



*While Documentation Was Not Available to
Fully Assess the Return Preparer Program,
Identification and Processing of Preparer
Penalties Can Be Improved*

July 29, 2008

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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.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 29, 2008

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

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

SUBJECT: Final Audit Report – While Documentation Was Not Available to Fully
Assess the Return Preparer Program, Identification and Processing of
Preparer Penalties Can Be Improved (Audit # 200730032)

This report presents the results of our review of return preparer penalties. The overall objective of this review was to determine whether the Return Preparer Program¹ is effectively managed and penalties are appropriate. This review was part of our Fiscal Year 2007 Annual Audit Plan.

Impact on the Taxpayer

One action the Internal Revenue Service (IRS) uses to try to correct unscrupulous preparer behavior is assessing penalties against preparers of inaccurate tax returns. In Tax Year 2005, tax return preparers were used for almost 60 percent of all individual tax returns filed. However, we were unable to review a sufficient number of examination case files to evaluate the Return Preparer Program because many of the files we requested were not provided. Tax and penalty assessments might not be sustained when the IRS cannot obtain the workpapers to identify the basis for the assessment if the taxpayer or preparer files an appeal or claim. This would result in unfair treatment of taxpayers who file accurate tax returns.

Synopsis

The Internal Revenue Code authorizes use of various sanctions (e.g., preparer penalties) against unscrupulous preparers of tax returns. Preparer penalties apply to instances in which an understatement of tax liability is due to 1) a position that was known—or that reasonably should

¹ Appendix V presents a glossary of terms used in this report.



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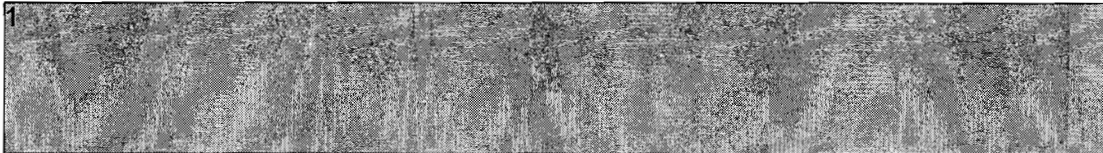
have been known—by the preparer and the position did not meet the applicable legal standard or 2) a willful attempt to understate the tax liability or the reckless or intentional disregard of rules or regulations by the preparer. Preparer penalty cases can involve the examination of an individual tax return or a group of tax returns, referred to as a Program Action Case (PAC). Between January 1, 2004, and February 17, 2007, the IRS assessed penalties totaling \$2.9 million on 525 individual tax return preparers. This represents less than 1 percent of the return preparers identified on individual tax returns examined during the period.

Although we identified several tools used to promote and manage the Return Preparer Program, we were unable to assess the overall effectiveness of the Program. Specifically, we were unable to obtain and review an adequate number of closed examination or penalty case files to reach conclusions on some of our audit tests.

IRS files maintenance was the subject of a report recently issued by the Government Accountability Office.² The report noted that 10 percent to 14 percent of the case files requested were not provided in 2 prior audits the Government Accountability Office had conducted, and that 19 percent were not provided in 1 audit conducted by the Treasury Inspector General for Tax Administration. In this review, the percentage of files not provided was even higher (59 percent of the examination case files without a return preparer penalty, and 80 percent of the examination case files with a return preparer penalty). The IRS needs to determine the cause of the problem and take corrective action, as recommended by the Government Accountability Office.

While we were unable to assess the overall effectiveness of the Return Preparer Program, we did identify some conditions in our sample cases that warrant management's attention. When preparer penalty cases are not adequately considered or opened, preparer misconduct might not be identified and penalized, and management might not have the information necessary to identify patterns of noncompliance and initiate PACs. We reviewed 17 cases without penalties and determined that:

- Three cases had apparent preparer violations, but preparer penalties were not pursued.
- Eight cases did not include required documentation in the workpapers that a preparer penalty case was not warranted.



² *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* (GAO-07-1160, dated September 2007).



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In May 2008, the IRS made changes to its Embedded Quality Review System. These changes will help the IRS determine the extent to which penalties are not considered or documented and to take the appropriate corrective actions.

We also reviewed 10 cases with penalties assessed. While we believe that the penalties assessed against the preparers were warranted in the 10 cases, we noted that:

- 8 of the 10 cases did not appear to have been reviewed by the Return Preparer Coordinator.
- 3 of the 10 cases included inappropriate comments about the preparer that could indicate that the preparer might be subject to a penalty investigation.

In addition to examination cases, we reviewed 30 PACs in 2 Area Offices. These files were physically located at the offices we visited, so we were able to obtain all the cases in the sample. Many of the procedures were properly followed, including decisions to open cases, properly notify the preparers, and effectively communicate and coordinate between the involved parties. However, we identified 8 PACs for which more than the allowed number of tax returns was included in the initial sample and 11 PACs for which the Return Preparer Coordinator did not determine how to proceed with the PAC in a timely manner. During our review, the IRS made changes to its procedures that addressed these issues on the PACs.

In addition, one Area Office did not maintain logs of activity or key events in PAC administrative files. Activity logs help provide for more efficient use of resources when 1) the PACs are included in an operational review and 2) a newly appointed Return Preparer Coordinator takes over the administration of an ongoing PAC.

Recommendations

We recommended that the Director, Examination, Small Business/Self-Employed Division, 1) ensure that Embedded Quality Review System data relating to preparer penalties are analyzed to determine the extent of instances when preparer penalties are not considered and asserted and take necessary corrective action, 2) remind examiners about the importance of keeping preparer penalty information separate from client examination workpapers, and 3) ensure that all Area Offices adopt a means of documenting key events for each PAC.

Response

IRS management agreed with our recommendations. The Director, Examination, Small Business/Self-Employed Division, will ensure that:

- An analysis of Embedded Quality Review System data relating to return preparer penalties is conducted to determine the extent of instances when preparer penalties are



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not considered and asserted and take appropriate corrective actions based on the results of the analysis.

- A reminder is issued to examiners regarding the importance of separating preparer penalty information from client examination workpapers.
- All Area Directors provide confirmation that their Return Preparer Coordinators are following procedures for documenting key events for each PAC within their Areas.

However, management was concerned that the measurable benefits on tax administration shown in Appendix IV of this report might be overstated. They believed that further analysis of the facts and circumstances surrounding the preparers' actions would be required to estimate the number of penalties that would have applied. Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment

While we recognize that an examiner might determine that a penalty should not be asserted after conducting a penalty investigation in the cases we included in Appendix IV, no penalty investigations were conducted in these cases. Therefore, we did not adjust the potential outcome measures included in this report.

Copies of this report are also being sent to IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.



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Abbreviations

GAO	Government Accountability Office
IRS	Internal Revenue Service
PAC	Program Action Case
RPC	Return Preparer Coordinator



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Background

In Tax Year 2005, tax return preparers were used for almost 60 percent of all individual tax returns filed. The Internal Revenue Service (IRS) has identified unscrupulous preparers, often when examining a preparer's client tax returns. These examinations identify adjustments to the client's tax liability due to items such as inflated expenses or deductions and unreported income. Understatement of tax liability is a contributing factor to the tax gap,¹ which has been estimated to be about \$345 billion per year, with individual underreporting totaling \$197 billion.²

The Internal Revenue Code authorizes use of various sanctions (e.g., preparer penalties) against unscrupulous preparers of tax returns. The penalties apply to instances in which an understatement of tax liability is due to 1) a position that was known—or that reasonably should have been known—by the preparer and the position did not meet the applicable legal standard (\$250 penalty per return during the time period covered by our review) or 2) a willful attempt to understand the tax liability or the reckless or intentional disregard of rules or regulations by the preparer (\$1,000 penalty per return during the time period covered by our review).³ The preparer penalty amounts increased to, respectively, \$1,000 and the higher of \$5,000 or 50 percent of the income derived by the return preparer of the tax return for tax returns prepared after May 25, 2007. Because these penalties are assessed per return, the total amount of the penalty can quickly escalate when a preparer penalty case involves multiple years for each taxpayer and many taxpayers. Other sections of the Internal Revenue Code authorize assessment of additional penalties related to return preparers, but our report addresses only the two mentioned above.

Penalty cases are initiated within the Examination function to determine if the preparer should be subject to a penalty or other sanction. These cases can be initiated based on examination of an individual tax return or a group of tax returns.

A group of tax returns prepared by one tax return preparer being examined under the coordination of the Area Office Return Preparer Coordinator (RPC) is referred to as a Program Action Case (PAC). Initiation of a PAC requires the approval of the Area Office Director. Generally, no more than 30 client tax returns should be included in the initial PAC sample to determine if there is a trend of errors by the preparer.

Initiation of a penalty case against a preparer based on examination of a client tax return that is not part of a PAC must be approved by the group manager. The RPC should be advised of the

¹ Appendix V presents a glossary of terms used in this report.

² Individual underreporting includes underreported income and overstated deductions and exemptions on tax returns of individuals.

³ Internal Revenue Code Sections 6694(a) and (b).



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case and its result, but he or she does not provide the same degree of coordination as with PACs. We will refer to these as preparer penalty cases.

The IRS has implemented various types of procedures for working PACs and preparer penalty cases. PAC procedures effective during our review were provided in an interim guidance memorandum issued on February 18, 2005, and in the Preparer/Promoter Penalties section of the Penalty Handbook in the Internal Revenue Manual. Procedures for opening and processing preparer penalty cases were also in the Penalty Handbook. Step-by-step instructions for these cases were maintained in a document on the Return Preparer webpage of the IRS Intranet at the time of our review. On February 1, 2008, the IRS issued a new section of the Internal Revenue Manual that describes RPC duties and responsibilities.

As a result of PACs and preparer penalty cases, the IRS assessed penalties totaling \$2.9 million on 525 individual return preparers from January 1, 2004, through February 17, 2007.⁴ This represents less than 1 percent of the return preparers identified on individual tax returns examined during the period. As of February 17, 2007, 220 of the 525 preparer accounts still had a balance due, and 38 contained indicators that the amounts were currently not collectible. In 80 of the 220 cases, the most recent penalty assessment occurred prior to January 1, 2006.

This review was performed at the Small Business/Self-Employed Division Area Office Examination function Planning and Special Programs function offices in Chicago, Illinois; Philadelphia, Pennsylvania; and St. Paul, Minnesota, during the period May through December 2007. 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. Except as noted below, we believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Our scope was limited in two areas because we were unable to obtain all of the case files requested. This includes our reviews of preparer penalty case files for which preparer penalties were assessed and examinations in which no preparer penalties were assessed. As a result of the limitations, we will report only those observations made on the limited number of cases reviewed. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁴ These figures include only those penalties relating to Internal Revenue Code Sections 6694(a) and (b).



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Results of Review

National and Area Office Personnel Have Tools in Place to Promote and Manage the Return Preparer Program

The Return Preparer Program National Analyst and the RPCs located in Area Offices have communication channels in place to remain informed of current issues and have procedures to educate revenue agents and tax compliance officers about preparer penalties. For example:

- The National Analyst holds monthly conference calls with Area Office RPCs. This facilitates information sharing and provides a means for the National Analyst to discuss trends identified during operational reviews and visitations.
- The National Headquarters staff conducts reviews and assistance visits to Area Offices. These actions provide the National Analyst with information on the effectiveness of the Program and processes that need improvement.
- The RPCs participate in group meetings in the two Area Offices we visited. These meetings provide opportunities to increase the awareness of preparer penalties and to instruct examiners about preparer penalty requirements and procedures.
- The RPCs in the two Area Offices we visited were available to provide advice to revenue agents and tax compliance officers regarding preparer activity. This is helpful to examiners because preparer penalty cases are not worked as often as routine taxpayer examinations, and examiners might need to be reminded of the requirements and procedures.
- The RPCs submit quarterly status reports for open and closed PACs and preparer penalty cases in their Area Offices. The National Analyst uses the input to identify Area Offices to visit for operational reviews and prepares a national report to measure the Program as a whole.
- A Return Preparer webpage on the IRS Intranet contains links to reference materials and other essential information that examiners can use to obtain information about preparer penalty cases.

In addition, the IRS is in the process of developing a Servicewide Return Preparer Strategy. The goal of the Strategy is to enhance tax administration through collaboration with return preparers, by providing clear guidance and support while ensuring compliance with the tax laws.



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While the IRS has many tools in place to promote and manage the Return Preparer Program, we were unable to assess the overall effectiveness of the Program. Specifically, we were unable to obtain and review an adequate number of closed examination or penalty case files to reach conclusions for some of our audit tests.

Closed Examination and Penalty Case Files Were Not Always Provided

IRS files maintenance was the subject of a report recently issued by the Government Accountability Office (GAO).⁵ The report noted that 10 percent to 14 percent of the case files requested were not provided in 2 prior audits the GAO had conducted, and that 19 percent were not provided in 1 audit conducted by the Treasury Inspector General for Tax Administration. In our current review, the percentage of files not provided was even higher. Specifically:

- 30 (59 percent) of 51 sampled examination case files without a return preparer penalty were not provided. We eliminated 4 of the 21 cases provided because the examinations were conducted via correspondence, or there was no direct contact with the taxpayer or preparer, which left just 17 cases without penalties for our review.
- 39 (80 percent) of 49 sampled examination case files with a return preparer penalty were not provided, which left just 10 penalty cases for our review.

While we requested the samples of examination case files multiple times from storage files using routine procedures and special requests through IRS management, we never received the examination case files. National Headquarters and Area Office return preparer personnel advised us that they also have had difficulty obtaining closed penalty case files. The GAO determined that the IRS does not have sufficient data with which to assess the performance of its paper case file management processes or to identify the reasons why case files cannot be located. The IRS responded to the GAO report that it would form a study group to address the issue. IRS management advised us that their study will include all types of case files, including penalty case files. Therefore, we made no recommendation for this area.

It is important for the IRS to determine the cause of the problem and take corrective action. In addition to workpapers explaining the IRS' reasoning for assessing penalties or additional tax, examination case files routinely include the original tax returns filed by the taxpayers. When the IRS cannot obtain the workpapers to identify the basis for an assessment, additional tax and penalty(ies) might not be sustained if the taxpayer or preparer files an appeal or claim. This would result in unfair treatment of taxpayers who file accurate tax returns.

⁵ *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* (GAO-07-1160, dated September 2007).

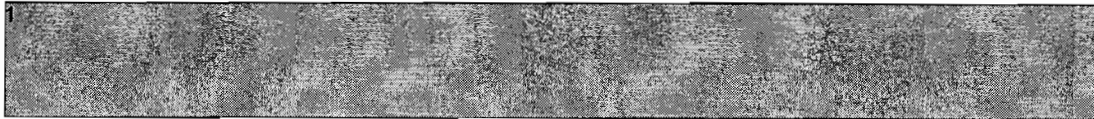


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Examiners Did Not Always Adequately Consider Preparer Penalties or Follow Preparer Penalty Procedures During Examinations

Although we were unable to assess the overall effectiveness of the Return Preparer Program, we did identify some conditions in our sample cases that warrant management's attention. Examiners are required to consider preparer violations in every field and office examination. When an examiner believes that a preparer violation exists, he or she should open a preparer penalty case to determine if sanctions against the preparer are warranted. When it is determined that there is no preparer violation, the examiner should document the case file accordingly. However, examiners are also cautioned that the applicability of any penalties related to the return preparer should be separated from the taxpayer's (client's) case file. Our review of 17 examination cases for which no penalty was assessed showed that these procedures were not always followed. For example:

- Three cases had apparent preparer violations, but preparer penalties were not pursued.⁶ The examination issues (net operating loss carryover, gross receipts, and itemized deductions) were not obscure and did not involve controversial sections of the Internal Revenue Code. The adjustments to the issues on these cases resulted in increases in total tax of between \$23,000 and \$71,000. Appendix VI presents further explanation of the issues in the three cases.
- Eight cases did not include required information in the workpapers that a preparer penalty case was not warranted. Documenting consideration of the preparer penalty is one means of getting examiners to consider the need for a preparer penalty during examinations of client tax returns. In the remaining cases, the consideration was generally noted on the penalty approval form workpaper, which has checkboxes to indicate whether the preparer penalty was considered.



When preparer penalty cases are not adequately considered or opened, preparer misconduct might not be identified and penalized, and RPCs might not have the information necessary to identify patterns of noncompliance and to initiate PACs.

The RPCs in the two Area Offices we visited believe that there is some reluctance to initiate preparer penalty cases because of the time involved to complete the examinations and the potentially conflicting priority of needing to initiate other examinations that help fulfill the Examination Plan. However, because we were unable to review a sufficient number of cases, we

⁶ These cases are included in Appendix IV.



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could not determine if there were trends that identified more specific reasons why penalty cases were not pursued and files were not documented.

We reviewed the Embedded Quality Review System to obtain additional information regarding the assessment of preparer penalties. Although the System captured data regarding penalties overall, specific information relating to preparer penalties was not available. However, in May 2008, the IRS added a reason code to the penalty attribute regarding consideration and assertion of preparer penalties. This information could be useful to determine how often penalties are not considered or documented and to identify the possible reasons.

Recommendation

Recommendation 1: The Director, Examination, Small Business/Self-Employed Division, should ensure that Embedded Quality Review System data relating to preparer penalties are analyzed to determine the extent of instances when preparer penalties are not considered and asserted and take necessary corrective action.

Management's Response: IRS management agreed with the recommendation. The Director, Examination, Small Business/Self-Employed Division, will ensure that an analysis of Embedded Quality Review System data relating to preparer penalties is conducted to determine the extent of instances when preparer penalties are not considered and asserted. Appropriate corrective action will be determined and implemented based upon the results of this analysis.

However, management was concerned that the measurable benefits on tax administration might be overstated. They believed that further analysis of the facts and circumstances surrounding the preparers' actions would be required to estimate the number of penalties that would have applied.

Office of Audit Comment: While we recognize that an examiner might determine that a penalty should not be asserted after conducting a penalty investigation, no penalty investigations were conducted in these cases. Therefore, we did not adjust the potential outcome measures included in Appendix IV.

Return Preparer Coordinators Did Not Always Review Preparer Penalty Case Files, but Penalties Assessed Were Warranted

Although we were able to obtain case files for only 10 of the 49 sampled preparers that had a penalty assessed, we saw an indication that many procedures were followed. For example:

- The group manager's approval was obtained for initiating the preparer penalty case.
- Statutes were being observed to protect the assessment.



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- Applicable copies of the client tax return and examination workpapers were included in the case files to support the reason for opening the preparer penalty case.
- Preparers were referred to the Office of Professional Responsibility when appropriate.

Because the number of preparer penalty cases available for our review was limited, we could not determine if these procedures were followed in the majority of cases. However, we identified the following conditions that warrant management's attention:

- 8 of the 10 case files did not contain an indication that the RPC had reviewed the case.
- 3 of the 10 case files included copies from client examination workpapers that contained inappropriate comments about the preparer that could indicate the preparer might be subject to a penalty investigation.⁸ This is the same condition that we observed in one of the cases without penalties.

While we believe that the penalties assessed against the 10 preparers were warranted, when the cases are not subject to quality review, the RPCs might not have adequate information with which to identify patterns of noncompliance and initiate PACs.

Procedures for preparer penalty cases on the Return Preparer webpage of the IRS Intranet require that all preparer penalty cases be reviewed by the RPC. In addition, an interim guidance memorandum issued in August 2005 made group clerks responsible for sending the closed cases to the RPC and explaining RPC responsibilities for reviewing the cases. However, Internal Revenue Manual procedures that existed when the cases included in our review were processed were not clear on the subject and could even have appeared to contradict procedures on the webpage and in the interim guidance. The IRS revised the Internal Revenue Manual on February 8, 2008, to clarify the requirement to forward penalty case files through the RPC for review. Therefore, we made no recommendation in this area. The National Analyst and RPCs should continue to monitor the process to ensure that the revised procedures are effective.

In addition, the procedures on the IRS webpage and in the Internal Revenue Manual include a caution that all information on a return preparer's activities and the applicability of any penalties relating to the return preparer should be separated from the taxpayer's (client's) case file. We did not contact the examiners to determine why they included the comments on preparers in the client workpapers. However, the fact that a preparer penalty was being considered for the preparers of client tax returns could inadvertently be disclosed to the client taxpayers if they requested and obtained copies of their examination workpapers.

⁸ These cases are included in Appendix IV.



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Recommendation

Recommendation 2: The Director, Examination, Small Business/Self-Employed Division, should issue a reminder to examiners about the importance of keeping preparer penalty information separate from client examination workpapers.

Management's Response: IRS management agreed with the recommendation. The Director, Examination, Small Business/Self-Employed Division, will ensure that a reminder is issued to examiners regarding the importance of separating preparer penalty information from client examination workpapers by publishing in the *Technical Digest* an article that includes a link to the Return Preparer Program web site where detailed information is contained regarding case procedures.

Management Implemented Many Controls and Procedures for Program Action Cases, but Some Improvements Can Be Made

Our review of 30 PACs physically located in 2 Area Offices identified many controls and procedures in place to ensure an effective PAC process. For example:

- The RPCs performed adequate research on preparers to ensure that PACs were initiated on preparers when there were indications that the tax shown on the tax return was understated or a refund was overstated.
- Although the Area Offices did not conduct formal Penalty Steering Committee meetings to discuss and recommend PACs, they routed the PAC memoranda to critical personnel who would comprise a steering committee to obtain their concurrence before requesting the Area Office Director's approval. In addition, the Lead Development Center was notified of proposed PACs to avoid a potential duplication of efforts.
- When appropriate, the preparers were notified of the initiation of a PAC.
- Fact sheets or information memoranda were included with the examinations sent to the groups so the examiners would be aware of the types of questionable issues identified for the preparer.
- PACs were generally assigned to tax compliance officer groups, and tax returns for each preparer were assigned to one group. This helped to ensure efficiency and consistency within the PAC.
- Individual tracking codes were used for each project so the status of the examinations could be monitored through management information reports.



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However, management can make improvements in how Area Offices identify sample sizes, monitor PACs nearing closure to ensure that timely decisions are made, and maintain activity logs in the administrative case files.

PACs included larger initial samples of tax returns for examination than recommended by the procedures

The PAC interim guidance memorandum issued in February 2005 recommends that the initial sample of tax returns identified for examination in PACs should normally consist of no more than 30 tax returns prepared by the preparer (client tax returns). The RPCs are to monitor the results of the initial sample to determine if additional examinations are warranted.

Eight of the 30 PACs we reviewed in the 2 Area Offices included more than 30 client tax returns (80 returns to 141 returns) in the initial samples for examination, but the PAC memoranda did not contain justification for the larger sample sizes. Additional PACs contained more than 30 tax returns, but the increased sample sizes for most were either justified in the PAC memoranda or approved prior to issuance of the guidance limiting the initial sample size.

While the PAC interim guidance memorandum provides for limiting the initial sample size, the Internal Revenue Manual in effect when the PACs were initiated was vague on the subject. It provided that the RPC will requisition an “appropriate” sample of tax returns prepared by the subject preparer and that a sample of returns will be examined after PAC approval.

The Criminal Investigation Division also issued procedures on requests for assistance in opening PACs on questionable preparers and included the provision that the initial sample be limited to 30 client tax returns. The memorandum allowed for requesting additional cases in the initial sample under special circumstances when justification was provided. These assistance PACs often include more than 30 client tax returns to establish the trend and dollar harm to the Federal Government for the Criminal Investigation Division to move the cases forward for prosecution.

The RPC in 1 Area Office misinterpreted the procedures and believed that the Area Office could include an initial sample of up to 60 client tax returns: the 30 returns provided for by the routine PAC procedures plus an additional 30 returns provided for by the Criminal Investigation Division procedures when initiating assistance PACs. This Area Office initiated four of the eight PACs in which larger initial samples were identified for examination. The Area Office is now aware that the initial sample should include only 30 tax returns regardless of the source of the PAC, unless a larger sample is formally requested and approved.

The examination of more tax returns than required, particularly by field examiners, could result in ineffective use of Examination function resources. The IRS was revising the Internal Revenue Manual during our review. The revision was issued on February 8, 2008, and clarified the sample size requirement for PACs. Therefore, we made no recommendation for this issue.



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RPCs did not determine how to proceed with PACs in a timely manner

The examinations were completed or substantially completed on 11 of the 30 PACs prior to our review, but the RPCs were not monitoring the PACs to ensure that timely decisions were made. Management information system reports showed that all or almost all examinations of the client tax returns were completed 1 month to 15 months (an average of 6 months) prior to our visit or the date the PAC was closed. However, the RPCs did not start the closing process in a timely manner, including actions such as determining whether penalties should be assessed or contacting the Examination function groups or the Criminal Investigation Division to discuss the results of the examinations or the status of the criminal investigation on the preparers for these PACs. The RPC staffs initiated these actions on some of the PACs while we were reviewing the PAC or when we asked about the current status of the PAC.

The RPCs we contacted advised us that they have overall responsibility to monitor ongoing PACs. However, little written guidance for monitoring ongoing PACs existed. The Internal Revenue Manual made RPCs responsible for coordinating “all” Examination function activity on income tax returns prepared by return preparers approved for program action (i.e., a PAC) by the Area Office Director. Procedures specifically relating to PACs included information for identifying preparers that should be included in a PAC and getting client tax returns in the examination stream but were silent on monitoring while the PACs were in process. The procedures then skipped to responsibilities for monitoring preparers after actions such as assessing penalties were completed.

Interim guidance was also silent on monitoring ongoing PACS. It required RPCs to monitor the results of the initial sample cases and, upon conclusion of the examinations, to determine whether the results warranted additional examinations. The guidance then continued with procedures for requesting examinations of additional client tax returns.

Untimely decisions about the results of PACs can 1) lead to ineffective use of resources when the results of the examinations do not support allegations about the preparer or 2) allow the preparer to remain unpenalized when the examinations support the allegations about the preparer.

In February 2008, the IRS issued a revision to the existing Internal Revenue Manual section and also added a new section describing the duties and responsibilities of the RPCs. The sections added specific monitoring requirements for the RPCs during ongoing PACs, including a provision to contact the Examination function group manager at least monthly to discuss the progress of each PAC and the need to consider closing the PAC if client returns are found to be substantially correct or the issues of concern are not found. These newly issued Manual sections fully address our concerns with monitoring ongoing PACS. Therefore, we made no recommendation for this issue. Future reviews of the Return Preparer Program by the IRS should determine whether the provisions added to the Internal Revenue Manual are being followed.



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One Area Office did not maintain logs of activity or key events in PAC administrative files

One Area Office maintained 1) an electronic file to record key events and decisions reached for each PAC and 2) a sheet in the front of the file to document dates when key events occurred. However, the other Area Office we reviewed did not maintain any type of log or record of key events or decisions.

Existing procedures do not require recordation of activities on PACs. However, documentation of this type would provide an appropriate means for recording the monitoring activities and meet the general internal control standards for the Federal Government.⁹ These standards require that “Information should be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities.”

Activity records would be especially helpful in the PACs because PACs can be ongoing for some time and the RPC position is intended to be a rotational assignment lasting approximately 3 years. Many of the PACs we reviewed were initiated prior to Calendar Year 2006 and were still ongoing. Some of the PACs were initiated by a prior RPC, and others will still be underway when current RPCs move to different positions. Activity records would help provide for more efficient use of resources, not only when the PACs are included in an operational review but also when a newly appointed RPC takes over the administration of an ongoing PAC.

Recommendation

Recommendation 3: The Director, Examination, Small Business/Self-Employed Division, should ensure that all Area Offices adopt a means of documenting key events for each PAC.

Management’s Response: IRS management agreed with the recommendation. The Director, Examination, Small Business/Self-Employed Division, will ensure that all Area Directors provide confirmation that their RPCs are following Return Preparer Penalty procedures for documenting key events for each PAC within their Areas.

⁹ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, dated November 1999).



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Return Preparer Program¹ is effectively managed and penalties are appropriate. However, we could not fully accomplish our audit objective because we were unable to obtain a sufficient number of preparer penalty case files and examination workpapers for review.

To review the appropriateness of preparer penalties assessed, we obtained a Master File extract of Master File Tax Account Code 55² accounts with a Transaction Code 240³ that posted from January 1, 2006, through February 17, 2007, with a Reference Number 622, 645, 646, or 650.⁴ The extract produced a universe of 671 Transaction Codes 240 on 232 preparers. While they did not have exact numbers for comparison, IRS personnel advised us that the number of penalties we identified seemed appropriate. Due to the small universe of cases, we used the judgmental sampling technique and decided on a sample size of 30 preparer penalty cases. We randomly identified a sample of 49 preparers to try to obtain 30 cases for review. However, we were able to obtain case files for only 10 cases. To validate our data, we researched the sample of 49 preparer cases on the Integrated Data Retrieval System and determined that the cases identified in the data extract were preparer penalties assessed under Internal Revenue Code Sections 6694(a) and (b) with the correct transaction dates and dollar amounts.

To identify examinations without a preparer penalty assessed, we obtained from the Examination Operational Automation Database a download of examinations closed from January 1, 2004, through June 20, 2007, for which a preparer was shown in the Database. We were advised by IRS personnel that the examiners do not always enter a preparer in this Database, so the data might be incomplete. Therefore, we did not attempt to validate these data.

The Examination Operational Automation Database output contained 328,779 examinations for 131,661 unique preparers. We then performed queries to identify cases 1) without penalties, 2) with issues that commonly result in assessment of a preparer penalty, and 3) with an assessment of more than a specified amount.

The resulting universe included 4,530 examinations for 3,939 unique preparers. Because IRS personnel advised us that the data might not be complete, we used the judgmental sampling

¹ Appendix V presents a glossary of terms used in this report.

² A code used to designate accounts of individuals that have miscellaneous penalty assessments.

³ A code used to input an assessment of miscellaneous penalties. The reference number with the transaction code identifies the type of penalty.

⁴ These reference numbers represent preparer penalty assessments made under the authority of Internal Revenue Code Sections 6694(a) and (b).



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technique and decided on a sample size of 30 examination cases. We randomly identified a sample of 51 cases to try to obtain 30 cases for review. However, we were able to obtain case files for only 21 of the 51 examinations. While reviewing the 21 case files, we eliminated an additional 4 cases because the contacts were made via correspondence or there had been no contact with the taxpayer or preparer during the examination. We reviewed the remaining 17 case files.

To identify PACs to review, we obtained a list of the 262 open and closed PACs initiated by the Midwest and Central Area Offices from January 1, 2004, through July 19, 2007. To select PACs for review that appeared to have had sufficient work completed to assess, we used the judgmental sampling technique and selected the PACs based on the number of client examinations either in process or closed and discussions with the RPCs concerning the status of the PACs. The sample included 15 PACs from each Area Office.

To accomplish our audit objective, we:

- I. Evaluated oversight provided to the Return Preparer Program.
 - A. Reviewed visitation and assistance reports and teleconference notes to determine oversight provided for the Program on a national level.
 - B. Discussed how National Headquarters and Area Office quarterly management information systems statistical reports are prepared and used.
 - C. Determined local emphasis placed on the Program by reviewing the RPCs' educational outreach schedules and training material.
 - D. Identified local procedures used by the RPCs to determine whether the procedures are consistent with national procedures/policies.
- II. Determined whether questionable practices by preparers were being identified. We could not fully complete this sub-objective because of the scope limitation.
 - A. Reviewed copies of questionnaires prepared by the National Headquarters Analyst to determine whether the use of preparer penalties is encouraged.
 - B. Determined RPC procedures for reviewing files/referrals, identifying trends and actions taken once identified, and concerns with obtaining referrals from groups. Also, we held discussions with examiners to determine their awareness of a preparer investigation when examining a selected tax return not associated with a PAC or preparer penalty case and whether they become aware of prior issues once the PAC or preparer penalty case is closed and penalties are imposed.
 - C. Reviewed the sample of 17 examinations in which there was no preparer penalty assessed to determine whether preparer penalties were considered when appropriate and case files were properly documented.



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- III. Determined whether preparer penalties assessed were appropriate. We could not fully complete this sub-objective because of the scope limitation.
 - A. Reviewed the sample of 10 penalty case files identified from the Master File extract to determine whether procedures were followed and penalty criteria were correctly and consistently applied.
 - B. Reviewed the preparer accounts on the Integrated Data Retrieval System to determine the current status of the penalty payment and whether the penalties were properly posted to the accounts.
- IV. Determined whether PACs were properly approved and controlled.
 - A. Reviewed the sample of 30 PACs (15 from the Midwest Area Office and 15 from the Central Area Office) to determine whether:
 - 1. Preparer issues for the proposed PACs were discussed with appropriate personnel of other functions and the PACs were properly approved prior to initiating the PAC examinations or expanding the sample of examinations.
 - 2. Examinations were initiated promptly to allow for timely determinations about preparer penalties and RPCs were actively monitoring the progress of the PACs.
 - 3. Applicable sanctions were pursued by the RPCs if the examinations did not result in penalty assessments and decisions to close the PACs were appropriate.
- V. Determined the adequacy of efforts to monitor preparers after penalties were applied and to educate preparers about the effects of noncompliance.
 - A. Held discussions with the RPCs to determine the extent of their efforts to:
 - 1. Monitor preparer behavior after a penalty was assessed.
 - 2. Monitor preparer accounts for correct posting and payment of the penalties.
 - 3. Coordinate with other functions regarding preparer penalty issues.



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Appendix II

Major Contributors to This Report

Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Carl L. Aley, Director

Parker F. Pearson, Director

Amy L. Coleman, Audit Manager

Joseph P. Snyder, Lead Auditor

Lawrence R. Smith, Senior Auditor

Chanda L. Stratton, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Communications, Liaison, and Disclosure SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
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 Liaison: Deputy Commissioner, Small Business/Self-Employed Division SE:S:E



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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 Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; 3 taxpayer (preparer) accounts totaling at least \$750 (see page 5).

Methodology Used to Measure the Reported Benefit:

We selected a judgmental sample of 17 taxpayers (preparers' clients) from a universe of 3,939 for whom there was a preparer shown for the tax return and on which no preparer penalty was assessed.

A preparer penalty might have been warranted in 3 of the 17 cases on which no preparer penalty was assessed. The penalty in each case would be at least \$250, depending on the type of penalty proposed. We could not determine the exact penalty amount that would have been proposed because the preparers were not contacted by the examiners to discuss potential preparer penalties.

Type and Value of Outcome Measure:

- Taxpayer Privacy – Potential; four taxpayers (preparers) affected (see pages 5 and 6).

Methodology Used to Measure the Reported Benefit:

We selected judgmental samples of 27 taxpayers (preparers' clients) for whom there was a preparer shown for the tax return (10 on which a preparer penalty was assessed, and 17 on which no preparer penalty was assessed). The universes were 671 and 3,939, respectively. Our review of the examination workpapers identified four cases containing comments that the preparer was negligent, was a problem preparer, or should be referred to the RPC. This information about the preparers could be disclosed to the taxpayers if they requested a copy of their examination workpapers.



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Appendix V

Glossary of Terms

Area Office – A geographic organizational level used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.

Criminal Investigation Division – A function in the IRS that investigates potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law.

Embedded Quality Review System – A quality review function within the IRS that measures performance against attributes that are designed to identify actions that move the case toward resolution through appropriate and timely actions. The attributes were designed to measure adherence to existing guidelines.

Examination Operational Automation Database – An Examination function database providing the ability to track examination results by issue.

Integrated Data Retrieval System – The IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Internal Revenue Manual – The official source of information on policies and procedures for use by all IRS offices.

Lead Development Center – A function in the IRS that centralizes the receipt and development of leads on abusive tax schemes and promoters.

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

Office of Professional Responsibility – A function in the IRS that administers the laws and regulations governing the practice of tax professionals before the Department of the Treasury and the IRS.

Penalty Steering Committee – A group formed to identify patterns of preparer abuse and recommend the initiation of projects on potentially abusive return preparers. Members can include Planning and Special Programs function representatives, a representative designated by the Area Director, and a Criminal Investigation Division representative.

Planning and Special Programs – A function responsible for planning, ordering, and delivering tax returns for examination to the field examination groups.

Preparer Penalty Case – The examination of a preparer's client's tax return that is not part of a Program Action Case.



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Program Action Case – The examination of tax returns prepared by one preparer or preparer firm when information indicates a pattern of noncompliance with the Internal Revenue Code.

Return Preparer Coordinator – A designated staff member from the Planning and Special Programs function responsible for coordinating all aspects of the Return Preparer Program.

Return Preparer Program – A program that allows for the examination of tax returns prepared by a particular preparer if information indicates that a pattern of noncompliance exists. The examinations are useful in identifying erroneous entries on tax returns and determining if penalties are warranted against the tax return preparer.

Revenue Agent – An employee in the Examination function who conducts examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes.

Tax Compliance Officer – An employee in the Examination function who primarily conducts examinations of individual taxpayers through interviews at IRS field offices.

Tax Gap – The difference between what taxpayers should have paid in tax and what they actually paid on time.



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Appendix VI

Cases for Which Preparer Penalties Might Have Been Warranted

The following information is from the examination case files we reviewed. We believe that preparer penalties were warranted. However, no preparer penalties were assessed.

Main Adjustment Issue	Total Adjustment Amount	Total Tax Adjustment	Explanation of Case
Long-Term Capital Loss Carryover	1		
Profit or Loss From Business (Schedule C) Gross Receipts			
Itemized Deductions			



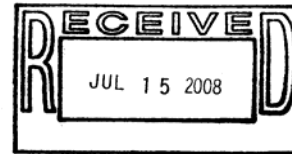
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Appendix VII

Management's Response to the Draft Report



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



July 14, 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak *Kathy K. Petronchak*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – While Documentation Was Not Available to Fully Assess the Return Preparer Program, Identification and Processing of Preparer Penalties Can Be Improved (Audit # 200730032)

Thank you for the opportunity to review and comment on your draft report titled, "While Documentation Was Not Available to Fully Assess the Return Preparer Program, Identification and Processing of Preparer Penalties Can Be Improved". I appreciate your observations regarding the important role of return preparers in tax administration and the impact return preparer penalties can have on unscrupulous behavior. I am pleased your report highlighted the corrective actions already taken by the IRS to address issues identified during the course of your review.

We concur with the report's recommendations, but have concerns the measurable benefits on tax administration may be overstated. Further analysis of the facts and circumstances surrounding the preparers' actions would be required to estimate the number of penalties that would have applied. In the cited cases, a number of mitigating factors, including reasonable cause, may have existed that would result in an examiner concluding preparer penalties should not be considered and/or asserted.

I regret return preparer penalty case files were not readily available for your review. As noted in your report, a cross functional team is addressing the issue.

Attached is a detailed response outlining our corrective actions. If you have any questions or concerns, please contact me at (202) 622-0600 or Monica Baker, Director, Examination at (202) 283-2659.

Attachment



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Attachment

RECOMMENDATION 1:

The Director, Examination, Small Business/Self-Employed (SB/SE) Division, should ensure that Embedded Quality Review System data relating to preparer penalties are analyzed to determine the extent of instances when preparer penalties are not considered and asserted and take necessary corrective action.

CORRECTIVE ACTIONS:

We concur with this recommendation. The Director, Examination (SB/SE Division), will ensure an analysis of EQMS data relating to preparer penalties is conducted to determine the extent of instances where preparer penalties are not considered and asserted. Appropriate corrective actions will be determined and implemented based upon the results of this analysis of the EQMS data.

IMPLEMENTATION DATE:

January 15, 2009

RESPONSIBLE OFFICIAL:

Director, Examination Policy (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Exam Policy will monitor the status and advise the Director, Examination of any delays in implementation.

RECOMMENDATION 2:

The Director, Examination, Small Business/Self-Employed Division, should issue a reminder to examiners about the importance of keeping preparer penalty information separate from client examination workpapers.

CORRECTIVE ACTIONS:

We concur with this recommendation. The Director, Examination (SB/SE Division), will ensure a reminder is issued to examiners regarding the importance of separating preparer penalty information from client examination workpapers by publishing an article in the Technical Digest that includes a link to the Return Preparer Program (RPP) website where detailed information is contained regarding RPP case procedures.

IMPLEMENTATION DATE:

January 15, 2009

RESPONSIBLE OFFICIAL:

Director, Examination Policy (SB/SE Division)



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Return Preparer Program, Identification and Processing of
Preparer Penalties Can Be Improved*

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Exam Policy will monitor the status and advise the Director, Examination of any delays in implementation.

RECOMMENDATION 3:

The Director, Examination, Small Business/Self-Employed Division, should ensure that all Area Offices adopt a means of documenting key events for each PAC.

CORRECTIVE ACTIONS:

We concur with this recommendation. The Director, Examination (SB/SE Division), will ensure all Area Directors provide confirmation that their RPP Coordinators are following RPP procedures for documenting key events for each PAC within their Areas. Information regarding the appropriate PAC documentation procedures is located on the RPP website.

IMPLEMENTATION DATE:

October 15, 2008

RESPONSIBLE OFFICIAL:

Director, Examination Policy (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Exam Policy will monitor the status and advise the Director, Examination of any delays in implementation.