Errors in Failure to Pay Penalty Amounts Occur When the Penalty Is Computed Manually

September 2004

Reference Number: 2004-30-184

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 27, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Errors in Failure to Pay Penalty Amounts Occur When the Penalty Is Computed Manually (Audit # 200430007)

This report presents the results of our review of manually computed Failure to Pay (FTP) penalty amounts. The overall objective of this review was to determine whether Internal Revenue Service (IRS) employees manually computed the FTP penalty correctly, and manual computations were limited to only those situations where IRS computers could not make the computation. This review was conducted because of the large number of taxpayer accounts affected, the complexity of the manual FTP penalty computation, and prior IRS error rates for manually calculated interest amounts.

Normally, IRS computer programs automatically calculate the amount of the FTP penalty. However, there are situations where penalties are prohibited or limited to specific periods and must be computed manually by IRS employees. We identified approximately 164,000 manual computations of the FTP penalty during Calendar Years 2001 through 2002. The penalties are computed manually because the calculations contain variables that are not programmed into IRS computers. In these situations, an IRS employee enters a code into the computer to "restrict" the computer from calculating the penalty. Manually performing these complex penalty calculations significantly increases the potential for errors and is very resource intensive. A prior Treasury Inspector General for Tax Administration report[1] discussed significant IRS errors in manual calculations of interest on restricted accounts.

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[1] *The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations* (Reference Number 2002-30-042, dated December 2001).

In summary, IRS is miscalculating restricted FTP penalty amounts and unnecessarily restricting certain accounts. In a sample of 50 taxpayer accounts that were restricted and had manually calculated FTP penalties, 24 percent contained errors in the penalty calculation, were unnecessarily restricted, or both.

In our opinion, several factors contributed to the penalty calculation errors, including the complexity of the calculations and the limited amount of time IRS employees perform such calculations relative to their other work. Most of the accounts restricted in error were Substitute for Return (SFR)[2] accounts. It appears tax examiners are not familiar with the changes that simplified the FTP penalty computation for SFR accounts that allows the computer to perform the computation.

We recommended the Director, Office of Penalties and Interest, consider including the manual computation of the FTP penalty as part of the responsibilities of a centralized group the IRS is forming to quality review restricted interest. If not included, the Director should provide training to IRS employees to ensure the FTP penalty, when manually computed, is accurately calculated. The Director should perform an independent review of SFR accounts to determine if a high percentage of these accounts continue to be unnecessarily restricted and, if so, ensure training is provided that emphasizes the appropriate circumstances for restricting these types of accounts.

Management's Response: IRS management agreed with our recommendations. They stated that a key aspect of having the centralized group handle quality review of the manually computed FTP penalties will be their ability to link this work with the other work performed by the group. Therefore, the Director, Payment Compliance, Small Business/Self-Employed Division, will study whether the manual computation of the FTP penalty could be linked with the centralized group once it becomes functional. In the meantime, efforts will be made to ensure all affected employees receive the necessary training and timely receive the related material for updates and reviews. In addition, the Office of Penalties and Interest will conduct a review of SFR accounts to determine the source of any unnecessary restrictions and, if necessary, will advise the affected employees accordingly. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

[2] A tax return prepared by the IRS showing the tax due for an individual taxpayer who fails to file a return.

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Background

The Internal Revenue Service (IRS) imposes penalties on taxpayers to encourage voluntary compliance with tax laws. Voluntary compliance consists of preparing an accurate return, timely filing that return, and timely paying any taxes due.

A Failure to Pay (FTP) penalty is imposed when (1) any tax due on an original return is not paid by the due date of the return, or (2) the taxpayer is assessed additional tax that was not shown on the original return and does not pay the subsequent assessment within 21 days. The penalty is not imposed if the taxpayer shows the failure to pay was due to reasonable cause and not due to willful neglect.

Generally, the FTP penalty is calculated at 0.5 percent of the unpaid tax for each month the tax remains due, until a maximum penalty of 25 percent of the tax due is reached. There are circumstances when the FTP penalty rate changes. Taxpayers who timely file their returns and enter into installment agreements have the FTP penalty rate reduced from 0.5 percent to 0.25 percent. On the other hand, the rate increases from 0.5 percent to 1 percent when a notice of intent to levy or notice and demand for immediate payment is issued.

Normally, IRS computer programs automatically calculate the amount of the penalty. However, there are situations where penalties are prohibited or limited to specific periods and must be computed manually by IRS employees. They are computed manually because the calculation contains variables that are not programmed into IRS computers. In these situations, an IRS employee enters a code into the computer to "restrict" the computer from calculating the penalty.

A prior Treasury Inspector General for Tax Administration (TIGTA) report[1] discussed significant IRS errors in manual interest calculations on restricted accounts. The IRS agreed to take corrective actions to improve that process. During this current audit, we reviewed the manual calculations of

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[1] *The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations* (Reference Number 2002-30-042, dated December 2001).

the FTP penalty on restricted accounts and determined if they were computed accurately and only restricted when necessary.

This review was performed during the period January through June 2004 through analysis and review of tax return information obtained from the IRS' Business Master File[2] and Individual Master File.[3] The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Taxpayer Accounts With Manually Calculated Failure to Pay Penalties Were Restricted in Error or Calculated Incorrectly

Using a computer program, we identified approximately 164,000 taxpayer accounts that became restricted in Calendar Years 2001 through 2002 and had manually calculated FTP penalties.[4] In a random sample[5] of 50 of these accounts, we found 12 (24 percent) contained errors in the penalty calculation, were unnecessarily restricted, or both.

Penalties calculated incorrectly

Of the 50 accounts reviewed, 9 (18 percent) contained inaccurately computed FTP penalties. For five of the nine accounts, taxpayers had already paid the incorrect amounts and an IRS adjustment would be necessary to correct the error. The other 4, even though miscalculated, had reached the maximum 25 percent penalty amount, so the effect of the IRS employees' errors was negated.

In our opinion, several factors contributed to the IRS employees' penalty calculation errors:

- FTP penalty calculations can be very complex, involving several variables that must be factored into the calculation to obtain the correct penalty amount.

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[2] The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
[3] The IRS database that maintains transactions or records of individual tax accounts.
[4] According to IRS records, approximately 32 million FTP penalties were assessed during Fiscal Years 2001 and 2002.
[5] A non-statistical random sample was selected because resources were not available to review a statistically valid sample.

Specifically, IRS tax examiners must determine the correct date to begin assessing the penalty. These dates may vary depending on the type of account. For example, qualifying taxpayers affected by natural disasters or serving in combat zones receive an extension to file and pay their taxes, extending the FTP penalty start date. Taxpayers in bankruptcy status have the FTP penalty suspended from computation. Also, the FTP penalty rate changes when the taxpayer enters into an installment agreement or receives a notice of intent to levy, or when a notice and demand for immediate payment is issued. In addition, since the FTP penalty is only assessed on the unpaid tax, any other accrued penalties and/or interest must not be included in the calculation.

- Many of the IRS employees calculating penalties do so a relatively small percentage of their work time and do not become skilled in applying the various rules associated with these calculations.
- Many employees in different functions within the IRS work restricted penalty accounts. Decisions regarding employee training and quality control are subject to the views of various IRS managers who may have differing opinions regarding the level of commitment their functions should give these matters.

Inherent in the IRS' mission to apply the tax law with integrity and fairness is the concept to collect the proper amount of money from each taxpayer. If penalty amounts owed by taxpayers are not calculated accurately, the IRS risks collecting too little or too much money from taxpayers whose account balances are calculated in error. The average dollar amounts of the miscalculated penalties in our sample were relatively small. However, the percentage these calculations varied from the correct amount was significant. On average, the IRS computed amount differed from the correct amount by 112 percent.

Our sample was not valid for projecting the overall dollar effect on taxpayers. However, because our accounts were selected at random, it is reasonable to believe similar error rates would apply over the population.[6]

Accounts Restricted in Error

Of the 50 accounts reviewed, 7 were unnecessarily restricted from computing the FTP penalty amount. It is important that only those tax accounts that require manual calculation of penalties be restricted for reasons including the following:

- Manually calculating penalties is very time-consuming. Because FTP calculations can often be very complex, the amount of time needed to perform the calculations can be significant. After an account is restricted, employees must periodically update the penalty calculation manually until the account is full paid or until the maximum penalty of 25 percent of the tax due is reached.
- Manually performing complex penalty calculations significantly increases the potential for errors. Calculation errors can occur when the account is initially restricted or later when the amount of penalty owed is manually updated.

Further review of the seven accounts that were unnecessarily restricted indicated a potential problem with a particular type of account in the sample. Specifically, we found accounts worked by the Substitute for Return (SFR) function,[7] particularly those accounts with return due dates after July 30, 1996, were often unnecessarily restricted. Overall, 26 of 50 accounts reviewed were worked by the SFR function. Of these 26 accounts, 6 had return due dates after July 30, 1996, and 4 of the 6 were unnecessarily restricted.

The Congress enacted changes to the FTP penalty computation for SFR accounts with return due dates after July 30, 1996. Accounts with a return due date prior to this

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[6] The random sample of 50 cases used to estimate the error rate of the population carries a 90 percent confidence level with a precision of plus or minus 9 percent.
[7] The SFR function prepares "substitute" returns for individual taxpayers that fail to file a return.

date still require manual computation of the FTP penalty; however, accounts with due dates after July 30, 1996, can be calculated by the computer.

Even though we cannot reliably project our sample results, there are indications tax examiners are not familiar with the change in the requirements to restrict SFR accounts. Unnecessarily restricting accounts increases both the workload for IRS employees and the opportunity for calculation errors.

Recommendations

Based on a recommendation made in the prior TIGTA report (see page 1), the IRS has committed to limit the quality review of restricted interest to a centralized function known as the Complex Interest Quality Measurement System (CIQMS). This centralization is scheduled to take place in January 2005. Accordingly, the Director, Office of Penalties and Interest, should:

1. Consider including the quality review of the manually computed FTP penalty as part of the responsibilities of the CIQMS. If not included, the Director should ensure all IRS tax examiners calculating penalties are properly trained to manually compute the FTP penalty. The computation of the FTP penalty could be included with the training package developed for computing restricted interest.

<u>Management's Response</u>: IRS management stated that a key aspect of having the centralized group handle quality review of the manually computed FTP penalties will be their ability to link this work with the other work performed by the group. Therefore, the Director, Payment Compliance, Small Business/Self-Employed Division, agreed to study whether the quality review of the manual computation of the FTP could be linked to the CIQMS once it becomes functional. In the meantime, the Office of Penalties and Interest will consult with the appropriate functions responsible for creating the training modules to ensure all affected personnel have received the necessary training and timely receive the related material for updates and reviews.

2. Perform an independent review of SFR accounts with return due dates after July 30, 1996, to determine if, in

fact, a high percentage of these accounts continue to be unnecessarily restricted. If warranted, the Director should then ensure training is provided that emphasizes the appropriate circumstances for restricting these types of accounts.

Management's Response: The Office of Penalties and Interest will conduct a review of SFR accounts to determine the source of any unnecessary restrictions and, if necessary, will advise the affected employees accordingly.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether Internal Revenue Service (IRS) employees manually computed the Failure to Pay (FTP) penalty correctly, and manual computations were limited to only those situations where IRS computers could not make the computation.

To accomplish our objective, we:

I. Determined the policies and procedures followed by the IRS for manually computing the FTP penalty and whether these procedures were compliant with the appropriate tax laws.

   A. Reviewed the penalty Internal Revenue Manual instructions.

   B. Interviewed applicable IRS management and employees to determine the procedures being used to manually compute FTP penalties on taxpayer and business accounts.

   C. Reviewed applicable/available training material for processing manual computations of FTP penalties.

   D. Reviewed the appropriate Internal Revenue Code sections, revenue procedures, and any IRS Counsel rulings relating to the manual computation of FTP penalties.

II. Determined the volume of manual FTP penalties found on the Individual Master File[1] and the Business Master File[2] that were manually computed for the last 2 tax years prior to January 1, 2003. We obtained a computer extract of all accounts found on these Master Files for the last 2 tax years prior to January 1, 2003, containing taxpayer accounts (modules, both individual and business) with computer codes indicating a manually computed FTP penalty.

III. Determined whether manual FTP penalties were correctly computed and whether the FTP penalties were unnecessarily restricted.

   A. Selected a random sample[3] of taxpayer accounts with a manually computed FTP penalty for the last 2 tax years prior to January 1, 2003.

   B. Reviewed the sampled accounts to determine if the amount of the manual FTP penalty was computed correctly on the accounts.

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[1] The IRS database that maintains transactions or records of individual tax accounts.
[2] The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
[3] A non-statistical random sample of 50 accounts was selected because resources were not available to review a statistically valid sample (the population totaled 164,297).

C. Reviewed the sampled accounts to determine if the IRS unnecessarily restricted taxpayers' accounts from normal computer-generated penalty computations.

D. Obtained review assistance from qualified penalty experts within the IRS to determine if our analysis of the manual FTP penalty computations and restricted accounts was correct.

Appendix II

Major Contributors to This Report

Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Kyle R. Andersen, Acting Director
Bill R. Russell, Audit Manager
Scott D. Critchlow, Lead Auditor
Douglas C. Barneck, Senior Auditor
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Appendix III

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- Commissioner, Wage and Investment Division SE:W

Appendix IV

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
SEP 22 2004

SEP 17 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Errors in Failure to Pay Penalty Amounts Occur When the Penalty is Computed Manually (Audit # 200430007)

I have reviewed your draft report evaluating our Failure to Pay (FTP) Penalty Program. The draft report very clearly reflects the difficulties involved in administering this penalty including: three distinct rates on amounts due that change monthly; different calculation start times; and, suspension of penalty accruals for periods of disaster, bankruptcy, and participation in combat zones. The penalty also is subject to diverse reasonable cause abatement criteria and two systems – Master File and the Integrated Data Retrieval System – are used to compute, assess and track these penalty amounts. While we generally agree with your recommendations, we believe that the concept of handling the quality review of the FTP penalty as part of the Complex Interest Quality Measurement System (CIQMS) needs further study.

We have already taken a number of actions that will improve our ability to compute the penalty accurately. The Office of Penalties and Interest reviews multifunctional penalty training modules, issues field alerts, responds to inquiries on unique problems, and initiates system change requests. We also ensure penalty computations are in accordance with all related statutes.

Our comments on your recommendations follow:

RECOMMENDATION 1
Consider including the quality review of the manually computed FTP penalty as part of the responsibilities of the CIQMS. If not included, the Director should ensure all IRS tax examiners calculating penalties are properly trained to manually compute the FTP penalty. The computation of the FTP penalty could be included with the training package developed for computing restricted interest.

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CORRECTIVE ACTION
A key aspect of having the centralized group handle quality review of the manually computed FTP penalties will be our ability to link this work with the CIQMS. Since this system is just coming on line, we will need to study this part of the recommendation further before we agree to make such a change. In the meantime, as part of their annual review of FTP penalty training modules, the Office of Penalties and Interest will consult with the functions at the source of the training modules to ensure that all affected personnel have received the necessary training and that the material continues to be forwarded timely for updates and reviews.

IMPLEMENTATION DATE
July 15, 2005

RESPONSIBLE OFFICIAL
Director, Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Director, Office of Penalty and Interest will advise the Director, Payment Compliance, Small Business/Self-Employed Division of any corrective action delays.

RECOMMENDATION 2
Perform an independent review of SFR accounts with return due dates after July 30, 1996, to determine if, in fact, a high percentage of these accounts continue to be unnecessarily restricted. If warranted, the Director should then ensure training is provided that emphasizes the appropriate circumstances for restricting these types of accounts.

CORRECTIVE ACTION
The Office of Penalties and Interest will review a sample of the specified accounts. We will determine the source of any unnecessary restrictions and advise the field accordingly.

IMPLEMENTATION DATE
May 1, 2005

RESPONSIBLE OFFICIAL
Director, Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Director, Office of Penalty and Interest will advise the Director, Payment Compliance, Small Business/Self-Employed Division of any corrective action delays.

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If you have any questions, please call me at (202) 622-0600 or Robert L. Hunt, Acting Deputy Director, Compliance Policy, Small Business/Self Employed Division, at (202) 283-2200.