

**The Strategy to Reemphasize Penalties in
Corporate Examinations Could Be Enhanced**

August 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 23, 2005

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

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Strategy to Reemphasize Penalties in
Corporate Examinations Could Be Enhanced
(Audit # 200430024)

This report presents the results of our review of the Internal Revenue Service's (IRS) Corporate Examinations. The overall objective of this review was to determine whether penalties were recommended during corporate examinations in accordance with IRS policies and procedures. To meet our objective, we reviewed a sample of closed corporate examinations, evaluated the adequacy of controls that ensure examiners properly consider and recommend penalties, and assessed the status of ongoing changes to improve the administration of penalties.

In summary, the IRS has taken significant actions to implement a strategy that reemphasizes the role penalties play in promoting compliance with and fairness in the tax system by imposing an economic cost on those who do not voluntarily comply with the tax laws. There are a number of important reasons for taking these actions, including the tax gap (estimated to be in excess of \$300 billion) and the use of potentially abusive transactions that understate corporate tax liabilities.

While important steps have been taken to reemphasize penalties, we identified two issues the IRS could address to increase the likelihood its strategy will be successful and maximize the potential deterrent effect penalties may have on compliance. The

issues include improving the quality of penalty determinations in corporate examinations and ensuring penalties are accurately reported in the IRS Data Books.¹

Regardless of what new strategies and practices are established, the quality of penalty determinations is ultimately the responsibility of the examiners. We reviewed 45 corporate examination cases that were closed in Fiscal Year (FY) 2004 and found 35 (78 percent) cases in which IRS procedures were not followed in determining appropriate penalties for assessment. Although each of the cases in our universe had at least 1 tax year with an additional recommended assessment exceeding \$10,000, examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that applicable penalties were considered. Our case review results are similar to findings that continue to be identified by the IRS' Quality Assurance staffs as well as those reported previously by the former IRS Internal Audit function² and the Government Accountability Office (GAO).³

Some in the media have expressed skepticism over whether the IRS is really serious about using penalties as an enforcement tool. In FY 2002, for example, the IRS Data Book showed there were just 22 negligence penalties assessed against corporations out of 35,056 corporate examinations closed that year. However, when we compared penalty data from the IRS Master File⁴ to that reflected in IRS Data Books, we found a significant number of negligence penalties and other accuracy-related penalties were misclassified in the IRS Data Books under the category of "Other." When we corrected for the misclassifications, our analysis showed the IRS, on average, annually assessed 1,935 negligence or other accuracy-related penalties in corporate examinations during FYs 1999 through 2004. Consequently, if not corrected, the misclassifications could undermine the potential deterrent effect negligence penalties may have on compliance.

To improve the quality of penalty determinations in corporate examinations, we recommended the Commissioner, Small Business/Self-Employed (SB/SE) Division, and Commissioner, Large and Mid-Size Business (LMSB) Division, ensure (1) examiners receive more specific written feedback on the quality of their penalty determinations, (2) managers review and approve decisions not to recommend penalties when there is a substantial understatement, and (3) actions are initiated to implement a standardized form to document the penalty decision process. To maximize the potential deterrent effect penalties may have in convincing corporations to remain compliant, the Director, Examination, SB/SE Division, should ensure the numbers of negligence and other accuracy-related penalties are accurately reflected in IRS Data Books.

¹ IRS Data Books contain tax administration statistics on such topics as examination activities, collections, penalties, and refunds.

² Now the Treasury Inspector General for Tax Administration Office of Audit.

³ *Tax Administration: Negligence and Substantial Understatement Penalties Poorly Administered* (GAO/GGD-91-91, dated July 1991).

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

Management's Response: The Commissioner, SB/SE Division, agreed with the report's conclusion and will take corrective actions that are responsive to our recommendations. First, performance management reminders will be issued to the field to support the recommendation for proper documentation and managerial involvement. Second, when examination adjustments result in a substantial understatement, non-assertion of the penalty will be subject to managerial review. Both the LMSB and SB/SE Divisions will communicate this requirement to the field via guidance memoranda. In addition, the SB/SE Division will revise the IRM to include this requirement. Third, the existing Penalty Approval Form 300 will be revised to provide the required proper documentation for the penalty decision process. Fourth, the Director, Examination, SB/SE Division, will issue a memorandum to the Chief Financial Officer to indicate the correct transaction code and reference number for retrieving negligence and other accuracy-related penalty assessment data from the Master File. Management's complete response to the draft report is included as Appendix V.

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

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The Strategy to Reemphasize Penalties in Corporate Examinations Could Be Enhanced

Background

The public's willingness to voluntarily comply with its responsibilities for preparing an accurate tax return, filing it timely, and paying any tax due on time is the foundation of our tax system. To encourage voluntary compliance, the Congress placed numerous penalty provisions in the tax laws for the Internal Revenue Service (IRS) to administer through its Examination and various other compliance programs.

Spread across the IRS' four operating divisions, the Examination Program is one of the agency's largest compliance programs. Its examiners are primarily responsible for determining the correct liabilities for taxpayers, including their liabilities for penalties. Examinations of corporate taxpayers are usually conducted in the field by the more experienced examiners working in either the Small Business/Self-Employed (SB/SE) Division or the Large and Mid-Size Business (LMSB) Division.¹

During an examination of a corporate tax return, examiners are required to consider a number of penalties when recommending adjustments to a corporation's tax liability. The numerous penalties generally fall into two broad categories: delinquency and accuracy-related. Delinquency penalties are intended to encourage the timely filing of income tax and information returns while accuracy-related penalties promote the preparation and submission of complete and correct information on tax returns. According to our analysis of underlying information for the 2004 IRS Data Book,² the IRS assessed corporations with 112,719 delinquency penalties and 1,309 accuracy-related penalties. Additional information on various penalties within these two broad categories is included in Appendix IV.

To ensure examiners are properly considering and recommending delinquency and accuracy-related penalties, the IRS has an array of controls in place. The IRS Policy Statement on Penalties, the Internal Revenue Manual

¹ The taxpayers served by the SB/SE Division include small businesses and self-employed individuals, while taxpayers served by the LMSB Division include corporations with assets of more than \$10 million.

² IRS Data Books contain tax administration statistics on such topics as examination activities, collections, penalties, and refunds.

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(IRM),³ IRS Examination Auditing Standards, and numerous memoranda issued by senior executives provide guidance, direction, and assistance to examiners in making their penalty determinations. A variety of first-line managerial practices, such as in-process or completed case reviews, have also been developed. These reviews are designed to ensure examiners are conducting quality examinations in accordance with IRS policies, procedures, and auditing standards. Additionally, the Quality Assurance staff may review the case file after the examination closes to assess the degree to which the examiner complied with the auditing standards, including those related to penalties. The purpose of these reviews is to collect information about the examination process, communicate areas of concern up the chain of command, identify potential training needs, and improve work processes.

This review was performed in the IRS LMSB and SB/SE Divisions, which are respectively headquartered in Washington, D.C., and New Carrollton, Maryland. The audit was performed in accordance with *Government Auditing Standards* during the period September 2004 through April 2005. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Internal Revenue Service Has Taken Significant Actions to Reemphasize the Role Penalties Play in Tax Administration

The IRS has taken significant actions to implement a strategy that reemphasizes the role penalties play in promoting compliance with and fairness in the tax system by imposing an economic cost on those who do not voluntarily comply with the tax laws. In June 2004, the IRS issued a new policy statement on penalties that established direction for the future and included overall goals⁴ for developing and implementing the policy. The new policy goals, like those of its predecessor, are focused on ensuring penalties are fairly and consistently applied. Unlike the

³ The IRM serves as the official compilation of procedures, instructions, and guidelines that govern operations in the IRS.

⁴ According to the United States Office of Management and Budget Circular A-11, *Preparing, Submitting, and Executing the Budget*, goals are broad statements of desired outcomes that should reflect the agency's priorities and provide a clear direction for future action.

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previous policy goals, however, the new ones address the role of accuracy-related and fraud penalties in deterring the use of abusive tax transactions and other noncompliant behavior that can undermine effective tax administration.

There are a number of important reasons for taking these actions, including the tax gap (estimated to be in excess of \$300 billion) and the use of potentially abusive transactions that understate corporate tax liabilities. Additionally, the IRS was criticized in the 1990s for what some perceived was an agency climate that emphasized revenue production at the expense of serving taxpayers.⁵ In responding to the criticisms, the IRS concedes enforcement suffered during this period and perhaps even contributed to the increase in abusive taxpayer behavior that currently exists. Figure 1 provides an overview of the goals reflected in the IRS' new penalty policy.

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

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

To support the consistent application of penalties, the Appeals function and Office of Chief Counsel have clarified

⁵ For example, in “A Concept for Modernizing the Internal Revenue Service,” Document 10405, the IRS pointed out that it had focused more on enforcement than service.

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their roles in the administration of penalties. The recently issued Office of Chief Counsel Notice 2004-036, for example, highlights the Office of Chief Counsel's role with respect to the imposition of penalties. It states "in deciding whether to settle docketed cases, [Office of] Chief Counsel attorneys must consider the hazards of litigation with respect to the penalties independent of the hazards of litigation with respect to the underlying tax adjustments." The Appeals function similarly provided clarification in a June 2004 memorandum that it will no longer trade penalty issues but will, instead, resolve penalties on the basis of their merits.

To assist examiners and other field employees in the consistent development and application of penalties, an agency-wide training session on penalty administration was provided in 2004. The training session, among other things, instructed field personnel to give heightened scrutiny to cases involving a "listed" transaction or those the IRS considers potentially abusive, as well as transfer pricing issues. To augment the training, a comprehensive audit technique guide was developed and made available agency-wide to examiners. The document addresses the new penalty policy and considerations that apply to all taxpayers involved in tax shelter transactions. Additionally, there are other guidance documents and resources widely available to field personnel that include a penalty handbook, fraud handbook, technical advisors, and attorneys in the Office of Chief Counsel.

While important steps have been taken to reemphasize penalties, we identified two issues the IRS could address to increase the likelihood its strategy will be successful. The IRS could improve the quality of penalty determinations in corporate examinations. It could also ensure penalties are accurately reported in the IRS Data Books to maximize the potential deterrent effect penalties may have on compliance.

The IRS has long required its examiners to document case files with procedures used, information obtained, and conclusions reached in deciding to recommend or not recommend applicable penalties during examinations. This documentation is a key component in a quality penalty determination for two reasons. First, the documentation is

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used as a control by third-party reviewers such as first-line managers. Second, the documentation is crucial when a corporation challenges a penalty determination. In these instances, the facts and circumstances developed and documented by the examiner are used in deciding whether the penalty should be sustained. Consequently, pro forma statements such as “no penalties applicable” are unacceptable according to the IRS procedures and should not be used.

When there is an understatement of income exceeding \$10,000, the required documentation should contain even more detail than that required in other examinations because the examiner’s manager should be actively involved. The purpose of this involvement is to develop a plan for jointly obtaining and documenting potential fraudulent activities that may be needed in a referral to the IRS Criminal Investigation Division for possible criminal prosecution.

We reviewed 45 corporate examination cases that were closed in Fiscal Year (FY) 2004 and found 35 (78 percent) cases in which IRS procedures were not followed in recommending appropriate penalties for assessment. Although each of the cases in our universe had at least 1 tax year with an additional recommended assessment exceeding \$10,000, examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that applicable penalties were considered. As shown in Figure 2, most of the problems dealt with accuracy-related and/or information return penalty determinations.

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Figure 2: Number of Problems Identified in Penalty Determinations for 45 Corporate Examinations

Delinquency penalty for not timely filing a corporate income tax return.	5
Negligence, substantial understatement, or valuation misstatement penalties (accuracy-related).	23
Information return penalties related to Form 5471, Form 5472, and the Form 1099 Series of Information Documents (⊕)	18
Fraud penalty.	3
Overall number of problems identified (√).	49

(⊕) *These are, respectively, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, and other information returns used to report real estate and numerous other transactions.*

(√) *The total does not add up to 45 since multiple penalties were present in some cases.*

Source: TIGTA analysis of closed examination cases.

For the most part, the cases reviewed did not entail complicated tax law issues and, except for a few instances, IRS officials who reviewed the problems in our case reviews agreed with our conclusions. We found, for example, 2 cases in which expenses were significantly overstated and well over \$10,000 of income was misstated and/or not reported. Although the IRS considers these conditions potential fraud indicators, there was no documentation that indicated the manager and examiner developed an action plan in the cases as required. Additionally, no accuracy-related penalties were applied even though we found no obvious reasons why they should not have been applied.

In numerous cases, examiners did not document the steps taken to ensure required information returns were filed even though not filing the returns or filing them late can involve significant penalties. In two cases, for example, corporations filed delinquent information returns to report foreign investment activities. In these instances, IRS guidance to examiners requires consideration of a \$10,000 penalty for each failure to file. However, we found no documentation showing the penalty was considered or assessed.

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Our results are similar to findings that continue to be identified by the IRS' Quality Assurance staffs, as well as those reported previously by the Government Accountability Office (GAO). In FY 2004 reports to IRS management, the Quality Assurance staffs in the SB/SE and LMSB Divisions reported that correct penalty determinations were made in no more than 67 percent⁶ of the cases reviewed. In 1991, the GAO reported⁷ finding problems with examiner substantial understatement and negligence penalty determinations. In the same 1991 report, the GAO also noted that the former IRS Internal Audit function⁸ had found substantial understatement penalties were not being recommended when they should have been as early as May 1985.

Examiners could be held more accountable for the quality of penalty determinations

Regardless of what new strategies and practices are established, the quality of penalty determinations is ultimately the responsibility of the examiners. As we have reported previously,⁹ performance feedback can be a very effective tool in helping examiners understand and meet their responsibilities. It also provides opportunities to give meaningful and constructive feedback on examiners' performance, pinpoint and address performance gaps, and hold examiners accountable for results. According to the United States Merit Systems Protection Board (MSPB),¹⁰ continually monitoring and providing feedback to employees is perhaps the most important component of

⁶ The percentage represents the combined average of LMSB Division cases (59 percent) and SB/SE Division cases (77 percent).

⁷ *Tax Administration: Negligence and Substantial Understatement Penalties Poorly Administered* (GAO/GGD-91-91, dated July 1991).

⁸ Now the TIGTA Office of Audit.

⁹ *Performance Management in the Large and Mid-Size Business Division's Industry Case Program Needs Strengthening* (Reference Number 2005-30-084, dated May 2005)

¹⁰ The MSPB is an independent, quasi-judicial agency that oversees and adjudicates the application of merit system principles within the Executive Branch.

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managing performance. In a 2003 report¹¹ to the President and the Congress, the MSPB stated:

This component, more than any other, can give employees a sense of how they are doing and can motivate them to be as effective as possible. Ideally, through these ongoing interactions between employees and supervisors, employees learn how their work fits into the goals of the work unit and how it contributes to the larger mission of the agency.

We reviewed the performance feedback provided to 33¹² examiners for the 45 cases we reviewed and found considerable evidence that strongly suggests first-line managers could take better advantage of workload reviews, midyear progress reports, and annual appraisals to hold examiners more accountable for their penalty determinations. As summarized in Figure 3, our analysis shows 12 of the 33 examiners received no narrative feedback on the importance of making quality penalty determinations in the workload reviews, midyear progress reports, and annual appraisals they received in FYs 2004 and 2005 (through January 2005).

¹¹ *The Federal Workforce for the 21st Century: Results of the Merit Principles Survey 2000* (September 2003).

¹² We were unable to secure performance feedback for all the examiners because some of the examiners had retired or transferred to other divisions or the documentation was not readily available.

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Figure 3: Analysis of Narrative Comments Addressing the Quality of Penalty Determinations in the Performance Feedback of 33 Examiners During FYs 2004 and 2005 (Through January 2005)

	Examiners	
	Number	Percentage
No narrative comment in workload reviews.	16	48
No narrative comment in midyear progress reports.	26	79
No narrative comment in annual appraisal.	26	79
No narrative comment in workload reviews, midyear progress reports, or annual appraisals.	12	36

Source: TIGTA analysis of examiner performance feedback for the 15-month period ending January 2005.

Managerial review and approval is needed in decisions not to recommend penalties when there is a substantial understatement

The IRM requires managerial review and approval of all recommended penalty assessments during examinations. This review and approval process helps guard against erroneous penalty assessments and incorrect calculations. However, the IRM does not ensure penalty decisions are sound when they result in not applying a penalty. The IRM,¹³ in these instances, generally does not require managerial review and approval, even if the examination results in a substantial understatement. Proper review and approval of penalty decisions in all examinations with a substantial understatement could help ensure the proper penalty decision was made, as well as address some of the longstanding problems with the quality of penalty determinations.

¹³ LMSB Division examiners are required to obtain managerial approval for recommending or not recommending penalties in certain abusive tax shelter transactions; whereas, SB/SE Division examiners are required to obtain managerial approval only in cases in which penalties are applied.

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Developing a standardized form for documenting penalty decisions could be useful particularly when there is a substantial understatement

To help ensure procedures and processes are followed and documented in LMSB Division examinations, first-line managers and examiners are required to complete a standardized Administrative Procedures form¹⁴ to include in examination case files. Although the form does not address penalties, it solicits answers to other important procedural and process questions as well as references to where supporting documentation for the answers are located in the case file. It also requires first-line managers and examiners to sign and date the form certifying the actions were completed.

If well-designed, we believe a similar form could be developed at minimal cost that would provide an effective tool for improving the documentation process for penalty decisions. Like the Administrative Procedures form, the one for documenting penalty decisions will need to become a mandatory part of the examination process, included in examination case files, and its use evaluated during reviews by the Quality Assurance staffs in the SB/SE and LMSB Divisions. It will also need to contain questions that, among other things, encourage examiners to seek written documentation from corporations to include in case files justifying why particularly penalties should not be applied.

Seeking such written documentation from corporations will be especially useful when there is a substantial understatement given that the standard for assessing a penalty in these instances contains objective criteria. In effect, the criteria creates a presumption that a substantial understatement penalty will be applied in a corporate examination when an understatement exceeds \$10,000 or 10 percent of the corrected tax, whichever is greater.¹⁵ While the penalty can be avoided, certain conditions must

¹⁴ Form 13327 (Rev. 09-2004).

¹⁵ According to IRS Notice 2005-12, the substantial understatement penalty criteria is being modified to understatements that exceed the lesser of (1) 10 percent of tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.

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first be met¹⁶ and the burden of proof for meeting those conditions is on the corporation. Consequently, corporations have an incentive to outline in writing, for examiners to evaluate, the reasons a substantial understatement penalty should not be applied. Although examiners are not currently prohibited from requesting such written documentation from corporations, we found no instances in our case reviews where examiners used this technique. Instead, case files indicated examiners generally relied on oral statements provided by the corporation's tax representative, shareholders, or officers to make their penalty determinations.

Numerous benefits would accrue by incorporating a well-designed penalty procedure and process form into the examinations. First, the form will help address the questions we and others have raised over the supporting documentation for penalty determinations. Second, it will facilitate managerial review and thereby help ensure the propriety of the penalty decision process. Third, it will ensure the facts and circumstances from the perspective of both the corporation and the Federal Government are fully developed and presented. Full development of the penalty is important for the Appeals function to sustain a penalty and for the Office of Chief Counsel to successfully defend the recommended penalty assessment if the corporation challenges the penalty. Finally, it will reinforce the IRS' policy of giving full and fair consideration to evidence that favors not imposing penalties.

¹⁶ For example, a corporation can avoid the penalty by showing that it has reasonable cause and acted in good faith.

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Recommendations

To improve the quality of penalty determinations in corporate examinations, the Commissioner, SB/SE Division, and the Commissioner, LMSB Division, should coordinate with their respective Directors to:

1. Ensure first-line managers provide more specific written feedback to examiners during workload reviews on the quality of their penalty determinations and incorporate the feedback into examiner midyear progress reports and annual appraisals when appropriate.

Management's Response: Performance management reminders will be issued to the field to support the recommendation for proper documentation and managerial involvement.

2. Require managerial review and approval of decisions not to recommend penalties when there is a substantial understatement.

Management's Response: When examination adjustments result in a substantial understatement, non-assertion of the penalty will be subject to managerial review. Both the LMSB and SB/SE Divisions will communicate this requirement to the field via guidance memoranda. In addition, the SB/SE Division will revise the IRM to include this requirement.

3. Initiate actions to develop and implement a standardized form to document the penalty decision process. At a minimum, the form should be completed for and included in case files where examinations result in a substantial understatement. Additionally, it should contain specific questions that need to be answered for making quality penalty determinations, include supporting documentation for answers, be certified by first-line managers and examiners, and incorporated into reviews of Quality Assurance staffs.

Management's Response: The existing Penalty Approval Form 300 will be revised to provide the required proper documentation for the penalty decision process.

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The Internal Revenue Service Data Books Could Provide More Information About the Assessment of Accuracy-Related Penalties

The IRS Data Book annually provides information on a broad base of tax administration subjects that include the number of returns filed with the IRS, amounts collected and refunded, taxpayer assistance issues, and results from enforcement efforts. Additionally, the IRS Data Book serves as an internal control¹⁷ since it helps ensure accountability for IRS operations by providing the Congress, media, and other stakeholders with information to better understand the challenges facing the agency and how well the agency is meeting those challenges.

In publicly prepared remarks in March 2005,¹⁸ the IRS Commissioner indicated that enforcing the tax law is the area where the IRS challenges remain the greatest. To this end, the IRS Commissioner has made discouraging and deterring corporations from participating in abusive tax transactions a top priority in the IRS enforcement efforts. He also articulated a supporting enforcement strategy that encompasses mandating the assessment of stiff accuracy-related penalties against those involved in abusive tax transactions.

However, some in the media have expressed skepticism over whether the IRS is really serious about using penalties as an enforcement tool, given the information presented in the IRS Data Books. In FY 2002, for example, the IRS Data Book showed there were just 22 negligence penalties assessed against corporations out of the 35,056 corporate examinations closed that year. We compared penalty data from the IRS Master File¹⁹ to that reflected in the IRS Data Books and found a significant number of negligence

¹⁷ Internal control, according to the GAO, is a major part of managing an organization. It comprises the plans, methods, and procedures used to meet missions, goals, and objectives and, in doing so, supports performance-based management.

¹⁸ IRS News Release: IR-2005-30.

¹⁹ The Master File contains postings of all tax data and related information pertaining to taxpayers so the file reflects a continuous updated and current record of each taxpayer's account. All settlements with taxpayers are effected through computer processing of the Master File account. The Master File data are also used for accounting records; issuance of refund checks, bills, or notices; answering inquiries; classifying returns for audit; preparing reports; and other matters concerned with the processing and enforcement activities of the IRS.

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penalties and other accuracy-related penalties were misclassified in the IRS Data Books under the category of “Other.”

When we corrected for the misclassifications, our analysis showed the IRS, on average, annually assessed 1,935 negligence or other accuracy-related penalties in corporate examinations during FYs 1999 through 2004. Consequently, if not corrected, the misclassifications could undermine the potential deterrent effect negligence penalties may have on compliance. Figure 4 contains a summary of our analysis and shows that approximately 11,611 negligence and other accuracy-related penalties were assessed against corporations in FYs 1999 through 2004, not the 194 as reported in IRS Data Books.

Figure 4: Differences Between the Number of Negligence and Other Accuracy-Related Penalties Assessed in the IRS Data Book and on the IRS Master File During FYs 1999 – 2004			
Fiscal Year	Number of Negligence Penalties Assessed According to IRS Data Books	Number of Negligence/ Accuracy-Related Penalties Assessed According to the IRS Master File	Difference
2004	25	1,309	1,284
2003	12	1,589	1,577
2002	22	1,512	1,490
2001	35	1,672	1,637
2000	38	2,062	2,024
1999	62	3,467	3,405
Totals	194	11,611	11,417

Source: IRS Data Books and the IRS Master File.

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Our discussions with IRS personnel in the SB/SE Division Office of Penalties and Interest²⁰ and our own analysis found the misclassifications occurred because the IRS is capturing negligence penalty data using a pre-1990 Master File code, rather than a new code that was put in effect for returns due on or after January 1, 1990.

Recommendation

4. The Director, Examination, SB/SE Division, should initiate actions with appropriate IRS officials to ensure the numbers of negligence and other accuracy-related penalties are properly captured for and accurately reflected in IRS Data Books.

Management's Response: The Director, Examination, SB/SE Division, will issue a memorandum to the Chief Financial Officer to indicate the correct transaction code and reference number for retrieving negligence and other accuracy-related penalty assessment data from the Master File.

²⁰ The SB/SE Division Office of Penalties and Interest is organizationally located under the Director, Examination, SB/SE Division. According to IRS documents, the SB/SE Division Office of Penalties and Interest has agency-wide responsibility for coordinating policy and procedures concerning the administration of penalties and interest, ensuring consistency with the penalty policy statement, reviewing and analyzing penalty and interest information, researching taxpayer attitudes and opinions, and determining appropriate action necessary to promote voluntary compliance.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether penalties were recommended during corporate examinations in accordance with Internal Revenue Service (IRS) policies and procedures. We relied on the IRS' internal management reports and databases to meet our objective. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required a significant amount of time. Additionally, we used judgmental sampling techniques, unless otherwise noted, to minimize time and travel costs. To accomplish the objective, we:

- I. Reviewed a significant amount of source material to gain an understanding of penalties and the penalty assessment process. These sources included the Internal Revenue Code, Treasury Regulations, revenue procedures, and the Internal Revenue Manual, penalty handbooks, memoranda, Audit Technique Guides, and training materials.
- II. Reviewed prior Government Accountability Office (GAO) reports, information from the IRS quality management systems, penalty studies, discussion papers, and similar documents prepared by IRS internal and external stakeholders to identify concerns and issues with penalties.
- III. Analyzed a judgmental sample of 45 cases out of approximately 2,427 corporate examination returns having a recommended assessment exceeding \$10,000 that were closed in Fiscal Year (FY) 2004 to determine whether penalties were applied in accordance with IRS policies and procedures. In selecting our sample cases, we excluded cases with recommended assessments under \$10,000 because the standard for asserting the substantial understatement penalty includes criteria that understatements exceed \$10,000. We also excluded Coordinated Industry Cases¹ from our sample because different techniques are used in these examinations.
- IV. Analyzed FYs 2004 through 2005 (through January 2005) workload reviews, midyear progress reports, and annual appraisals for the examiners of the 45 cases included in the review to assess the types, quality, and amount of feedback they received on their penalty determinations.
- V. Used the GAO *Standards for Internal Control in the Federal Government* to assess the adequacy of controls established to ensure quality penalty determinations are made in corporate examinations.

¹ A Coordinated Industry Case is any case assigned to the Large and Mid-Size Business Division where the taxpayer and its effectively controlled entities warrant the application of team examination procedures and techniques.

Major Contributors to This Report

Curtis W. Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Philip Shropshire, Director

Frank Dunleavy, Audit Manager

William Tran, Lead Auditor

Robert Jenness, Senior Auditor

Debra Mason, Auditor

Arlene Feskanich, Information Technology Specialist

Judith Harrald, Information Technology Specialist

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Appendix III

Report Distribution List

Commissioner C
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**The Strategy to Reemphasize Penalties in
Corporate Examinations Could Be Enhanced**

Appendix IV

Overview of Selected Penalties Applicable to Corporate Examinations

This appendix provides a brief overview of some common penalties examiners should consider and possibly apply during a corporate examination. There are relief standards that can be invoked to avoid the imposition of the penalties below. The Internal Revenue Code (I.R.C.), for example, generally provides that penalties can be avoided if there was reasonable cause and the corporation acted in good faith.

Selected Penalties Considered During a Corporate Examination		
Delinquency Penalties		
Title	I.R.C. Section(s) †	Overview
Failure to File	6651(a)(1)	If a corporate examination results in a tax deficiency and the tax return was not filed by the prescribed due date (or extended due date), a failure to file penalty can be applied on the tax deficiency from the tax return due date (or extended due date) until paid or until the maximum penalty is applied.
Failure to File Information Returns	6721, 6722, 6723, 6679, 6038(b), 6038A(d)	Corporations are required to file certain information returns and/or furnish certain statements to payees under various sections of the I.R.C. Information return reporting penalties can involve amounts ranging from \$50 up to \$250,000.
Accuracy-Related Penalties		
Negligence	6662(c)	Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records. The penalty is 20 percent of the portion of the underpayment attributable to negligence.
Substantial Understatement	6662(d)	The substantial understatement penalty may be applied when an understatement exceeds \$10,000 or 10 percent of the tax required to be shown for the tax year, whichever is greater. The penalty is equal to 20 percent of the underpayment of tax attributable to the understatement.√
Substantial Valuation Misstatement	6662(e)	The substantial valuation misstatement penalty is applicable if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. The penalty is 20 percent of the underpayment of tax.

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Gross Valuation Misstatement	6662(h)(2)(A)	Similar to the substantial valuation penalty, the gross valuation misstatement penalty may be imposed if the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis. The penalty is 40 percent of the underpayment of tax.
Fraud	6663(a)	If any underpayment of tax is due to fraud, a penalty may be imposed equal to 75 percent of the portion of the underpayment due to fraud. Although the I.R.C. does not define the term fraud, most courts define fraud as the “intent to evade tax.”

+ Citations are to I.R.C. (2005).

√ According to Internal Revenue Service Notice 2005-12, the substantial understatement penalty criteria is being modified to understatements that exceed the lesser of (1) 10 percent of tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.

Source: I.R.C.

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Appendix V

Management's Response to the Draft Report



SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

July 21, 2005

RECEIVED
JUL 27 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown *Kevin M. Brown*
Commissioner, Small Business/Self-Employed (SB/SE) Division

SUBJECT: Draft Audit Report – The Strategy to Reemphasize
Penalties in Corporate Examinations Could Be Enhanced
(Audit # 200430024)

We have reviewed your draft report evaluating our reemphasis on penalties and the extent to which penalty considerations follow current policy and procedures in corporate examinations. We agree with your conclusion that the character and extent of penalty considerations can be improved.

In an effort to address consistency in return-related penalties, the Internal Revenue Service (IRS) has taken a number of actions. These actions include issuing a revised Penalty Policy Statement 20-1 and an Audit Technique Guide relating to accuracy-related penalties, and conducting an Interactive Video Teleconference to reemphasize accuracy-related penalties. We believe this reemphasis will improve the quality of appropriate penalty considerations and further advance fairness and consistency with respect to criteria used in penalty assertions. The training also stressed the need for uniformity in applying criteria to determine non-assertion of penalties for reasonable cause exceptions and statutory provisions. All of these actions were completed during the last quarter of Fiscal Year (FY) 2004 and are expected to improve the quality of penalty determinations during FY 2005.

Our comments on your recommendations are as follows:

RECOMMENDATION 1

Ensure first-line managers provide more specific written feedback to examiners during workload reviews on the quality of their penalty determinations and incorporate the feedback into examiner midyear progress reports and annual appraisals when appropriate.

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CORRECTIVE ACTION

Both the Large and Mid Size Business (LMSB) and SB/SE Divisions believe that appropriate guidance is in place to ensure first-line managers properly document and provide specific written feedback to examiners during workload reviews, which includes penalty determinations. The Internal Revenue Manual (IRM) provides specific guidance to managers regarding managerial involvement and proper documentation in coordinating and monitoring the examination process. In particular, guidance is given on preparing appraisals and documenting performance as well as conducting on-site visits. Managers also have other tools and guidance to assist them in evaluating and documenting feedback on employee performance, such as the National Agreement and the IRS Performance Management System: Guide for Evaluating Employees.

In response to a review by the Treasury Inspector General for Tax Administration (TIGTA) on performance management in the LMSB Division's Industry Case Program (final audit report # 2005-30-084), LMSB Division agreed to issue a performance management reminder to the field. The SB/SE Division also will issue a performance management reminder to the field to support your recommendation for proper documentation and managerial involvement.

IMPLEMENTATION DATE

October 15, 2005

RESPONSIBLE OFFICIAL(S)

National Program Manager, Office of Penalties and Interest, SB/SE Division.

CORRECTIVE ACTION MONITORING PLAN

National Program Manager, Office of Penalties & Interest, will advise the Director, Examination Policy, SB/SE Division, of any delays in accomplishing this corrective action.

RECOMMENDATION 2

Require managerial review and approval of decisions not to recommend penalties when there is a substantial understatement.

CORRECTIVE ACTION

When examination adjustments result in a substantial understatement as defined in Internal Revenue Code (IRC) Section 6662(d)(1)(B), non-assertion of the penalty will be subject to managerial review. Both the LMSB and SB/SE Divisions will communicate this requirement to the field via guidance memoranda. In addition, the SB/SE Division will revise IRM to include this requirement.

IMPLEMENTATION DATE

October 15, 2005 for memoranda
January 15, 2006 for IRM revisions

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RESPONSIBLE OFFICIAL(S)

National Program Manager, Office of Penalties and Interest, SB/SE Division.
Director, Performance, Quality Assurance, and Audit Assistance, LMSB Division.

CORRECTIVE ACTION MONITORING PLAN

National Program Manager, Office of Penalties & Interest, will advise the Director, Examination Policy, SB/SE Division, of any delays in accomplishing this corrective action.

RECOMMENDATION 3

Initiate actions to develop and implement a standardized form to document the penalty decision process. At a minimum, the form should be completed for and included in case files where examinations result in a substantial understatement. Additionally, it should contain specific questions that need to be answered for making quality penalty determinations, include supporting documentation for answers, be certified by first line managers and examiners, and be incorporated into reviews of Quality Assurance staffs.

CORRECTIVE ACTION

The SB/SE Division will revise the existing Penalty Approval Form 300 to provide the required proper documentation.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

National Program Manager, Office of Penalties and Interest, SB/SE Division.

CORRECTIVE ACTION MONITORING PLAN

National Program Manager, Office of Penalties & Interest, will advise the Director, Examination Policy, SB/SE Division, of any delays in accomplishing this corrective action.

RECOMMENDATION 4

The Director, Examination, SB/SE Division, should initiate actions with appropriate IRS officials to ensure the numbers of negligence and other accuracy-related penalties are properly captured for and accurately reflected in IRS Data Books.

CORRECTIVE ACTION

The Director, Examination, SB/SE Division, will issue a memorandum to the Chief Financial Officer to indicate the correct transaction code and reference number for retrieving IRC Section 6662 assessment data from the Master File. The data previously shown in the IRS Data Book mistakenly reflected only negligence penalty assessments under IRC Section 6653 (obsoleted by P.L. 101-239 in 1989) relating to returns due before January 1, 1990.

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IMPLEMENTATION DATE

October 15, 2005

RESPONSIBLE OFFICIAL(S)

National Program Manager, Office of Penalties and Interest, SB/SE Division.

CORRECTIVE ACTION MONITORING PLAN

National Program Manager, Office of Penalties & Interest, will advise the Director, Examination Policy, SB/SE Division, of any delays in accomplishing this corrective action.

If you have any questions, please contact me at (202) 622-0600, or Marsha Ramirez, Director, Examination Policy, SB/SE Division, at (202) 283-2518.