal*.

Raising the tolerance amount could reduce other taxpayer burdens associated with the need to contact the IRS by telephone or in writing.

Small business owners were frustrated with the IRS' toll-free telephone system and concerned about waiting for replies to their letters.

Other Burdens Raising the tolerance amount could reduce the taxpayer burdens of frustration and annoyance.

The IRS sends to a taxpayer an initial notice informing him/her of the penalty charge. The notice provides a toll-free number for the taxpayer to call the IRS to discuss any IRS errors. The notice also provides an address to write to the IRS to request abatement or reduction of the penalty.

The IRS reported in 1995 that small business owners have expressed frustration with their attempts to receive assistance from the IRS' toll-free telephone system. Many said their calls were never answered or, if the call was answered, they were placed on hold for considerable periods of time.¹⁸ These frustrations may have continued in 1999. In that year, the Level of Service (i.e., the relative success rate of taxpayers who are calling the toll-free telephone line for bills and notices) was 46 percent.¹⁹

The 1995 IRS report also stated that small business owners and practitioners have expressed "great

¹⁸ *IRS Outreach to Small Business*, August 18, 1995.

¹⁹ The Level of Service (LOS) improved to 59 percent in FY 2000. However, 1999 and 2000 statistics may not be directly comparable because the IRS changed its method of computing the LOS.

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annoyance" with IRS procedures regarding turnaround time on correspondence. For example, taxpayers included in our sample who wrote to the IRS to request abatement of a penalty would need to wait approximately 5 weeks from the time the letter was received by the IRS to receive a response.

The IRS incurred costs for taxpayer contacts generated by penalties

Like taxpayers, the IRS also incurred costs in sending and responding to correspondence related to these penalties. And, like taxpayers, the IRS would not have incurred these costs if the tolerance amount had been increased.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

The IRS spent an estimated \$286,000 handling taxpayer contacts generated by failure to deposit penalties of up to [REDACTED] from Forms 941 filed for the quarter ending March 31, 1999, as follows:

- \$249,000 to mail correspondence, receive responses, and resolve the issues raised in the responses.
- \$37,000 to handle telephone calls.

These costs were incurred to process penalties for taxpayers who fully paid their taxes and were billed for the failure to deposit penalty only. Had the tolerance amount been increased, these costs would not have been incurred.

The IRS may have spent an estimated \$1.1 million in 1999 for handling taxpayer contacts generated by small failure to deposit penalties.

If the quarter included in our audit is typical of other quarters, the IRS may have spent approximately \$1.1 million handling taxpayer contacts on these penalties in 1999: \$996,000 for correspondence and \$148,000 for telephone calls.

Recommendations

(b)(3):26 U.S.C. 6103,(b)(7)(E)

The Chief Operations Officer should:

1. Immediately increase the dollar tolerance for charging a failure to deposit penalty to at least [REDACTED] to conform with the IRS mission and

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contribute to more effective and efficient tax administration. Higher amounts should also be considered to account for any short-term changes in IRS costs and to include consideration of taxpayer costs.

2. Periodically re-evaluate the tolerance amount and change the amount, as appropriate, in line with changes to costs.

Management's Response: Management's response was due on September 27, 2000. As of September 28, 2000, management had not responded to the draft report.

Educational Efforts Should Be Directed at Taxpayers Who Were Not Compliant But Were Not Penalized Due to the Tolerance

The IRS mission is, in part, to help taxpayers understand and meet their tax responsibilities. An IRS strategic goal is to provide top quality service to all taxpayers. One way of providing this service is through better and more targeted taxpayer education.

The IRS has a number of initiatives to help educate businesses about deposit requirements. These initiatives include contacting new employers to provide information on employment tax responsibilities and classes for taxpayers who were charged a deposit penalty for the first time, in addition to the more traditional sources of information, such as IRS publications.

The IRS does not include in its educational efforts taxpayers who were not penalized because of the tolerance amount.

However, the IRS does not include in its educational efforts taxpayers who did not comply with the Federal Tax Deposit law but were not charged a failure to deposit penalty due to the tolerance amount. The IRS does not notify the taxpayers that they did not comply and give the reason for the noncompliance.

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The IRS is not taking advantage of an opportunity to improve taxpayers' abilities to meet deposit requirements.

The IRS does not notify these taxpayers because controls are not in place for the Masterfile to identify them. As a result, the IRS is not taking advantage of an opportunity to improve taxpayers' abilities to meet Federal Tax Deposit requirements.

Recommendations

The Chief Operations Officer should:

3. Include in its ongoing educational efforts taxpayers who are not penalized due to the tolerance amount by identifying them on the Masterfile and then sending an educational notice advising them of their noncompliance, the reason for the noncompliance, and how to prevent it in the future.
4. Monitor the success of these notices in improving compliance.

The Tolerance Policy Statement Does Not Consider the Taxpayer's Point of View

IRS policies are major decisions that govern and guide IRS personnel in the administration of internal revenue laws, and they form a framework within which IRS officials prepare procedures and instructions. The IRS policies are available to the public.

One of the IRS' guiding principles states that the IRS needs to understand the customer's (taxpayer's) point of view and use this understanding to prevent and solve problems and provide quality service. This principle represents a significant shift in emphasis, from an internal focus to a customer focus.

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The tolerance policy focuses on IRS costs and does not recognize taxpayer costs in handling small cases.

The IRS adopted the tolerance policy in 1960, 38 years before it emphasized customer needs.

The current tolerance policy provides that IRS functions should not work on smaller, less productive cases where the revenue involved would not warrant the handling costs and the interests of the government would not be jeopardized.²⁰ However, this policy does not recognize taxpayer costs in handling the same small cases. It does not weigh taxpayer costs against the potential benefit of improving taxpayers' understanding of their tax responsibilities and meeting those responsibilities.

The IRS adopted the tolerance policy in 1960, 38 years before the IRS emphasized customer needs. The IRS mission in the 1960s did not address service to the taxpayer. However, the IRS revised its mission in 1998 to include an emphasis on providing quality service. The IRS also began shifting emphasis from its own internal operations to administering its responsibilities from the taxpayer's point of view. However, the tolerance policy was not changed simultaneously.

As a result, the current tolerance policy statement may unintentionally misinform the public and misguide IRS employees responsible for administering the policy that the taxpayer's viewpoint is not to be considered along with the interest of the government.

Recommendation

5. The Chief Operations Officer should revise the tolerance policy statement to include consideration of the taxpayer's point of view when setting tolerances.

Conclusion

The IRS' penalty administration and understanding of Federal Tax Deposit requirements are among the most

²⁰ The National Taxpayer Advocate stated that the "interests of the government" have been viewed as raising revenue.

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serious problems facing taxpayers, especially small businesses. Penalty relief has been a concern of the Congress, the Department of the Treasury, and the IRS. In addition to concerns about penalties, the OMB is concerned about the paperwork burden on taxpayers.

A warranted increase to the tolerance amount would simplify penalty administration affecting thousands of small businesses by reducing the number of times they need to interact with the IRS. It would also provide those taxpayers with millions of dollars in immediate penalty relief and cost savings, as they would not need to pay penalty charges that are no longer appropriate and would not incur costs responding to IRS correspondence on the penalties.

Increasing the tolerance amount would provide cost savings to the IRS. It would also provide the IRS with an opportunity to expand its educational efforts, marketing them to reach an untapped group of customers who have not met the complex deposit requirements.

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Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to determine whether the Internal Revenue Service's (IRS) dollar tolerance amount under which a failure to deposit penalty is not assessed should be changed to conform with IRS policy and contribute to more effective and efficient tax administration. To accomplish this objective, we:

- A) Researched the Internal Revenue Manual (IRM) from 1960 to the present to determine when the IRS tolerance policy statement was approved and evaluated its conformance to the IRS mission.
- B) Researched the IRM and the Law Enforcement Manual (LEM) from 1984 to the present to determine when the current tolerance amount was established and evaluated the IRS' support for selecting that amount.
- C) Determined at dollar amounts above the tolerance: (1) the number and amount of penalties that would not be assessed, and (2) the number and amount of these penalties that would not be abated if the tolerance amount was raised, by selecting two statistically valid random samples from the Masterfile (the IRS' computer system of taxpayer accounts) records (see Appendix VII - Detailed Population and Sample Data).
 - 1) Assessments of the Failure to Deposit Penalty. To identify records for review, we used data from the Masterfile showing Employer's Quarterly Federal Tax Returns (Form 941) filed for the quarter ending March 31, 1999.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We identified a population of 427,402 records that had at least 1 failure to deposit penalty assessment for [redacted] or less. We used attribute sampling with a confidence level of 90 percent, an expected rate of occurrence of 50 percent, and a precision of +/- 5 percent to determine a sample size of 271 records.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We defined an occurrence as a record with a total assessed failure to deposit penalty of [redacted] or less, but not \$0. We established an occurrence by reviewing additional Masterfile records showing Federal Tax Deposits for the sampled quarter. Of the 271 sampled records, 186 met the definition of an occurrence.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We further analyzed the 186 records to identify those with a total assessed failure to deposit penalty of [redacted] or less. Of the 186 records, 108 met this

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criterion. We based our estimates on analyses conducted on these 108 records.

- 2) Abatements of Assessed Failure to Deposit Penalties. To identify records for review, we used data from the Masterfile showing Forms 941 filed for the quarter ending March 31, 1999.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We identified a population of 78,459 records that had at least 1 failure to deposit penalty assessment for [redacted] or less and codes indicating that a taxpayer may have made a request for abatement. We used attribute sampling with a confidence level of 90 percent, an expected rate of occurrence of 50 percent, and a precision of +/- 5 percent for determining a sample size of 271 records.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

We defined an occurrence as a record with a total assessed penalty of [redacted] or less, but not \$0, and adjustment documents or Masterfile codes indicating that a taxpayer had requested an abatement of the failure to deposit penalty for reasonable cause. We identified 80 records that met this definition of an occurrence.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We further analyzed the 80 records to identify those with a total assessed failure to deposit penalty of [redacted] or less. Of the 80 records, 43 met this criterion. We based our estimates on analyses conducted on these 43 records.

- 3) To help us apply statistical sampling techniques and use the sample results to make estimates over the populations, we coordinated our work with the IRS' Statistics of Income Division.
- D) Evaluated non-quantifiable costs and benefits of increasing the tolerance amount by soliciting comments from the following IRS functions: the Office of Penalty and Interest Administration; the Assistant Commissioners (Collection), (Criminal Investigation) and (Customer Service); the Director, Legislative Affairs; the National Director, Office of Public Liaison and Small Business; and the National Taxpayer Advocate.
 - E) Assessed the taxpayer's cost of responding to an assessment and requesting an abatement by:
 - 1) Interviewing IRS personnel from the Office of Program Evaluation and Risk Analysis.
 - 2) Evaluating Bureau of Labor Statistics data, including the Consumer Price Index from 1986 through 1999, the Employment Cost Index for 1986 through 1999, and the National Compensation Survey for 1997.
 - 3) Evaluating salary guides cited in *The Wall Street Journal*.

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- F) Determined the IRS' cost of processing an assessment, a request for abatement, and an abatement by:
- 1) Interviewing employees from the Philadelphia Service Center Federal Tax Deposit Unit and Customer Service Telephone Unit to determine the processing procedures for failure to deposit penalty assessments and requests for abatements.
 - 2) Researching the IRM to determine the appropriate letters, computer notices, stuffers, and envelopes used for failure to deposit penalty assessments and abatements.
 - 3) Evaluating wage and benefits data for 1986 and 1999 from the Office of Personnel Management.
 - 4) Researching and evaluating processing cost data obtained from the IRS Costing Guides for Fiscal Years (FY) 1986 and 1998. We also obtained the cost of toll-free telephone service for FY 1999 from the Customer Service function.
- G) Determined the IRS' procedures for collecting a lower dollar assessment of a penalty and the success in collecting these assessments by:
- 1) Interviewing IRS employees from the Assistant Commissioners (Collection) and (Customer Service).
 - 2) Reviewing the IRM and the LEM.
- H) Evaluated the characteristics of the taxpayers who would benefit from penalty relief at amounts above the current tolerance amount by further analyzing the samples of failure to deposit penalty assessments from C.1. and failure to deposit penalty abatements from C.2.
- 1) Using the sample from C.1, we obtained additional Masterfile information and evaluated the records for taxpayer characteristics. For example, these characteristics included the type and number of notices and letters issued, the number of payments made after the tax return was filed, and whether the taxpayer had fully paid all assessed liabilities.
 - 2) Using the sample from C.2, we evaluated IRS documents showing the results of taxpayer contact and Masterfile records. We used the data to identify whether the contact was a request for abatement for reasonable cause, whether the contact was made by telephone or in writing, and the IRS' decision whether to grant or deny the abatement.

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Appendix II

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Appendix III

Report Distribution List

Deputy Chief Financial Officer, Department of the Treasury
Deputy Commissioner Operations C:DO
Chief Operations Officer OP
Commissioner, Small Business/Self-Employed Division S
Assistant Commissioner (Customer Service) OP:C
Assistant Commissioner (Examination) OP:EX
National Director, Specialty Taxes OP:EX:ST
Director, Office of Interest and Penalty Administration OP:EX:ST:I&P
National Taxpayer Advocate C:TA
Audit Liaisons:
 Office of the Assistant Commissioner (Customer Service) OP:C
 Office of the Assistant Commissioner (Examination) OP:EX

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Appendix IV

Outcome Measures

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

Finding and recommendation:

The current tolerance amount was established in 1986, and the Internal Revenue Service (IRS) has not increased it to keep pace with changes in the value of the dollar. Businesses that did not make proper deposits may have fallen under the penalty tolerance amount in 1986 (and thus would not have had to pay the penalty) but would likely be penalized with the same practices in 2000. This represents an increase in taxpayer burden. The tolerance amount was not changed because the IRS does not have a process for periodically evaluating the tolerance amount in comparison with costs. The IRS should: (1) increase the tolerance amount, and (2) periodically re-evaluate the tolerance amount and change it, as appropriate, to be in line with changes to costs (see page 4).

Type of Outcome Measure:

- Taxpayer Burden - Actual
- Cost Savings - Recommendation That Funds Be Put to Better Use (Reductions in Outlays) - Actual

(b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E)

Value of the Benefit:

(b)(3):26 U.S.C. 6103,(b)(7)(E)

• **Taxpayer burden** Taxpayers had an estimated [redacted] contacts ([redacted] in writing and [redacted] by telephone) with the IRS originating with a failure to deposit penalty of up to [redacted] from Forms 941 filed for the quarter ending March 31, 1999. These taxpayers fully paid their taxes and were billed for the failure to deposit penalty only.

Had the tolerance amount been increased, the contacts would not have been necessary. If the results of our sampled quarter are typical of any quarter, we estimate that taxpayers would no longer need to handle approximately [redacted] contacts for the 3 quarters remaining in Calendar Year (CY) 2000, at the time we notified the IRS. (b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E)

• **Cost savings** In our sampled quarter, the IRS would receive actual savings of an estimated [redacted] for correspondence that it would no longer need to process and telephone calls that taxpayers would not need to make for failure to deposit penalties.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

If the results of our sampled quarter are typical of any quarter, we estimate that the actual savings would be approximately [redacted] (rounded) for the 3 quarters

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remaining in CY 2000, at the time we notified the IRS. These funds could be put to better use.

Methodology Used to Measure the Reported Benefit:

We determined that dollar amounts above the current tolerance: (1) the number and amount of penalties that would not be assessed, (2) the number and amount of these penalties that would not be abated, and (3) the impact of any changes on taxpayers and the IRS.

We selected two statistically valid random samples from Masterfile (the IRS' primary computer system) records to accomplish this objective. To help us apply statistical sampling techniques and use the sample results to make estimates over the populations, we coordinated our work with the IRS' Statistics of Income Division. We also analyzed the IRS' costs.

(1) Assessments of the Failure to Deposit Penalty To identify records for review, we used data from the Masterfile showing Forms 941 filed for the quarter ending March 31, 1999.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E) We identified a population of [redacted] records that had at least 1 failure to deposit penalty assessment for [redacted] or less. We used attribute sampling with a confidence level of 90 percent, an expected rate of occurrence of 50 percent, and a precision of +/- 5 percent to determine a sample size of [redacted] records. (b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E) We defined an occurrence as a record with a total assessed failure to deposit penalty of [redacted] or less, but not \$0. We established an occurrence by reviewing additional Masterfile records showing Federal Tax Deposits for the sampled quarter. Of the [redacted] sampled records, [redacted] met the definition of an occurrence. (b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E) We further analyzed the 186 records to identify those records with a total assessed failure to deposit penalty of [redacted] or less. Of the [redacted] records, [redacted] met this criterion. We based our estimates on analyses conducted on these [redacted] records. (b)(3):26 U.S.C. 6103,(b)(7)(E)

(b)(3):26 U.S.C. 6103,(b)(7)(E) We also used the additional Masterfile information to evaluate the records for taxpayer characteristics. For example, these characteristics included the type and number of notices and letters issued, the number of payments made after the tax return was filed, and whether the taxpayer had fully paid all assessed liabilities.

(b)(3):26 U.S.C. 6103,(b)(7)(E) We also used the additional Masterfile information to evaluate the records for taxpayer characteristics. For example, these characteristics included the type and number of notices and letters issued, the number of payments made after the tax return was filed, and whether the taxpayer had fully paid all assessed liabilities.

(2) Abatements of Assessed Failure to Deposit Penalties To identify records for review, we used data from the Masterfile showing Forms 941 filed for the quarter ending March 31, 1999.

(b)(3):26 U.S.C. 6103,(b)(7)(E) We identified a population of [redacted] records that had at least 1 failure to deposit penalty assessment for [redacted] or less and codes indicating that a taxpayer may have made a request for abatement. We used attribute sampling with a confidence level of 90 percent,

(b)(3):26 U.S.C. 6103,(b)(7)(E)

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(b)(3):26 U.S.C.
6103,(b)(7)(E)

an expected rate of occurrence of 50 percent, and a precision of +/- 5 percent for determining a sample size of [redacted] records.

(b)(3):26 U.S.C. 6103,(b)(7)(E)

We defined an occurrence as a record with a total assessed penalty of [redacted] or less, but not \$0, and adjustment documents or Masterfile codes indicating that a taxpayer had requested an abatement of the failure to deposit penalty for reasonable cause. We identified [redacted] records that met this definition of an occurrence.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We further analyzed the [redacted] records to identify those with a total assessed failure to deposit penalty of [redacted] or less. Of the [redacted] records, [redacted] met this criterion. We based our estimates on analyses conducted on these [redacted] records.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

(b)(3):26 U.S.C.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

We reviewed additional Masterfile records and IRS documents (when available) to identify whether the contact was a request for abatement for reasonable cause, whether the contact was made by telephone or in writing, and the IRS' decision whether to grant or deny the abatement.

(b)(3):26 U.S.C.
6103,(b)(7)(E)

(3) The IRS' Costs To determine the IRS' costs of processing an assessment and a request for abatement, we:

- Evaluated wage and benefits data for 1986 and 1999 obtained from the Office of Personnel Management. The evaluation was based on basic salaries for a Grade 9, Step 5 employee adjusted for locality pay (an adjustment to reflect private-sector salaries on a city-by-city basis).
- Determined the cost of processing notices, letters, payments, and requests for abatement using data obtained from the IRS for Fiscal Year 1998, the most recent information available at the time of our review. These data included costs such as salaries, benefits, printing various types of correspondence, IRS information documents included with that correspondence, envelopes, postage, quality assurance, and overhead. We also evaluated comparable costs for 1986, where available.
- Determined the cost of toll-free telephone service for 1999 using data obtained from the IRS. These data included salaries, benefits, and circuitry costs.

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Appendix V

Glossary of Terms

Abatement – A reduction in the assessment of tax, penalty, or interest when it is determined the assessment is incorrect or when the taxpayer should be relieved of a liability, e.g., penalty abatement for reasonable cause.

American Institute of Certified Public Accountants (AICPA) – The national professional organization of Certified Public Accountants.

Assessment – Formal bookkeeping entry of tax debt including penalty and/or interest that has been determined to be due and collectable by the Internal Revenue Service (IRS) and to be charged to a taxpayer's account.

Consumer Price Index (CPI) – The Bureau of Labor Statistics publishes the CPI. The CPI is the most widely used measure of inflation. It measures the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Customer Service – The IRS component that answers tax law questions over the telephone and with automated systems.

Delinquency – A situation in which a taxpayer has filed a return, has not fully paid, and is in collection status.

Employer's Quarterly Federal Tax Return (Form 941) – Form that must be filed each calendar quarter by employers who withhold tax on wages or who must pay social security or Medicare tax.

Employment Cost Index (ECI) – The Bureau of Labor Statistics publishes the ECI. The ECI measures the change over time in the cost of labor. The cost of labor includes wages, salaries, and employer costs for employee benefits.

Failure to Deposit – Penalties may apply if the taxpayer does not make required deposits on time, makes deposits for less than the required amount, or does not use the Electronic Funds Transfer Payment System when required. The penalties do not apply if any failure to make a proper and timely deposit was due to reasonable cause and not to willful neglect.

General Accounting Office's "Standards for Internal Control in the Federal Government" – The overall framework for establishing and maintaining internal control.

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Internal Control – An integral component of an organization's management that provides reasonable assurance that the objectives of efficiency of operations are being achieved (as well as other objectives).

Internal Revenue Manual (IRM) – The official compilation of policies, delegated authorities, procedures, instructions, and guidelines relating to the organization, functions, administration, and operations of the IRS.

Law Enforcement Manual (LEM) – Protects information of a procedural nature, the release of which to the public would hinder the law enforcement process. The LEM includes those IRS materials which are not available to the public and are classified as "Official Use Only."

Letter – Correspondence sent to a taxpayer as a result of an IRS employee exercising his/her judgment in working/resolving a specific taxpayer case or correspondence.

Level of Service (LOS) – The relative success rate of taxpayers who are calling for toll-free telephone services. For Fiscal Year (FY) 1999, the LOS was expressed as the total number of calls answered divided by the total call attempts, to arrive at the percentage of callers who actually received service. In FY 2000, the LOS is based on a combined percentage of three toll-free telephone lines because the reporting system did not allow for individual totals.

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

Mission of the IRS – Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and applying the tax law with integrity and fairness to all.

National Compensation Survey (NCS) – The Bureau of Labor Statistics publishes the NCS. The NCS is a statistical survey program on levels and trends in compensation for civilian workers in private industry establishments and state and local governments.

Notices – For the purpose of this report, bills that are sent to taxpayers who have filed a tax return and have not fully paid the balance or have not paid additional assessments of tax, penalties, or interest. For example, the CP 161 is the first notice issued to inform the taxpayer of tax, penalty, and/or interest due.

Office of Management and Budget (OMB) – Assists the President in overseeing the preparation of the Federal budget and supervising its administration in Executive Branch agencies. In addition, the OMB oversees and coordinates the Administration's procurement, financial management, information, and regulatory policies. In each of these areas, one of the OMB's roles is to reduce any unnecessary burdens on the public.

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Office of Personnel Management (OPM) – The Federal government's human resources agency. The OPM's responsibilities include compensation policy development.

Penalty – Used by the IRS to encourage voluntary compliance with tax laws by: (1) helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer.

Policy – A major decision of the Commissioner within the framework of basic tax and administrative policies of the Treasury and the Congress, which govern and guide IRS personnel in the administration of internal revenue laws. They form a framework within which IRS officials prepare procedures and instructions.

Reasonable Cause – Based on all the facts and circumstances in each situation, allows the IRS to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining its tax obligations but is unable to comply with those obligations. It is important to note that the penalty relief does not make a non-compliant act compliant but rather relieves the taxpayer of the penalty incurred for failing to deposit as required.

Small Business/Self-Employed Division – The new IRS division that serves approximately 45 million taxpayers who are fully or partially self-employed individuals and small businesses. The Division includes corporations and partnerships with assets less than or equal to \$5 million and self-employed and supplemental income earners with business-like characteristics.

Taxpayer Advocate Service – The IRS component that ensures that taxpayer problems, which have not been resolved through normal channels, are promptly and properly handled.

Taxpayer Compliance Burden – The time and money spent by individuals and businesses to comply with the Federal tax system.

Tolerance – The allowable deviation from standard operations to facilitate administration of a program. A tolerance can take the form of a dollar amount.

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Appendix VI

Federal Tax Deposits and the Failure to Deposit Penalty¹

Introduction

The past three decades have been marked by a growing appreciation for the importance of the time value of money and the benefits of efficiently using "float" (money in transit from a transferor to a transferee). Reflecting that awareness, the Congress and the Internal Revenue Service (IRS) have taken a number of steps to see that tax revenues collected by, or on behalf of, the Federal government are actually made available to the government as quickly and as efficiently as possible.

Enforcing prompt payment also reduces the risk of collection problems. This is particularly important when the taxes involved are trust fund taxes, such as withheld social security, because the government gives employees credit for amounts withheld on their behalf even if those amounts are not paid over to the government.

It is not efficient for the IRS to collect payments directly and then transport those payments to a bank for deposit for taxpayers who pay, or who collect and pay over, large amounts of tax. These taxpayers must deposit their payments directly into government accounts at Federal Reserve branches or at commercial banks authorized to act as Federal depositories. Currently, such deposits account for over 80 percent of the Federal government's cash flow. To further enhance efficiency, those who deposit significant amounts of tax must make their deposits electronically.

Deposit requirements

The IRS has broad authority to determine how Federal taxes are to be collected. The IRS has provided detailed guidance specifying how, how much, where, and when Federal taxes are to be deposited. Under these rules, deposits are required for taxes paid in connection with certain types of tax returns.

The largest category of tax deposits and the largest single source of Federal government revenue consists of employment taxes deposited by employers in connection with the Employer's Quarterly Federal Tax Return (Form 941). Employment taxes generally include income tax withheld from wages, tips, taxable fringe benefits, and supplemental

¹This information was excerpted from the Study of Present-Law Penalty and Interest Provisions as required by Section 3801 of the IRS Restructuring and Reform Act of 1998 (including provisions relating to corporate tax shelters), Volume I, pp. 129-136, prepared by the Staff of the Joint Committee on Taxation, July 22, 1999.

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unemployment compensation benefits and the amounts withheld for the employer and employee share of social security and Medicare taxes.

Employers are classified by size of tax liabilities for purposes of determining:

(1) whether an employer has to make deposits, (2) how often it must make them, and (3) how it must make them. Most employers can determine at the beginning of each calendar year the deposit schedule that applies for the year. The determination of the employer's deposit requirements for a calendar year depends upon the aggregate amount of employment taxes reported by the employer during a lookback period, which is the 12-month period ending on June 30 of the preceding calendar year.

No deposits. Employers with less than \$1,000 for a calendar quarter do not have to make deposits. Instead, employers may send their tax payments directly to the IRS along with their Forms 941.

Once-a-month depositors. Employers whose employment taxes are \$50,000 or less during the lookback period are required to make their deposits once a month. Each month's deposit is due the 15th day of the following month.

Twice-a-week depositors. An employer with more than \$50,000 of employment taxes during the lookback period is required to make its deposits up to twice a week, depending on when and how often it has paydays.

Next-business-day depositors. Whenever an employer's cumulative employment tax liability reaches \$100,000 within a single deposit period, it becomes liable to make deposits on the following banking day.

Penalties for failure to deposit

To avoid penalties, tax depositors must make their payments in full, on time, and in the right manner. There is a four-tier penalty rate structure for failures to make deposits. This penalty structure is designed to reward timely, voluntary correction of deposit shortfalls and/or quick compliance with IRS payment demands. The applicable penalty rates are as follows:

Tier 1: 2 percent if a taxpayer corrects a late or underdeposited amount within 5 days after the due date of the return on which it takes credit for the deposit.

Tier 2: 3 percent additional (5 percent overall) on late or short deposits that a taxpayer corrects more than 5 days after the return due date, but within 15 days.

Tier 3: 5 percent additional (10 percent overall) on late or short deposits that a taxpayer corrects more than 15 days after the return due date.

Tier 4: 5 percent additional (15 percent overall) on deposits that are not made within 10 days after the IRS issues a delinquency notice.

**The Internal Revenue Service Can Help Small Businesses Save Millions of Dollars
in Failure to Deposit Penalties**

(b)(3):26 U.S.C. 6103,(b)(7)(E)

Appendix VII

(b)(3):26 U.S.C.
6103,(b)(7)(E)

Detailed Population and Sample Data: Tolerance or Less

(b)(3):26 U.S.C.
6103,(b)(7)(E)

This appendix presents two tables with our specific audit results for each taxpayer characteristic included in the report. These tables show the sample results, the estimated number of occurrences in the population, and the estimated dollars in the population. These estimates are subject to variances based on a statistical "precision measurement."

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6103,(b)(7)(E)

For example, the taxpayer characteristic of "penalty assessed" has [REDACTED] occurrences in our sample of [REDACTED] or [REDACTED] percent of our sample. The characteristic has an estimated occurrence in the population of [REDACTED]. However, this estimate is subject to a variance: the number of occurrences may be more or less than [REDACTED]. The size of the variance is determined by a "precision measurement" which is derived from a mathematical formula. The precision measurement for this characteristic is 4.89 percent; that is, 4.89 percent more or less than [REDACTED] percent of occurrences in the sample. Therefore, the estimated number of occurrences in the population of the taxpayer characteristic of "penalty assessed" is [REDACTED] plus or minus the precision measurement. Another way of stating this variance is that the estimated number of occurrences in the population of the taxpayer characteristic of "penalty assessed" is between [REDACTED] and [REDACTED] occurrences.

(b)(3):26 U.S.C.
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6103,(b)(7)(E)

(b)(3):26 U.S.C.
6103,(b)(7)(E)

Failure to Deposit Penalty Assessments: Occurrences in Sample and Estimates of Occurrences in Population, by Taxpayer Characteristic

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6103,(b)(7)(E)

Taxpayer Characteristic	Population: [REDACTED]		Sample Size: [REDACTED]		Confidence: 90%		Precision: As shown		Average \$ per taxpayer	Estimated \$ in population	Estimated \$ in population with Precision Measurement (PM)	
	Occurrences in sample		Estimated occurrence in population	Estimated occurrence in population with Precision Measurement (PM)			+PM	-PM				
	Count	Count as % of sample		PM	+PM	-PM						
Penalty assessed	(b)(3):26 U.S.C. 6103,(b)(7)(E)											
Penalty paid												
Small business												
Liability for penalty only												
Current no balance due												
Current delinquent status												
1st notice, penalty only												
Subsequent notice: pen only												
Payments processed												
Totals may not equal support due to rounding.												

(b)(3):26 U.S.C.
6103,(b)(7)(E)

**The Internal Revenue Service Can Help Small Businesses Save Millions of Dollars
in Failure to Deposit Penalties**

(b)(3):26 U.S.C. 6103,(b)(7)(E) **Failure to Deposit Penalty Abatements for Reasonable Cause: Occurrences in Sample and Estimates of Occurrences in Population**

Population: [redacted] Sample Size: [redacted] Confidence: 90% Precision: As shown

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Request for Abatement in Writing

IRS decision on request for abatement	Occurrences in sample Count as % of Sample		Estimated occurrence: population population occurrence in Pop.	Est. occurrence in pop. with Precision Measure (PM)			Cost	Estimated occurrence: population occurrence in Pop.	Est. \$ in pop. with Precision Measure	
	Count	% Samp		PM	+PM	-PM			+PM	-PM
Granted	(b)(3):26 U.S.C. 6103,(b)(7)(E)									
Denied	(b)(3):26 U.S.C. 6103,(b)(7)(E)									
Total	(b)(3):26 U.S.C. 6103,(b)(7)(E)									

Request for Abatement by Telephone

Granted	(b)(3):26 U.S.C. 6103,(b)(7)(E)									
Denied	(b)(3):26 U.S.C. 6103,(b)(7)(E)									
Total	(b)(3):26 U.S.C. 6103,(b)(7)(E)									

Total Requests for Abatement in Writing and by Telephone

Granted	(b)(3):26 U.S.C. 6103,(b)(7)(E)									
Denied	(b)(3):26 U.S.C. 6103,(b)(7)(E)									
Total	(b)(3):26 U.S.C. 6103,(b)(7)(E)									

Totals may not equal support due to rounding.