Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments

September 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 2, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments (Audit # 200430016)

This report presents the results of our review of Federal Tax Deposit (FTD) penalties assessed and abated by the Internal Revenue Service (IRS). The overall objectives of this review were to determine whether current studies and workgroups were effectively addressing FTD compliance and issues raised by the IRS Taxpayer Advocate Service (TAS), whether recent changes were effective in improving FTD compliance, and whether other changes to the FTD penalty program could further improve compliance or reduce taxpayer burden.

In summary, there are specific rules regarding the timing and methods for making FTD payments. If payments are not made timely or correctly, the IRS imposes FTD penalties. These rules are considered by many to be complex and confusing. The IRS TAS has repeatedly cited concerns regarding this area of tax administration. We performed computer analyses of taxpayer accounts with FTD penalties assessed for Tax Year (TY) 2003 on the IRS Business Master File.[1] Our preliminary analysis identified over 1.4 million returns with FTD penalties assessed totaling $3.4 billion.

The number of FTD penalties assessed and subsequently abated has declined significantly. The IRS has taken steps to reduce both the number and dollar amounts of assessed and abated FTD penalties. It has developed notices to inform taxpayers of changes in deposit requirements as withholding and employment tax liabilities increase,

[1] 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.

and has implemented a one-time penalty abatement program for taxpayers that voluntarily use the Electronic Federal Tax Payment System for 1 full year.

The TAS reports cited the complexity of the FTD rules as a contributing factor to the high rates of FTD penalty assessments and abatements. We agree that these rules are complex and hard to understand and most likely contribute to the number of penalties assessed. However, our review of a judgmental sample of 194 penalties assessed on the TY 2003 Employer's Quarterly Federal Tax Returns (Form 941) indicated complexity was not the primary reason for many FTD penalty assessments. Of the 194 taxpayers with penalties, 183 had either a history of paying correctly or other indicators that they knew the deposit requirements. Most of these taxpayers just paid late or paid the tax with their returns instead of making timely and required FTD deposits.

The IRS currently has a program in place that helps avoid assessment of unnecessary FTD penalties on certain returns that do not have valid liability information included with them. Penalties on these returns would normally be computed by averaging the taxpayers' liabilities over the quarter. Instead of making the averaged penalty assessment, the IRS, in certain cases meeting its criteria, issues a Computer Paragraph (CP) 207 Notice[2] to the taxpayers asking for additional information to help avoid the penalty assessment. However, the criteria for this program are limited and do not necessarily identify all the larger-dollar cases.

The IRS Office of Penalties and Interest has developed and forwarded two Requests for Information Services to the IRS Chief Information Officer to expand this program to include significantly more of the averaged penalties. These steps should significantly reduce the large penalty assessments and abatements. However, we believe the IRS should take additional steps to further reduce the assessment/abatement problems.

We reviewed the 2,000 largest penalties assessed on Forms 941 in TY 2003. The penalties totaled almost $1.12 billion. Approximately $1.05 billion (94 percent) of that amount was abated as of April 26, 2005. Since approximately 26 percent of the 2,000 largest-dollar penalties we reviewed did not meet the criteria for the CP 207 Notice, but instead involved penalties computed based on apparently valid information filed with the returns, the IRS should consider developing a notice similar to the CP 207 Notice that will apply to these cases. Criteria for this notice would have to be based on research of the characteristics of these cases, including the amount of the penalties. In discussions with us, the TAS agreed with this concept but believes the IRS needs to make some improvements to the CP 207 Notice before expanding the program.

The IRS should also determine why certain taxpayers repeatedly incur and pay FTD penalties and take steps to change this trend. We identified more than 87,000 taxpayers that had FTD penalties assessed in 9 or more of the 12 quarters

[2] Computer-generated notices and letters of inquiry are mailed to taxpayers in connection with tax returns. A CP 207 Notice gives notification of impending FTD penalty assessments to be made without a schedule of liabilities.

during TYs 2001 through 2003, including 20,893 taxpayers with penalties assessed in all 12 quarters. We reviewed a statistical sample of accounts for 102 of these 20,893 taxpayers and found that 60 percent paid these penalties each quarter. The penalties assessed averaged $1,805 per quarter or $21,659 over the 3-year period.

We recommended the Director, Office of Penalties and Interest, Small Business/ Self-Employed (SB/SE) Division, work with appropriate staff from the offices of the Commissioners, Large and Mid-Size Business Division, SB/SE Division, and Wage and Investment Division to (1) address the TAS' concerns with the CP 207 Notice, (2) ensure the steps proposed by the IRS Office of Penalties and Interest to expand the CP 207 Notice reviews are implemented, and (3) commission a research project with the objective of identifying other large FTD penalties that are likely to be reversed and developing procedures similar to those used with the CP 207 Notice. We also recommended these officials commission a research project to identify taxpayers that incur and timely pay FTD penalties on a recurring basis with the objective of determining the cause and developing a strategy to reduce assessment of repeat penalties for this taxpaying segment.

<u>Management's Response</u>: IRS management agreed with our recommendations. They have enhanced the programming for the CP 207 Notice generation process and developed a new CP 207L Notice for proposed penalties of $100,000 or more. Management's response addresses cases meeting the criteria for the CP 207 Notice (no valid liability information included on the return) but does not address cases based on apparently valid information filed with the returns, as recommended. On August 12, 2005, the Office of Penalties and Interest requested a copy of the data reviewed in our audit and will study those data for characteristics of other cases that may benefit from a notice similar to the CP 207 Notice. In addition, the Office of Penalties and Interest and the TAS plan to review the effectiveness of the revised CP 207 Notice and new CP 207L Notice in mid-2007 when they will have 4 quarters of posted information available. Therefore, we concur with the corrective action proposed by the IRS.

The Director, Office of Penalties and Interest, will also commission a research project to identify taxpayers that incur and timely pay FTD penalties on a recurring basis, determine the cause(s) of this behavior, and develop a strategy to reduce repeat penalty assessments for this taxpaying segment. Management's complete response to the draft report is included as Appendix VII.

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 Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Background

Business taxpayers generally pay their Federal payroll taxes by periodically depositing payment amounts in a bank or other financial institution that is authorized to accept these payments. This type of payment is called a Federal Tax Deposit (FTD). FTDs account for most of the revenue received by the Internal Revenue Service (IRS). Taxes that are paid through the FTD process include:

- Income taxes withheld from employees.
- Social Security and Medicare taxes withheld from employees plus the employer's matching portion.
- Federal unemployment taxes.
- Certain excise taxes.

There are specific rules regarding the timing and methods for making FTD payments. For example, a business with a history of significant tax liabilities may be required to deposit using the IRS Electronic Federal Tax Payment System (EFTPS).[1] Also, the timing of the required deposit is generally based on the business' past and present tax liabilities.

If payments are not made timely or correctly, the IRS imposes FTD penalties.[2] Penalties for untimely payments are assessed on a sliding scale based on the amount of time the payments are late. Penalties for payments made incorrectly, such as including a payment with a tax return when deposits are required or not making required electronic deposits, are also imposed.

These rules are considered by many to be complex and confusing. The IRS Taxpayer Advocate Service (TAS) stated in its 2003 Annual Report:

> *There is a significant problem in the administration of the FTD penalty. A substantial number of penalties assessed under IRC [Internal Revenue Code] section 6656 are abated. Current IRS practices result in both the IRS and taxpayers expending valuable time and resources in*

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[1] Close to 96 percent of the dollars collected for employment taxes are received via the EFTPS.
[2] See Appendix V for details regarding penalty assessments.

negotiating requests for abatement of the FTD penalty. Further, taxpayer confusion about Federal tax reporting can lead to penalties.

This Report also noted that, the higher a penalty amount, the more likely it was to be abated. The Report indicated that, of $4.9 billion in FTD penalties assessed in 2003, nearly $3 billion was abated. The TAS 2002 Annual Report also cited concerns about difficulties taxpayers have with rules relating to when deposits must be made.

We initiated this review to determine whether actions undertaken by the IRS were effectively addressing issues raised by the TAS, as well as addressing other FTD compliance issues. We performed computer analyses of taxpayer accounts with FTD penalties assessed in Tax Year (TY) 2003 on the IRS Business Master File (BMF).[3] Our preliminary analysis identified over 1.4 million returns with FTD penalties assessed totaling $3.4 billion, with the Employer's Quarterly Federal Tax Return (Form 941) accounting for 97 percent of all returns with penalties and 92 percent of the penalty dollars assessed. Because of this, we limited our detailed review to Forms 941.

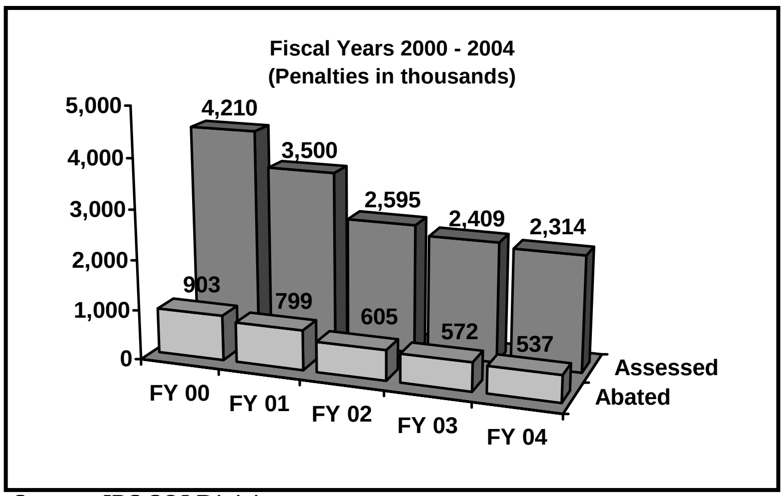
This review was performed from September 2004 through June 2005 at the Ogden, Utah, and Fresno, California, Campuses[4] using tax return information filed nationwide. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[3] 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.
[4] The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

The Number and Dollar Amounts of Federal Tax Deposit Penalties Assessed and Subsequently Abated Have Declined Significantly

The number of FTD penalties assessed and penalties abated has declined significantly. IRS Statistics of Income (SOI) Division data show that, between Fiscal Years (FY) 2000 and 2004, the number of employment tax-related FTD penalties decreased each year, from 4.2 million to 2.3 million. The number of penalties abated stayed about the same as a percentage of the total, approximately 22 percent.

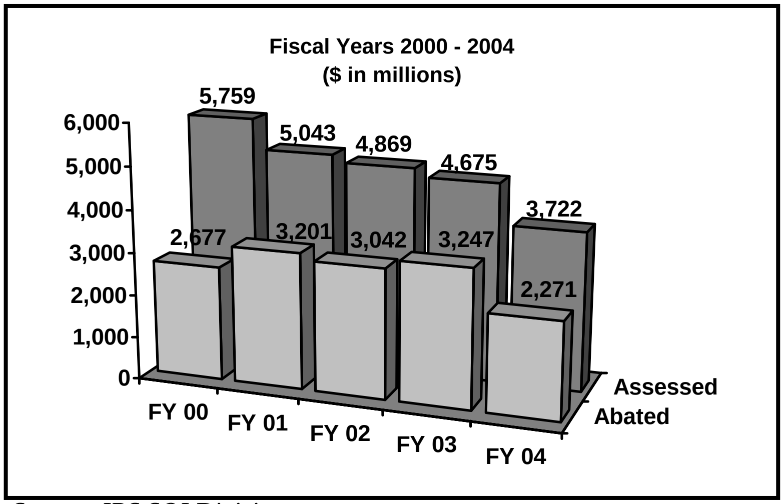
Figure 1: Total Number of FTD Penalties Assessed and Abated



Source: IRS SOI Division.

The dollar amounts of these assessed penalties also decreased significantly, from $5.7 billion to $3.7 billion. The dollars abated over that time averaged approximately 60 percent.

Figure 2: Total FTD Penalty Dollars Assessed and Abated



Source: IRS SOI Division.

We conducted a computer analysis of IRS tax return records and found that, of the 23.6 million TY 2003 Forms 941 filed, 1.43 million (6.1 percent) were assessed FTD penalties. Our numbers are lower than those in the SOI Division statistics because we included only Forms 941 and because we looked at each quarterly tax return in total and not as individual assessment and abatement transactions. For example, one return can have multiple assessments and abatements caused by changes to returns or by misapplied payments being located.

Although FTD penalties assessed and abated have declined significantly, approximately 1 in 16 Forms 941 filed is still assessed an FTD penalty.[5] We found the majority of penalties assessed and then abated were caused by taxpayer errors or omissions. This represents a challenge for both the IRS and business taxpayers.

[5] We discussed our results with the TAS, which applauded the IRS' efforts but expressed concern that there was no decline in the number of penalties abated as a percentage of penalties assessed and that the dollar amount of penalties abated stayed above 60 percent of the total.

The Internal Revenue Service Has Implemented Programs to Help Reduce Deposit Penalties for Taxpayers Having Changes in Their Deposit Requirements

In general, a business that has payroll taxes of $2,500 or more in a quarter is required to make monthly FTD payments (or deposits), due the 15th of each succeeding month. As a business grows and its employment tax liability increases, it may be required to start making what are referred to as semi-weekly deposits. Depending on the day of the week the tax liability is incurred, semi-weekly deposits are made on the subsequent Wednesday or Friday. The rules for these deposit requirements can be confusing. To help taxpayers make the change in deposit requirements, the IRS has implemented several steps to inform and educate them.

Before the start of a new tax year, taxpayers that have to change from monthly to semi-weekly deposits receive a Computer Paragraph (CP) 136 Notice informing them of their deposit requirement changes.[6] This Notice includes details regarding how the determination was made and provides instructions on how to make timely deposits.

The IRS Office of Penalties and Interest recently introduced a second notice that is sent to taxpayers as soon as it becomes apparent they may still be making monthly deposits instead of required semi-weekly deposits. The notice is sent after the first month of the new period is reviewed and is referred to as the early intervention notice (CP 236 Notice).[7] The IRS has also implemented an automatic waiver of the penalty (communicated by a CP 235 Notice) for the first quarter of the deposit requirement change if taxpayers do not meet the new deposit requirements.[8] With each notice, the IRS includes the rules and instructions regarding the taxpayer's new deposit requirements.

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[6] Computer-generated notices and letters of inquiry are mailed to taxpayers in connection with tax returns. A CP 136 Notice is the Annual Notification of FTD Deposit Requirements (941). Taxpayers, practitioners, and IRS employees raised some concerns to the TAS about the content of this Notice. The IRS has redesigned the Notice; the redesigned version is scheduled to go into effect in 2006.
[7] A CP 236 Notice is a Reminder to Deposit Semi-weekly.
[8] A CP 235 Notice is a Notice of Penalty Waiver Due to the Change in the Deposit Requirement.

The IRS Office of Penalties and Interest believed the additional notice (CP 236 Notice) would reduce the first and second quarter penalties from TY 2003 to TY 2004. Our computer analysis of these tax periods showed penalties assessed were, in fact, down approximately 16 percent and dollars assessed were down almost 25 percent. There were about 1.5 percent fewer returns filed in the 2004 period, but the numbers are still adequate to show the intended effect was achieved.

The Internal Revenue Service Is Implementing a One-Time Penalty Abatement for Taxpayers Who Voluntarily Use the Electronic Federal Tax Payment System for 1 Year

The IRS implemented the EFTPS to improve the accuracy of deposit information and to make it easier for taxpayers to make deposits. Electronic collections increased from $1.15 trillion in 1998 to $1.6 trillion in 2004. Currently, almost 96 percent of employment taxes are paid by electronic funds transfers. Electronic deposits help to significantly reduce deposit errors and errors in filling out and processing paper FTD coupons.

The IRS, through its Taxpayer Education and Communication Office, is marketing the EFTPS through a new incentive program. Beginning with TY 2005, the IRS will provide a one-time FTD penalty abatement for taxpayers that voluntarily enlist in the EFTPS program and use it successfully for 1 full year.

Taxpayers Responsible for Making Timely Payments Failed to Do So

The TAS Annual Reports cited the high rates of FTD penalty assessments and abatements as an issue involving the complexity of the FTD rules. We agree that these rules are complex and, during initial reading, can be hard to understand (see Appendix VI). This complexity most likely contributes to the number of penalties assessed; however, our review of a judgmental sample of 194 penalties assessed on TY 2003 Forms 941 indicated the reasons for assessment of FTD penalties were not just instruction or complexity issues. We determined 183 of those taxpayers had either a history of paying correctly or other indicators that they knew the deposit requirements, such as prior waivers and reasonable cause abatements of the penalty. Most of these taxpayers just paid late or paid with the returns instead of making timely and required FTD deposits.

From our sample of 194 penalties, 10 cases did involve changes in deposit requirements. However, the early notification program mentioned above had fully informed these taxpayers of their deposit requirements. Taxpayers in all 10 cases had received the automatic first quarter waiver of the FTD penalty, and 6 of those had received an additional reasonable cause abatement of penalty for the second quarter.

The Internal Revenue Service Should Review Potential Large-Dollar Federal Tax Deposit Penalties Before Making Actual Assessments

The IRS has committed to reduce taxpayer burden and improve compliance related to FTD penalties and has implemented several steps mentioned previously. We identified additional steps the IRS could take to further accomplish this objective. The first step, discussed here, involves large-dollar FTD penalty assessments. (A second step is discussed on page 10.)

We stratified the FTD penalties assessed on Forms 941 during TY 2003 and reviewed the characteristics of the 2,000 largest penalty transactions.[9] These penalties totaled almost $1.12 billion and ranged from nearly $102,000 to over $32 million. Approximately $1.05 billion (94 percent) of that amount had been abated as of April 26, 2005. This 94 percent reversal rate supports the TAS 2003 Annual Report contention that large-dollar penalties are much more likely to be reversed.

The IRS currently has a program in place that helps avoid assessment of unnecessary FTD penalties on certain returns that do not have valid liability information included with them. Penalties on these returns would normally be computed by averaging the taxpayers' liabilities over the quarter. Instead of making the averaged penalty assessment, the IRS, for cases meeting its criteria, issues a CP 207 Notice[10] to the taxpayers asking for additional information to help avoid the penalty assessment. However,

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[9] These penalties were predominately assessed to taxpayers in the Large and Mid-Size Business (LMSB) and the Tax Exempt and Government Entities (TE/GE) Divisions. While approximately 92 percent of all assessments involved taxpayers in the Small Business/Self-Employed (SB/SE) Division, only 14 percent of these large assessments involved SB/SE Division taxpayers, while 48 and 38 percent, respectively, involved LMSB and TE/GE Division taxpayers.

[10] A CP 207 Notice gives notification of impending FTD penalty assessments to be made without schedule of liabilities.

the IRS limited the criteria for this program and did not address all the larger-dollar cases.

The IRS Office of Penalties and Interest has developed and forwarded two Requests for Information Services to the IRS Chief Information Officer to expand this program to include significantly more of the averaged penalties. These steps should significantly reduce the large penalty assessments and abatements. We believe an additional step could further reduce large-dollar assessments and abatements.

Since approximately 26 percent of the 2,000 largest-dollar penalty cases we reviewed did not meet the criteria for the CP 207 Notice program, but instead involved penalties computed based on apparently valid information filed with the returns, the IRS should consider developing a notice similar to the CP 207 Notice that will apply to these cases. The intent would be to delay actual assessment on these cases and make contact with the taxpayers on large-dollar penalties that are not based on the averaging method to which the CP 207 Notice applies.

Criteria for this notice would have to be based on research of the characteristics of these cases including the dollar amount of the penalties and the probability that the penalties would be reversed. For example, criteria for issuing the notice could include dollar amounts representing a 75 percent probability of being reversed.

Our review was limited to penalties of nearly $102,000 and higher, which represented the top 2,000. Again, 94 percent of the total dollars assessed on our 2,000 penalty transactions were subsequently abated. Depending on resource availability, the IRS could set its criteria for issuing this notice significantly lower than the $102,000, which was the lowest penalty dollar amount in our strata.

By not assessing penalties over a certain dollar amount (which the IRS would set) before contacting the taxpayers directly to determine whether the proposed penalties are correct, the IRS could provide a more proactive and customer-oriented method to resolve these penalties. Such a program could also start the process to correct the probable problem earlier. We looked at the time it took to resolve 100 of the 2,000 cases and found the average time from the penalty assessment date to the abatement date was 13 weeks.

In discussions with us, the TAS agreed with the concept of expanding the use of the CP 207 Notice and developing a similar notice to address other large-dollar FTD penalties but expressed the opinion that the IRS needs to make some improvements to the CP 207 Notice and related IRS processing procedures before expanding the program.

Recommendations

The Director, Office of Penalties and Interest, Small Business/Self-Employed (SB/SE) Division, should coordinate with appropriate staff from the offices of the Commissioners, Large and Mid-Size Business (LMSB) Division, SB/SE Division, and Wage and Investment (W&I) Division, to:

1. Address the TAS' concerns with the CP 207 Notice and related processing issues.

Management's Response: The IRS has enhanced the programming for the CP 207 Notice generation process and developed a new CP 207L Notice for proposed penalties of $100,000 or more. The Director, Office of Penalties and Interest, SB/SE Division, and the TAS plan to review the effectiveness of the revised CP 207 Notice and new CP 207L Notice in mid-2007 when they will have 4 quarters of posted information available.

2. Ensure the steps proposed by the IRS Office of Penalties and Interest to expand the CP 207 Notice reviews are implemented.

Management's Response: The Director, Exam Policy, SB/SE Division, has obtained approval of Requests for Information Services that are on schedule to implement the expanded CP 207 Notices for generation on first quarter 2006 Forms 941.

3. Commission a research project with the objective of identifying other large FTD penalties that are likely to be reversed and developing a notice similar to the CP 207 Notice and implement procedures to contact the taxpayers and resolve the proposed penalties prior to

assessment. Criteria for this notice should be evaluated based on availability of resources and the probability that the penalty would ultimately be reversed.

Management's Response: The Large Corporation Units in Ogden, Utah, and Cincinnati, Ohio, will review CP 207L Notices and make taxpayer contacts prior to mailing. The Director, Exam Policy, SB/SE Division, will assess the benefit of reducing the notice dollar threshold based on the success of this CP 207L Notice process and the resources used to work this Notice.

Office of Audit Comment: Management's response addresses cases meeting the criteria for the CP 207 Notice (no valid liability information included on the return) but does not address cases based on apparently valid information filed with the returns, as recommended. On August 12, 2005, the Office of Penalties and Interest requested a copy of the data reviewed in our audit and will study those data for characteristics of other cases that may benefit from a notice similar to the CP 207 Notice. In addition, as mentioned earlier, the Office of Penalties and Interest and the TAS plan to review the effectiveness of the revised CP 207 Notice and new CP 207L Notice in mid-2007 when they will have 4 quarters of posted information available. Therefore, we concur with the corrective action proposed by the IRS.

The Internal Revenue Service Should Determine Why Certain Taxpayers Repeatedly Incur Federal Tax Deposit Penalties and Take Steps to Change This Trend

Many of the taxpayers included in our sample of 194 penalty cases (discussed previously) had multiple FTD penalties. For these cases, we reviewed the 6 quarters between January 1, 2003, and June 30, 2004, and found that 128 (66 percent) had penalties assessed in 3 or more of these 6 quarters. Because of the high rate of recurrence, we performed another computer analysis of the BMF to determine how many taxpayers had multiple FTD penalties assessed on TYs 2001, 2002, and 2003 quarterly returns. We found that, in the 12 quarters of those years, 908,000 taxpayers had more than 1 FTD penalty assessed. More than 87,000 taxpayers had penalties assessed in 9 or more quarters (913,915 separate penalty assessments).

We performed an analysis of the accounts of 20,893 taxpayers that had penalties assessed in all 12 quarters and found a large percentage of these taxpayers appeared to treat the penalty as a cost of doing business and/or did not fully understand the cause and impact of the penalty. We reviewed tax account information for a statistically valid sample of 102 of these 20,893 taxpayers and found that approximately 60 percent paid these penalties each quarter. The penalties assessed to these taxpayers averaged $1,805 per quarter or $21,659 during the 3-year period.[11]

Part of the IRS' mission is to help taxpayers understand their tax responsibilities. The IRS currently does not help taxpayers that continue to be assessed and pay FTD penalties determine why they continually incur these penalties and what the taxpayers could do to avoid them.

The IRS could use our computer-identified list of taxpayers or develop different criteria to identify taxpayers that pay the FTD penalty repeatedly. The IRS should consider either a direct contact program or a mailed survey to identify education or compliance areas that could be stressed to reduce this recidivism rate. By developing a strategy to reduce or eliminate the assessment of repeat penalties for this taxpaying segment, the IRS could save these taxpayers more than $270 million over a 3-year period.

Recommendation

4. The Director, Office of Penalties and Interest, SB/SE Division, should coordinate with appropriate staff from the offices of the Commissioners, LMSB Division, SB/SE Division, W&I Division, and the TAS to commission a research project to identify taxpayers that incur and timely pay FTD penalties on a recurring basis with the objective of determining the cause and developing a strategy to reduce assessment of repeat penalties for this taxpaying segment. Consideration should be given to contacting these taxpayers directly or through a notice or questionnaire.

Management's Response: The Director, Office of Penalties and Interest, SB/SE Division, has requested the data

[11] The other 40 percent involved taxpayers that had not paid their tax liabilities and had liens or other collection activity being enforced.

reviewed in this audit and, in September 2005, will commission a research project to identify taxpayers that incur and timely pay FTD penalties on a recurring basis, determine the cause(s) of this behavior, and develop a strategy to reduce repeat penalty assessments for this taxpaying segment.

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine whether current studies and workgroups were effectively addressing Federal Tax Deposit (FTD) compliance and issues raised by the Internal Revenue Service (IRS) Taxpayer Advocate Service (TAS), whether recent changes were effective in improving FTD compliance, and whether other changes to the FTD penalty program could further improve compliance or reduce taxpayer burden. To accomplish these objectives, we:

I. Determined whether current studies and workgroups were effectively addressing FTD compliance.

   A. Reviewed portions of the TAS 2002 and 2003 Annual Reports related to FTD penalty issues and the IRS Office of Penalties and Interest response to those reports to evaluate the extent of the reviews and complexity of raised issues.

   B. Reviewed research projects and employment tax literature compilations to identify studies being conducted and issues raised and/or resolved by those studies. This included the IRS Office of Penalties and Interest Final Report dated October 16, 1998.

   C. Reviewed the Office of Penalties and Interest Post Notice Review Compliance Initiatives and looked at work being conducted by the Taxpayer Advocacy Panel on an annual Employment Tax Return initiative.

II. Determined whether there were areas of the FTD penalty program that could be enhanced to improve compliance or reduce taxpayer burden.

   A. Obtained a computer database of Business Master File[1] accounts that had FTD penalty assessments (and any related abatements) made between January 1, 2001, and June 30, 2004.

   B. Selected and reviewed, from 1.4 million taxpayer accounts having FTD penalties assessed during 2003, a judgmental[2] sample of 194 (we selected 202 penalty transaction codes at random and eliminated 8 that were related to the Computer Paragraph (CP) 207 Notice[3] and were for $0.00) to determine the reasons for assessments and any subsequent abatements, to identify sample characteristics and

[1] 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.
[2] We used a judgmental sample because we did not expect to make any projections from our sample results.
[3] Computer-generated notices and letters of inquiry are mailed to taxpayers in connection with tax returns. A CP 207 Notice gives notification of impending FTD penalty assessments to be made without schedule of liabilities.

trends, and to determine any possible actions that could reduce burden or prevent unnecessary assessments.

C. Performed various data analyses to verify or refute assumptions regarding taxpayer categories and related FTD penalty trends. Special analyses included a review of taxpayers with multiple penalties and a review of the 2,000 largest-dollar assessments and subsequent abatements related to those large-dollar assessments. As part of this analysis, we selected a judgmental sample of 100[4] transactions and evaluated the average length of time taken to abate the penalty.

D. Performed a data analysis of taxpayers with penalties in multiple quarters. As part of this analysis, we selected a statistically valid sample of 102[5] of the 20,893 taxpayers (95 percent confidence, +/- 10 percent precision range, expected occurrence rate of 60 percent) with penalties assessed in all 12 quarters during Calendar Years 2001, 2002, and 2003.

III. Determined whether recent changes were effective in improving FTD compliance.

A. Performed a computer analysis to compare the numbers and dollar amounts of FTD penalties assessed in the first and second quarters of 2003 with the numbers and dollar amounts of penalties assessed in the first and second quarters of 2004 to determine whether the new CP 236 Notice (intervention notice, reminder to deposit semi-weekly) had reduced total penalties as the IRS predicted.

B. Reviewed the new program that allows a one-time waiver of the FTD penalty for taxpayers that move from paying with coupons to the Electronic Federal Tax Payment System (EFTPS) that starts in Tax Year 2005. We reviewed IRS publicity for this program as well as the Request for Information Services (RIS) developed to ensure proper programming and comments related to this RIS. As part of this analysis, we reviewed payroll tax payment trends for both the EFTPS and coupon payments for recent years.

IV. Determined whether issues raised by the TAS regarding clarity of notices, forms, and instructions were still of concern and whether changes could be made to improve the FTD process.

A. Reviewed all employment and excise tax forms and associated instructions that relate to FTD penalty provisions to determine clarity of instructions and possible areas for improvement.

B. Reviewed general notices, such as math error and balance due notices related to employment and excise tax returns, to identify high-volume issues and any relevant trends. We also reviewed notices specific to FTD penalties that are the responsibility of the IRS Office of Penalties and Interest. This included a detailed review of the

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[4] We used a judgmental interval sample because there was no need to project the results over the entire population.
[5] We selected a statistically valid sample so we could project our results across the entire population.

Annual Notification of FTD Deposit Requirements (CP 136 Notice), the Reminder to Deposit Semi-weekly (CP 236 Notice), and the Notice of Penalty Waiver Due to the Change in the Deposit Requirement (CP 235 Notice).

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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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. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $270,607,546 applicable to 12,494 taxpayer accounts (see page 10).

Methodology Used to Measure the Reported Benefit:

We obtained Internal Revenue Service (IRS) Business Master File[1] records of 20,893 Employer's Quarterly Federal Tax Returns (Form 941) filed for tax periods in Calendar Years 2001 - 2003 that had Federal Tax Deposit penalties assessed on all 12 quarterly returns. We selected a statistically valid sample of 102 of these taxpayers at a 95 percent confidence level, an expected error rate of 60 percent, and a precision of +/- 10 percent. We found that 59.8 percent of the taxpayers in our sample consistently paid these penalties. Based on the results of our sample, we estimate that 12,494 of the taxpayers in our population paid the penalties in each of the 12 quarters. On average, the penalties incurred by these taxpayers over the 3-year period totaled $21,659. By developing a strategy to reduce or eliminate assessment of repeat penalties for this taxpaying segment, the IRS could save these taxpayers $270,607,546 (12,494 taxpayers X $21,659).[2]

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[1] 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.
[2] This point estimate is based on a 95 percent confidence level and a precision of +/- $38,673,569.

Appendix V

Federal Tax Deposit Penalty Rules and Percentages

Failure to make timely deposit of employment taxes can result in the Federal Tax Deposit (FTD) penalty being assessed. The penalty is based on a graduated four-tier system. The penalty amount varies with the length of time within which the taxpayer corrects the failure to make the required deposit. It is determined as follows:

- **Two percent –** Payment is no more than 5 days late.
- **Five percent –** Payment is more than 5 days late but no more than 15 days late.
- **Ten percent** – Payment is more than 15 days late.
- **Fifteen percent –** If the payment is not made on or before the day that is 10 days after the date of the first delinquency notice to the taxpayer.

In addition,

- **Ten percent –** Amounts subject to electronic deposit requirements but not deposited using the Electronic Federal Tax Payment System.
- **Ten percent –** Deposits made at an unauthorized financial institution, paid directly to the Internal Revenue Service, or paid with the tax return (when FTD deposits are required).

Appendix VI

Federal Tax Deposit Rules – Publication 15 (Circular E), Employer's Tax Guide[1]

11. Depositing Taxes

In general, you must deposit income tax withheld and both the employer and employee social security and Medicare taxes (minus any advance EIC payments) by mailing or delivering a check, money order, or cash to a financial institution that is an authorized depositary for Federal taxes. However, some taxpayers are required to deposit using the Electronic Federal Tax Deposit System (EFTPS). See **How To Deposit** on page 20 for information on electronic deposit requirements for 2004.

Payment with return. You may make a **payment** with Form 941 instead of depositing if:

- You accumulate less than a $2,500 tax liability (reduced by any advance earned income credit) during the quarter (line 13 of Form 941), and you pay in full with a timely filed return. (However, if you are unsure that you will accumulate less than $2,500, deposit under the appropriate rules so that you will not be subject to failure to deposit penalties.), or
- You are a **monthly schedule depositor** (defined below) and make a payment in accordance with the **Accuracy of Deposits Rule** discussed on page 20. This payment may be $2,500 or more.

Separate deposit requirements for nonpayroll (Form 945) tax liabilities. Separate deposits are required for nonpayroll and payroll income tax withholding. **Do not** combine deposits for Forms 941 and 945 tax liabilities. Generally, the deposit rules for nonpayroll liabilities are the same as discussed below, except that the rules apply to an annual rather than a quarterly return period. Thus, the $2,500 threshold for the deposit requirement discussed above applies to Form 945 on an annual basis. See the separate **Instructions for Form 945** for more information.

When To Deposit

There are two deposit schedules—**monthly** or **semiweekly**—for determining when you deposit social security, Medicare, and withheld income taxes. These schedules tell you when a deposit is due after a tax liability arises (e.g., when you have a payday). Prior to the beginning of each calendar year, you must determine which of the two deposit schedules that you are required to use. The deposit schedule that you must use is based on the total tax liability that you reported on Form 941 during a four-quarter **lookback period** discussed below. Your deposit schedule is **not** determined by how often you pay your employees or make deposits (see **Application of Monthly and Semiweekly Schedules** on page 19).

CAUTION *These rules do not apply to Federal unemployment (FUTA) tax. See section 14 for information on depositing FUTA tax.*

Lookback period. Your deposit schedule for a calendar year is determined from the total taxes (i.e., not reduced by any advance EIC payments) reported on line 11 of your Forms 941 in a four-quarter lookback period. The lookback period begins July 1 and ends June 30 as shown in Table 1 below. If you reported **$50,000 or less** of taxes for the lookback period, you are a **monthly** schedule depositor; if you reported **more than $50,000**, you are a **semiweekly** schedule depositor.

Table 1. **Lookback Period for Calendar Year 2004**

Lookback Period					
2002		2003			2004
July 1 ↓ Sept. 30	Oct. 1 ↓ Dec. 31	Jan. 1 ↓ Mar. 31	Apr. 1 ↓ June 30	←	Calendar Year Jan.–Dec.

[1] Rev. January 2004

Adjustments and the lookback rule. Determine your tax liability for the four quarters in the lookback period based on the tax liability as **originally** reported on your Form 941. If you made adjustments to correct errors on previously filed Forms 941, these adjustments do not affect the amount of tax liability for purposes of the lookback rule.

If you report adjustments on your current Form 941 to correct errors on prior Forms 941, include these adjustments as part of your tax liability for the current quarter. If you filed Form 843 to claim a refund for a prior period overpayment, your tax liability does not change for either the prior period or the current period for purposes of the lookback rule.

Example: An employer originally reported a tax liability of $45,000 for the four quarters in the lookback period ending June 30, 2003. The employer discovered during January 2004 that the tax during one of the lookback period quarters was understated by $10,000 and corrected this error with an adjustment on the 2004 first quarter return. This employer is a monthly schedule depositor for 2004 because the lookback period tax liabilities are based on the amounts originally reported, and they were less than $50,000. The $10,000 adjustment is part of the 2004 first quarter tax liability.

Deposit period. The term **deposit period** refers to the period during which tax liabilities are accumulated for each required deposit due date. For **monthly schedule depositors**, the deposit period is a **calendar month**. The deposit periods for **semiweekly schedule depositors** are **Wednesday through Friday** and **Saturday through Tuesday**.

Monthly Deposit Schedule

You are a monthly schedule depositor for a calendar year if the total taxes on **line 11** of Form 941 for the four quarters in your lookback period were $50,000 or less. Under the monthly deposit schedule, deposit Form 941 taxes on payments made during a month by the 15th day of the following month. See also **Deposits on Banking Days Only** later.

Monthly schedule depositors should **not** file Form 941 on a monthly basis. Also, do **not** file **Form 941-M,** Employer's Monthly Federal Tax Return, unless you are instructed to do so by an IRS representative.

New employers. During the first calendar year of your business, your tax liability for each quarter in the lookback period is considered to be zero. Therefore, you are a **monthly schedule depositor** for the first calendar year of your business (but see the **$100,000 Next-Day Deposit Rule** on page 20).

Semiweekly Deposit Schedule

You are a semiweekly schedule depositor for a calendar year if the total taxes on **line 11** of Form 941 during your lookback period were more than $50,000. Under the semiweekly deposit schedule, deposit Form 941 taxes for payments made on Wednesday, Thursday, and/or Friday by the following Wednesday. Deposit amounts accumulated for payments made on Saturday, Sunday, Monday, and/or Tuesday by the following Friday. See also **Deposits on Banking Days Only** later.

Note: *Semiweekly schedule depositors **must** complete **Schedule B (Form 941),** Employer's Record of Federal Tax Liability, and submit it with Form 941.*

Table 2. **Semiweekly Deposit Schedule**

IF the payday falls on a . . .	**THEN deposit taxes by the following . . .**
Wednesday, Thursday, and/or Friday	Wednesday
Saturday, Sunday, Monday, and/or Tuesday	Friday

Semiweekly deposit period spanning two quarters. If you have more than one pay date during a semiweekly period and the pay dates fall in different calendar quarters, you will need to make **separate deposits** for the separate liabilities. For example, if you have a pay date on Wednesday, March 31, 2004 (first quarter), and another pay date on Friday, April 2, 2004 (second quarter), two separate deposits would be required even though the pay dates fall within the same semiweekly period. Both deposits would be due Wednesday, April 7, 2004 (three banking days from the end of the semiweekly deposit period).

Summary of Steps To Determine Your Deposit Schedule

1. Identify your lookback period (see Table 1).
2. Add the total taxes (line 11 of Form 941) you reported during the lookback period.
3. Determine if you are a monthly or semiweekly schedule depositor:

If the total taxes you reported in the lookback period were . . .	Then you are a . . .
$50,000 or less	Monthly Schedule Depositor
More than $50,000	Semiweekly Schedule Depositor

Example of Monthly and Semiweekly Schedules

Rose Co. reported Form 941 taxes as follows:

2003 Lookback Period		2004 Lookback Period	
3rd Quarter 2001	$12,000	3rd Quarter 2002	$12,000
4th Quarter 2001	$12,000	4th Quarter 2002	$12,000
1st Quarter 2002	$12,000	1st Quarter 2003	$12,000
2nd Quarter 2002	$12,000	2nd Quarter 2003	$15,000
	$48,000		$51,000

Rose Co. is a monthly schedule depositor for 2003 because its tax liability for the four quarters in its lookback period (third quarter 2001 through second quarter 2002) was not more than $50,000. However, for 2004, Rose Co. is a semiweekly schedule depositor because the total taxes exceeded $50,000 for the four quarters in its lookback period (third quarter 2002 through second quarter 2003).

Deposits on Banking Days Only

If a deposit is required to be made on a day that is not a banking day, the deposit is considered timely if it is made by the close of the next banking day. In addition to Federal and state bank holidays, Saturdays and Sundays are treated as nonbanking days. For example, if a deposit is required to be made on a Friday and Friday is not a banking day, the deposit will be considered timely if it is made by the following Monday (if that Monday is a banking day).

Semiweekly schedule depositors have at least three banking days to make a deposit. That is, if any of the three weekdays after the end of a semiweekly period is a banking holiday, you will have one additional banking day to deposit. For example, if a semiweekly schedule depositor accumulated taxes for payments made on Friday and the following Monday is not a banking day, the deposit normally due on Wednesday may be made on Thursday (allowing three banking days to make the deposit).

Application of Monthly and Semiweekly Schedules

The terms "monthly schedule depositor" and "semiweekly schedule depositor" **do not** refer to how often your business pays its employees or even how often you are required to make deposits. The terms identify which set of deposit rules that you must follow when an employment tax liability arises. The deposit rules are based on the dates when wages are paid (i.e., cash basis); **not** on when tax liabilities are accrued for accounting purposes.

Monthly schedule example. Spruce Co. is a monthly schedule depositor with seasonal employees. It paid wages each Friday. During March it paid wages but did not pay any wages during April. Under the monthly deposit schedule, Spruce Co. must deposit the combined tax liabilities for the four March paydays by April 15. Spruce Co. does not have a deposit requirement for April (due by May 15) because no wages were paid and, therefore, it did not have a tax liability for April.

Semiweekly schedule example. Green, Inc., which has a semiweekly deposit schedule, pays wages once each month on the last day of the month. Although Green, Inc. has a semiweekly deposit schedule, it will deposit just once a month because it pays wages only once a month. The deposit, however, will be made under the semiweekly deposit schedule as follows: Green, Inc.'s tax liability for the April 30, 2004 (Friday) payday must be deposited by May 5, 2004 (Wednesday). Under the semiweekly deposit schedule, liabilities for wages paid on Wednesday through Friday must be deposited by the following Wednesday.

$100,000 Next-Day Deposit Rule

If you accumulate a tax liability (reduced by any advance EIC payments) of $100,000 or more on any day **during a deposit period,** you must deposit the tax by the next banking day, whether you are a monthly or semiweekly schedule depositor.

For purposes of the $100,000 rule, do not continue accumulating a tax liability after the end of a deposit period. For example, if a semiweekly schedule depositor has accumulated a liability of $95,000 on a Tuesday (of a Saturday-through-Tuesday deposit period) and accumulated a $10,000 liability on Wednesday, the $100,000 next-day deposit rule does not apply. Thus, $95,000 must be deposited by Friday and $10,000 must be deposited by the following Wednesday.

However, once you accumulate at least $100,000 in a deposit period, **stop accumulating at the end of that day** and begin to accumulate anew on the next day. For example, Fir Co. is a semiweekly schedule depositor. On Monday, Fir Co. accumulates taxes of $110,000 and must deposit this amount on Tuesday, the next banking day. On Tuesday, Fir Co. accumulates additional taxes of $30,000. Because the $30,000 is not added to the previous $110,000 and is less than $100,000, Fir Co. must deposit the $30,000 by Friday (following the semiweekly deposit schedule).

CAUTION *If you are a **monthly schedule depositor** and accumulate a $100,000 tax liability on any day, you **become a semiweekly schedule depositor** on the next day and remain so for at least the rest of the calendar year and for the following calendar year.*

Example: Elm, Inc. started its business on April 1, 2004. On April 15, it paid wages for the first time and accumulated a tax liability of $40,000. On April 22, 2004, Elm, Inc. paid wages and accumulated a liability of $60,000, bringing its accumulated tax liability to $100,000. Because this was the first year of its business, the tax liability for its lookback period is considered to be zero, and it would be a monthly schedule depositor based on the lookback rules. However, since Elm, Inc. accumulated a $100,000 liability on April 22, it became a semiweekly schedule depositor on April 23. It will be a semiweekly schedule depositor for the remainder of 2004 and for 2005.

Elm, Inc. is required to deposit the $100,000 by April 23, the next banking day.

Accuracy of Deposits Rule

You are required to deposit 100% of your tax liability on or before the deposit due date. However, penalties will not be applied for depositing less than 100% if **both** of the following conditions are met:

- Any deposit shortfall does not exceed the greater of $100 or 2% of the amount of taxes otherwise required to be deposited and
- The deposit shortfall is paid or deposited by the shortfall makeup date as described below.

Makeup Date for Deposit Shortfall:

1) **Monthly schedule depositor.** Deposit the shortfall or pay it with your return by the **due date** of your Form 941 for the quarter in which the shortfall occurred. You may pay the shortfall with Form 941 even if the amount is $2,500 or more.
2) **Semiweekly schedule depositor.** Deposit by the **earlier of**:
   a) The first Wednesday or Friday (whichever comes first) that falls on or after the 15th of the month following the month in which the shortfall occurred or
   b) The due date of Form 941 (for the quarter of the tax liability).

For example, if a **semiweekly schedule depositor** has a deposit shortfall during January 2004, the shortfall makeup date is February 18, 2004 (Wednesday). However, if the shortfall occurred on the required April 2 (Friday) deposit due date for a March 29 (Monday) pay date, the return due date for the March 29 pay date (April 30) would come before the May 19 (Wednesday) shortfall makeup date. In this case, the shortfall must be deposited by April 30.

How To Deposit

The two methods of depositing employment taxes, including Form 945 taxes, are discussed below. See **Payment with return** on page 18 for exceptions explaining when taxes may be paid with the tax return instead of being deposited.

Electronic deposit requirement. You must make electronic deposits of all depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2004 if:

- Your total deposits of such taxes in 2002 were more than $200,000 or
- You were required to use EFTPS in 2003.

If you are required to use EFTPS and fail to do so, you may be subject to a 10% penalty. EFTPS is a free service provided by the Department of Treasury. If you are not required to use EFTPS, you may participate voluntarily. To get more information or to enroll in EFTPS, call 1-800-555-4477 or 1-800-945-8400. You can also visit the EFTPS website at **www.eftps.gov**.

New employers that have a Federal tax obligation will be pre-enrolled in EFTPS. Call the toll-free number located in your Employer Identification Number (EIN) Package to activate your enrollment and begin making your tax deposit payments.

Depositing on time. For deposits made by EFTPS to be on time, you must initiate the transaction at least one business day before the date that the deposit is due.

Deposit record. For your records an Electronic Funds Transfer (EFT) Trace Number will be provided with each successful payment that can be used as a receipt or to trace the payment.

Making deposits with FTD coupons. If you are not making deposits by EFTPS, use **Form 8109,** Federal Tax Deposit Coupon, to make the deposits at an authorized financial institution.

For new employers, if you would like to receive a Federal Tax Deposit (FTD) coupon booklet, call 1-800-829-4933. Allow 5 to 6 weeks for delivery. The IRS will keep track of the number of FTD coupons that you use and **automatically** will send you additional coupons when you need them. If you do not receive your resupply of FTD coupons, call 1-800-829-4933. You can have the FTD coupon books sent to a branch office, tax preparer, or service bureau that is making your deposits by showing that address on **Form 8109-C,** FTD Address Change, which is in the FTD coupon book. (Filing Form 8109-C will not change your address of record; it will change only the address where the FTD coupons are mailed.) The FTD coupons will be preprinted with your name, address, and EIN. They have entry boxes for indicating the type of tax and the tax period for which the deposit is made.

It is **very important** to clearly mark the correct type of tax and tax period on each FTD coupon. This information is used by the IRS to credit your account.

If you have branch offices depositing taxes, give them FTD coupons and complete instructions so that they can deposit the taxes when due.

Please use only **your** FTD coupons. If you use anyone else's FTD coupon, you may be subject to a failure to deposit penalty. This is because your account will be underpaid by the amount of the deposit credited to the other person's account. See **Deposit Penalties** below for penalty amounts.

How to deposit with an FTD coupon. Mail or deliver each FTD coupon and a single payment covering the taxes to be deposited to an authorized depositary. An authorized depositary is a financial institution (e.g., a commercial bank) that is authorized to accept Federal tax deposits. Follow the instructions in the FTD coupon book. Make your check or money order payable to the depositary. To help ensure proper crediting of your account, include your EIN, the type of tax (e.g., Form 941), and the tax period to which the payment applies on your check or money order.

Authorized depositaries must accept cash, a postal money order drawn to the order of the depositary, or a check or draft drawn on and to the order of the depositary. You may deposit taxes with a check drawn on another financial institution only if the depositary is willing to accept that form of payment. Be sure that the financial institution where you make deposits is an authorized depositary. Deposits made at an unauthorized institution may be subject to the failure to deposit penalty.

If you prefer, you may mail your coupon and payment to: Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, MO 63197. Make your check or money order payable to **Financial Agent.**

Depositing on time. The IRS determines whether deposits are on time by the date that they are received by an authorized depositary. To be considered timely, the funds must be available to the depositary on the deposit due date before the institution's daily cutoff deadline. Contact your local depositary for information concerning check clearance and cutoff schedules. However, a deposit received by the authorized depositary after the due date will be considered timely if the taxpayer establishes that it was mailed in the United States at least two days before the due date.

Note: *If you are required to deposit any taxes more than once a month, any deposit of $20,000 or more must be received by the authorized depositary by its due date to be timely. See section 7502(e)(3).*

Depositing without an EIN. If you have applied for an EIN but **have not** received it and you must make a deposit, make the deposit with the IRS. **Do not** make the deposit at an authorized depositary. Make it payable to the "United States Treasury" and show on it your name (as shown on Form SS-4), address, kind of tax, period covered, and date you applied for an EIN. Send your deposit with an explanation to your local IRS office or the service center where you will file Form 941. The service center addresses are on the back of Form 941 and are also available on the IRS website at **www.irs.gov**. **Do not** use **Form 8109-B,** Federal Tax Deposit Coupon, in this situation.

Depositing without Form 8109. If you have an EIN but do not have a preprinted Form 8109, you may use Form 8109-B to make deposits. Form 8109-B is an over-the-counter FTD coupon that is not preprinted with your identifying information. You may get this form by calling 1-800-829-4933. Be sure to have your EIN ready when you call. You will **not** be able to obtain Form 8109-B by calling 1-800-TAX-FORM.

Use Form 8109-B to make deposits **only if**—

- You are a new employer **and** you have been assigned an EIN, but you have not received your initial supply of Forms 8109 or
- You have not received your resupply of preprinted Forms 8109.

Deposit record. For your records, a stub is provided with each FTD coupon in the coupon book. The FTD coupon itself will not be returned. It is used to credit your account. Your check, bank receipt, or money order is your receipt.

How to claim credit for overpayments. If you deposited more than the right amount of taxes for a quarter, you can choose on Form 941 for that quarter to have the overpayment refunded or applied as a credit to your next return. Do not ask the depositary or EFTPS to request a refund from the IRS for you.

Deposit Penalties

Penalties may apply if you do not make required deposits on time, if you make deposits for less than the required amount, or if you do not use EFTPS when required. The penalties do not apply if any failure to make a proper and timely deposit was due to reasonable cause and not to willful neglect. For amounts not properly or timely deposited, the penalty rates are:

2% - Deposits made 1 to 5 days late.
5% - Deposits made 6 to 15 days late.
10% - Deposits made 16 or more days late. Also applies to amounts paid within 10 days of the date of the first notice the IRS sent asking for the tax due.
10% - Deposits made at an unauthorized financial institution, paid directly to the IRS, or paid with your tax return (but see ***Depositing without an EIN*** on page 21 and **Payment with return** on page 18 for exceptions).
10% - Amounts subject to electronic deposit requirements but not deposited using EFTPS.
15% - Amounts still unpaid more than 10 days after the date of the first notice that the IRS sent asking for the tax due or the day on which you received notice and demand for immediate payment, whichever is earlier.

Note: Late deposit penalty **amounts** are determined using **calendar days,** starting from the due date of the liability.

Order in which deposits are applied. Deposits generally are applied to the **most recent** tax liability within the quarter. If you receive a failure-to-deposit penalty notice, you **may designate** how your payment is to be applied in order to minimize the amount of the penalty. Follow the instructions on the penalty notice that you received. For more information on designating deposits, see Rev. Proc. 2001-58. You can find Rev. Proc. 2001-58 on page 579 of Internal Revenue Bulletin 2001-50 at **www.irs.gov/pub/irs-irbs/irb01-50.pdf.**

Example: Cedar, Inc. is required to make a deposit of $1,000 on June 15 and $1,500 on July 15. It does not make the deposit on June 15. On July 15, Cedar, Inc. deposits $2,000. Under the deposits rule, which applies deposits to the most recent tax liability, $1,500 of the deposit is applied to the July 15 deposit and the remaining $500 is applied to the June deposit. Accordingly, $500 of the June 15 liability remains undeposited. The penalty on this underdeposit will apply as explained above.

Trust fund recovery penalty. If income, social security, and Medicare taxes that must be withheld are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to you if these unpaid taxes cannot be immediately collected from the employer or business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be **responsible** for collecting, accounting for, and paying over these taxes, and who acted **willfully** in not doing so.

A **responsible person** can be an officer or employee of a corporation, a partner or employee of a partnership, an accountant, a volunteer director/trustee, or an employee of a sole proprietorship. A responsible person also may include one who signs checks for the business or otherwise has authority to cause the spending of business funds.

Willfully means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows that the required actions are not taking place.

Separate accounting when deposits are not made or withheld taxes are not paid. Separate accounting may be required if you do not pay over withheld employee social security, Medicare, or income taxes; deposit required taxes; make required payments; or file tax returns. In this case, you would receive written notice from the IRS requiring you to deposit taxes into a special trust account for the U.S. Government. You would also have to file monthly tax returns on **Form 941-M,** Employer's Monthly Federal Tax Return.

Appendix VII

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
AUG 1 5 2005

August 12, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments (Audit No. 200430016)

We have reviewed your report and appreciate the recognition of the Internal Revenue Service's (IRS) efforts to decrease the number of Federal Tax Deposit (FTD) penalties assessed annually. You specifically acknowledged the value of our systemic FTD penalty waiver notice (CP-235) and early intervention notice (CP-236) in decreasing FTD penalty assessments & subsequent penalty adjustments.

In May 2004, the Office of Penalties and Interest (OPI), along with the Taxpayer Advocate Service's (TAS) Office of Systemic Advocacy, convened a group of representatives from the Large & Mid-Sized Business (LMSB), Small Business/Self-Employed (SB/SE), and Tax Exempt & Government Entities (TE/GE) divisions, and the Office of Taxpayer Burden Reduction to review the FTD penalty process, notices and related returns and liability schedules. On April 20, 2005, the TAS posted the FTD Penalty Task Group's report on its public site. It stated "the group developed measurable solutions, proactive initiatives and informative messages to reduce FTD penalty assessments and increase customer satisfaction."

Your report also acknowledges our efforts to educate taxpayers in properly completing liability schedules filed with their tax returns. The 2005 revision of Publication 15 (Circular E) has a section devoted to educating the taxpayer in properly completing the liability schedule to avoid averaged FTD penalties. This addition to the publication, as well as the revised Form 941 and instructions, should reduce the number of incorrectly filed returns in the future. Also, the revised programming to the FTD penalty assessment notice (CP-207) process and the new notice, for averaged penalty assessments of $100,000 or more (CP-207L), should prove beneficial in decreasing FTD penalty assessments.

OPI and TAS plan to review the effectiveness of the revised CP-207 and new CP-207L in mid-2007, when they will have four quarters of posted information available. The delay in assessing FTD penalties, while securing correct liability information, should lead to additional reductions in FTD assessments. Our comments on your recommendations are as follow:

RECOMMENDATION 1
Address the TAS' concerns with the CP-207 and related processing issues.

CORRECTIVE ACTION
The Service has enhanced the programming for the CP-207 Notice generation process. When the proposed penalty is $100,000 or more, we will generate a CP-207L Notice, which we will review prior to mailing. Also we will generate a CP-207 Notice on any tax period having an invalid Record of Federal Tax Liability (ROFTL), even if the tax period is in a credit or balance due status.

IMPLEMENTATION DATE
The changes in the CP-207 generation and addition of the CP-207L are scheduled to be operational April 30, 2006 for Forms 940, 941, 943, 945 and CT-1.

RESPONSIBLE OFFICIAL
Director, Exam Policy SE:S:E:EP

CORRECTIVE ACTION MONITORING PLAN
National Program Manager, Office of Penalties and Interest will advise the Director, Exam Policy of any delays in accomplishing this planned corrective action.

RECOMMENDATION 2
Ensure the steps proposed by the IRS Office of Penalties and Interest to expand the CP207 Notice reviews are implemented.

CORRECTIVE ACTION
The approved Requests for Information Services EXM-5-0014A00 (CP-207L Identify Accounts with Averaged Penalties of $100,000 or More for Large Notice Review) and EXM-5-0017A (Issue CP-207 on Overpaid and Balance Due Accounts) are on schedule for generation on First Quarter 2006 Form 941 returns.

IMPLEMENTATION DATE
The new notices will generate on the First Quarter 2006 Form 941 tax periods, by the April 30, 2006 due date.

RESPONSIBLE OFFICIAL
Director, Exam Policy SE:S:E:EP

3

CORRECTIVE ACTION MONITORING PLAN
National Program Manager, Office of Penalties and Interest will advise the Director, Exam Policy of any delays in accomplishing the planned action.

RECOMMENDATION 3
Commission a research project with the objective of identifying other large FTD penalties that are likely to be reversed and developing a notice similar to the CP 207 Notice, and implement procedures to contact the taxpayers and resolve the proposed penalties prior to assessment. Criteria for this notice should be evaluated based on the availability of resources and the probability that the penalty would ultimately be reversed.

CORRECTIVE ACTION
We already have developed the CP-207L Notice to address proposed FTD penalties of $100,000 or more. The Large Corporation Units in Ogden's and Cincinnati's Technical Units will review these Notices and make taxpayer contact prior to mailing. We expect this new approach will decrease the number of large FTD penalties, thus reducing ARDI and addressing the concerns of TAS and LMSB. We will assess the benefit of reducing the notice dollar threshold based on the success of this CP-207L notice process and the resources used to work this notice.

IMPLEMENTATION DATE
July 31, 2007 is the planned review of the new CP-207L process and resulting penalty adjustments. At that time OPI, TAS, W&I, LMSB and TE/GE will evaluate the process.

RESPONSIBLE OFFICIAL
Director, Exam Policy SE:S:E:EP

CORRECTIVE ACTION MONITORING PLAN
National Program Manager, Office of Penalties and Interest will advise the Director, Exam Policy of any delays in accomplishing this planned action.

RECOMMENDATION 4
The Director, Office of Penalties and Interest, SE/SE Division, should coordinate with appropriate staff from the offices of the Commissioners, LMSB Division, SB/SE Division, W&I Division, and the TAS to commission a research project to identify taxpayers that incur and timely pay FTD penalties on a recurring basis with the objective of determining the cause and developing a strategy to reduce assessment of repeat penalties for the taxpaying segment. Consideration should be given to contacting these taxpayers directly or through a notice or questionnaire.

CORRECTIVE ACTION

OPI has requested the data reviewed in this audit. In September 2005, OPI and Research Division will commission a research project to identify taxpayers who incur and timely pay FTD penalties on a recurring basis, determine the cause(s) of this behavior, and develop a strategy to reduce repeat penalty assessments for this taxpaying segment.

IMPLEMENTATION DATE

September 30, 2006

RESPONSIBLE OFFICIAL

Director, Exam Policy SE:S:E:EP

CORRECTIVE ACTION MONITORING PLAN

National Program Manager, Office of Penalties and Interest will advise the Director, Exam Policy of any delays in accomplishing this action.

If you have any questions, please call me at (202) 622-0200 or Steve Burgess, Director, Examination, SB/SE at (202) 283-6955.