

**Collection Field Function Penalty Abatements
Need Proper Documentation and Coding**

September 2005

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



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 23, 2005

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Collection Field Function Penalty
Abatements Need Proper Documentation and Coding
(Audit # 200430017)

This report presents the results of our review of the Internal Revenue Service's (IRS) Penalty Abatement procedures. The overall objective of this review was to determine whether the Collection Field function (Cff)¹ was effectively and consistently abating penalties based on reasonable cause.

In summary, the IRS assesses penalties for various reasons related to the filing of tax returns and paying of taxes. When taxpayers do not file or pay their taxes timely, there are penalties assessed. The IRS has procedures in place that allow individuals to request that an assessed penalty be fully or partially abated (the monetary amount of the penalty will be eliminated or reduced). The IRS grants penalty abatements for various reasons, including the taxpayer showing a legitimate reason why the situation occurred that led to the penalty assessment. There are four categories in which the IRS allows relief from penalties: reasonable cause, statutory exception, administrative waiver, and correction of IRS error.

This audit report focuses on reasonable cause abatements made by revenue officers (RO) in the Cff. Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when a taxpayer exercises ordinary business care and prudence in determining his or her tax obligations but is

¹ Cff is the unit in the Small Business/Self-Employed Division field offices consisting of revenue officers who have personal contacts with taxpayers to collect delinquent accounts or secure unfiled tax returns.

unable to comply with those obligations. These abatements are high-risk transactions because the ROs use some discretion in determining if a taxpayer is eligible for the abatement based on the taxpayer's circumstances.

Our review of 156 abatements, involving 151 taxpayers, showed that abatements were consistent among offices; there were no unusual trends of 1 office having considerably more or fewer abatements. Also, taxpayers received similar consideration regardless of whether they had a representative.

However, 49 (31 percent) of the 156 abatements did not have either a sufficient explanation for or documentation to support the abatement for reasonable cause. In four abatements involving three taxpayers, the abatement was not appropriate because the taxpayers requested the abatements due to a possible embezzlement; however, there was not sufficient documentation to support that there was embezzlement. For the other 45 of 49 abatements, we identified the following examples of incomplete documentation: no Request for Adjustment (Form 3870) was available (although there were comments in the Integrated Collection System (ICS)² case histories that the Form 3870 was prepared or the abatement was mentioned), managerial approval was not documented, the reason for abatement was not documented on the Form 3870, and/or taxpayer correspondence was not available when required.

One possible reason for the lack of documentation is that the files are not being maintained properly after being sent from the field groups for processing and filing. It is important to maintain the source documentation for penalty abatements. These are high-risk transactions that need to be supported. Although it is possible the ROs prepared and forwarded the necessary documents to the Case Processing function based on the ICS history comments, without those documents it is impossible to know whether there was a valid reason supported by a taxpayer letter and proper approval. When documentation and approvals are not maintained, controls do not satisfactorily prevent manipulation of the process. As a result, we plan to send confirmation letters to taxpayers to verify the 49 abatements.

Also, management information on reasonable cause abatements is not reliable. The IRS uses a computer coding system to identify the reasons for penalty abatements. A primary code of RC 062 appears with the abatement transaction record for reasonable cause abatements. Along with that primary code, there is also a secondary code that is used to further explain the exact reason why the abatement meets the reasonable cause criteria. Our review of a sample of 156 abatements showed there were 46 instances of incorrect coding. Twenty-seven instances were coded as reasonable cause; however, they were not reasonable cause abatements. Nineteen instances had secondary codes that were not reasonable cause codes. We further determined that, from our population of 33,742 reasonable cause penalty abatements, a primary code of RC 062 was used with an invalid secondary code in 6,221 abatements (18 percent). Small Business/Self-Employed (SB/SE) Division management has informed us they

² The ICS is an IRS automated system used to control and monitor delinquent cases assigned to ROs in the IRS field offices.

plan to submit a Request for Information Services (RIS)³ to place a systemic verification on the IRS computer system that would allow only the specific secondary codes be used with RC 062.

We recommended the Director, Collection, SB/SE Division, ensure managers forward required supporting documentation for abatements and coordinate with the Director, Campus Compliance Services, to ensure documentation is properly maintained. Also, the Director, Campus Compliance Services, should ensure managers perform the required reviews of reason code input until the new systemic controls are established. The Director, Examination, SB/SE Division, should ensure the planned RIS is submitted for the systemic verification that will allow only the proper secondary codes to be used with RC 062.

Management's Response: The Commissioner, SB/SE Division, agreed with our recommendations. The Director, Collection Policy, will issue a memorandum to remind Collection field managers to review the required supporting documentation when the Form 3870 is submitted for approval. The approved Form 3870 will be electronically routed to Centralized Case Processing according to Internal Revenue Manual procedures. Also, the Director, Collection Business Reengineering, will develop controls to ensure that all supporting documentation is being maintained with the case file, and conduct annual reviews to ensure that the supporting documentation is properly maintained. In addition, the Director, Filing and Payment Compliance, will develop controls to ensure that Centralized Case Processing managers perform the required reviews of reasonable cause abatement requests to ensure the validity of the reason code input. Finally, the Office of Penalty and Interest will submit the final RIS for implementation no later than February 2006, with the expectation that programming will be completed by January 15, 2007. Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment: Although SB/SE Division management agreed with the recommendations, they did not agree that potentially \$10.8 million in revenue could be lost due to abatements not having supporting documentation available. While we agree that potentially the abatements could be proper, we think it is impossible to know they are proper without the supporting documentation being available. Therefore, there is a possibility that revenue within the range reported could be lost.

Copies of this report are also being sent to IRS officials who are 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.

³ A RIS is a request to change programming on IRS computer systems.

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Collection Field Function Penalty Abatements Need Proper Documentation and Coding

Background

The Internal Revenue Service (IRS) assesses penalties for various reasons related to the filing of tax returns and paying of taxes. When taxpayers do not file or pay their taxes timely, penalties are assessed. For example, the IRS assesses a penalty for failure to file a tax return by the date prescribed (including any applicable extensions), unless it is shown that the failure is due to reasonable cause and not due to willful neglect. The same penalty process applies if any tax shown on the return is not paid by the due date of that return or if Federal Tax Deposits (FTD)¹ are not deposited timely.

The IRS has procedures in place that allow individuals to request that an assessed penalty be fully or partially abated (the monetary amount of the penalty will be eliminated or reduced). The IRS grants penalty abatements for various reasons, including the taxpayer showing a legitimate reason why the situation occurred that led to the penalty assessment. There are four categories in which the IRS allows relief from penalties: reasonable cause, statutory exception, administrative waiver, and correction of IRS error.² Based on IRS Collection function reports, penalties totaling approximately \$6 billion were abated in Fiscal Year (FY) 2004.³

This audit report focuses on reasonable cause abatements made by revenue officers (RO) in the Small Business/Self-Employed (SB/SE) Division Collection Field function (CFf).⁴ Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when a taxpayer exercises ordinary business care and prudence in determining his or her tax obligations but is unable to

¹ FTDs include advance payments made by employers of taxes imposed under the Federal Insurance Contributions Act (FICA) and income taxes withheld from their employees' pay, and employers' share of the FICA tax. Generally, employers must deposit these taxes either once a month or twice a week, depending on the aggregate amount of employment tax reported in the 12-month period ending the preceding June 30.

² See Appendix V for explanations of these categories.

³ IRS Collection Report 5000-104 for FY 2004.

⁴ The CFf is the unit in the SB/SE Division field offices consisting of ROs who have personal contacts with taxpayers to collect delinquent accounts or secure unfiled tax returns.

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comply with those obligations. These abatements are high-risk transactions because the ROs use some discretion in determining if the taxpayer is eligible for the abatement based on the taxpayer's circumstances.

A taxpayer can request a reasonable cause penalty abatement in various ways, including sending a letter to the IRS, making a telephone contact, and working with the employee who is assigned the case. If a taxpayer has a delinquent tax case assigned to an RO in the CFf, the taxpayer should request the abatement through that RO. The taxpayer is required to request the abatement in writing if the amount is greater than \$250 per abatement or \$500 per tax period (multiple penalties could be assessed for 1 tax period). The RO is responsible for preparing a Request for Adjustment (Form 3870)⁵ and providing a complete statement explaining why the adjustment should be made. The Form 3870 also includes the codes to be input to the IRS computer system, dates, and assessment amounts to be adjusted. Some of these items are prepared by the RO and others are prepared by clerical support employees.

This review was performed at the IRS SB/SE Division Collection function in New Carrollton, Maryland; the Plantation, Florida, CFf office; and the Philadelphia, Pennsylvania, Campus⁶ Centralized Case Processing function during the period June 2004 through April 2005. The audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Abatements Were Consistent Among Offices, and Taxpayers With or Without Representation Received Similar Consideration

We reviewed 156 reasonable cause penalty abatements totaling \$917,343 that originated with ROs. These abatements were part of a nationwide statistically valid sample selected from a population of 33,742 abatements totaling \$49,203,966.

⁵ See Appendix VI for an example of Form 3870.

⁶ 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.

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The taxpayers included in our sample were small business taxpayers that had filed an Employer's Quarterly Federal Tax Return (Form 941) and had penalties abated for reasonable cause during May 1, 2003, through April 30, 2004.⁷ Figure 1 identifies the dollar range for the penalty abatements we reviewed.

Figure 1: Dollar Ranges for Abatements

| Dollar Range for Penalty Abatements | Number of Abatements |
|-------------------------------------|----------------------|
| Under \$250 | 68 |
| \$251- \$500 | 15 |
| \$501- \$1,000 | 28 |
| \$1001- \$5,000 | 33 |
| \$5,001- \$10,000 | 8 |
| \$10,001- \$15,000 | 2 |
| \$15,001- \$100,000 | 1 |
| \$100,001 over | 1 |
| <i>Total</i> | 156 |

Source: Treasury Inspector General for Tax Administration review of 156 penalty abatements and the Master File⁸ as of August 30, 2004.

Since the abatement process is somewhat judgmental, we analyzed the number of abatements by CFf offices. We determined that no unusual trends existed in which some CFf offices were processing more abatements than the others. Generally, the larger offices with more groups processed a larger number of abatements.

Finally, the IRS Oversight Board was concerned that taxpayers who do not have representatives are at a disadvantage when it comes to requesting and receiving abatements.⁹ Although we did not review any cases in an attempt to identify abatement requests that were denied, our review showed that taxpayers received satisfactory consideration regardless of whether they had representatives. One-half of the taxpayers in our sample received abatements without having a representative, while the other half had representatives.

⁷ We initially identified 226 abatements but later determined that not all of these abatements originated from ROs, so we eliminated the 70 cases that originated from a function other than the CFf.

⁸ The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁹ IRS Oversight Board Public Meeting, January 29, 2002.

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Abatements Did Not Have Proper Documentation to Support the Abatement for Reasonable Cause

When taxpayers are assessed taxes, many times there are applicable penalties such as failure to file, failure to pay, and failure to make FTDs. Taxpayers may request abatements of such penalties due to reasonable cause under certain circumstances. These circumstances include when taxpayers exercise ordinary business care and prudence in determining their tax obligations but are unable to comply with those obligations. Specific reasons can include:

- Standards (Federal Tax Regulations and IRS Policy Statements that contain specific criteria that may affect the assessment of penalties).
- Ordinary Business Care and Prudence.
- Death, Serious Illness, or Unavoidable Absence.
- Unable to Obtain Records.

When ROs abate penalties for reasonable cause, the following documentation is required to support the abatement:

- Form 3870, which is used to provide a complete statement explaining why the adjustment should be made.
- Taxpayer Letter – If the amount of the abatement is greater than \$250 per abatement or \$500 per tax period, the taxpayer is required to submit a letter with sufficient detail to show that ordinary business care was exercised.
- An Integrated Data Retrieval System (IDRS)¹⁰ Transaction Record Printout used by the RO to verify the amount of the abatement the taxpayer requested.

Our review of 156 abatements, involving 151 taxpayers, showed that 49 (31 percent) did not have either a sufficient explanation for or documentation to support the abatement for reasonable cause. Four abatements, involving three taxpayers, were not appropriate. Each of the three taxpayers stated in his or her request for abatement that an employee had embezzled the company's funds. However, IRS procedures state that the responsibility for depositing taxes

¹⁰ The IDRS is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

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cannot be delegated. Therefore, if embezzlement is the basis for the request for penalty removal, the taxpayer must have sufficient supporting documentation of the embezzlement, which could include filing criminal charges against the employee accused of embezzlement. In these three cases, there was no documentation supporting that charges were filed, and the ROs did not verify whether the taxpayer encountered fraud before allowing the abatement.

For the other 45 abatements, we identified the following incomplete documentation:

- In 20 abatements, no Form 3870 was in the case files. However, in 17 of these 20 instances, the Integrated Collection System (ICS) case history¹¹ included a comment that 1 was prepared. For the three remaining instances, comments existed in the ICS case history explaining the abatement.
- In five abatements, the Form 3870 either did not include the reason for the penalty abatement or have managerial approval documented on the Form. The Form 3870 Handbook requires that the RO provide a complete statement explaining why the adjustment should be made and managers are required to approve the abatement.
- In 20 abatements, taxpayer correspondence was not attached, and the abatement amount was over \$250 per abatement or \$500 per tax period. In addition to these 20, 15 of those listed above in the first bullet and 1 included in the second bullet also did not have the required taxpayer correspondence.

One possible reason for the lack of documentation is that the files are not being maintained properly after being sent from the field groups for processing. According to the information in most of the ICS case histories, there was a documented reason for the abatement and, in some instances, a Form 3870 that was prepared. At some point in the process, the Form 3870 and any supporting letter may have been misplaced. Functional managers may not be

¹¹ The ICS is an IRS automated system used to control and monitor delinquent cases assigned to ROs in the IRS field offices. The ICS case history documents the RO's activity on a case.

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verifying that all the documentation is maintained with the abatement request.

It is important to maintain the source documentation for penalty abatements. These are high-risk transactions that need to be supported and approved. Although it is possible the ROs prepared and forwarded the necessary documents based on the ICS case history comments, without those documents it is impossible to know whether there was a valid reason supported by a taxpayer letter and proper approval. When documentation and approvals are not maintained, controls do not satisfactorily prevent manipulation of the process. As a result, we plan to send confirmation letters to taxpayers to verify the 49 abatements discussed above.

When controls are not effective, the IRS may lose money due to inappropriate penalty abatements. Based on our statistically valid sample of abatements, we estimate 7,315 abatements involving approximately \$10.8 million may not have been appropriately documented. See Appendix IV for details.

Recommendation

The Director, Collection, SB/SE Division, should:

1. Ensure managers forward the required supporting documentation for abatements to the Case Processing function and coordinate with the Director, Campus Compliance Services, to ensure documentation is properly maintained.

Management's Response: The Director, Collection Policy, will issue a memorandum to remind Collection field managers to review the required supporting documentation when the Form 3870 is submitted for approval. The approved Form 3870 will be electronically routed to Centralized Case Processing according to Internal Revenue Manual (IRM) procedures. IRM 5.1.15 will be updated to include appropriate instructions to ROs.

The Director, Collection Business Reengineering, will develop controls to ensure that all supporting documentation is being maintained with the case file and conduct annual

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Management Information on Reasonable Cause Abatements Is Not Reliable

reviews to ensure that the supporting documentation is properly maintained.

The IRS uses a computer coding system to identify the reasons for penalty abatements. When a reasonable cause abatement is processed, employees should input a primary code of RC 062. Along with that primary code, employees also select a secondary code that is used to further explain the exact reason why the abatement meets the reasonable cause criteria. Computer terminal input operators and their managers should ensure the correct codes are entered into the IRS computer system. IRS procedures state that, when RC 062 is used, only the following secondary codes should be used:

Figure 2: Definitions of Secondary Reason Codes

| Penalty Reason Code (PRC) | Definition |
|----------------------------------|----------------------------------------------------------------------------------------------------------------|
| 22 | Taxpayer exercised ordinary business care and prudence/first-time filer |
| 24 | Death, serious illness, or unavoidable absence in immediate family of the party responsible (Individual taxes) |
| 25 | Records inaccessible |
| 26 | Death, serious illness, or unavoidable absence in immediate family of the party responsible (Business taxes) |
| 30 | Other (Acceptable Explanation) |
| 46 | Y2K-related ¹² penalty relief |
| 50/51 | User fee reversal ¹³ |

Source: Automated Data Processing and IDRS Information 2005 - Document 6209.

¹² Y2K is a term that was used to describe a possible computer error when the dates changed from Calendar Year 1999 to 2000.

¹³ A User Fee is a fee that the IRS is authorized to charge for services provided by the agency such as processing an installment agreement.

Collection Field Function Penalty Abatements Need Proper Documentation and Coding

Our review of 156 abatements identified 46 instances of incorrect coding.

- There were 27 instances in which RC 062 was used incorrectly; the actions should have been coded with reasons from the other penalty relief categories listed in Appendix V, such as:
 - Statutory Exception - PRC 044.
 - Corrected/Amended return, Original return prepared by the Service¹⁴ (Substitute for Return/6020B) - PRC 013.
 - Service Error - PRC 045.
 - Taxpayer relied on practitioner or third-party advice - PRC 023.
- There were 19 instances in which either the secondary codes used were not valid for use with RC 062 or a different secondary code should have been used.

We further determined that, over our population of 33,742, a primary code of RC 062 was used with an invalid secondary code in 6,221 (18 percent) of the abatements. One possible reason is that there is currently no systemic verification that allows only the proper secondary codes to be used with RC 062. Another possible reason is that Case Processing function managers did not ensure the proper coding was used.

Management information for reasonable cause abatements will not be reliable if the codes are not used correctly, and trends will not be valid concerning the reasons abatements are made. This affects the IRS' ability to correctly report to outside stakeholders the reasons for abatements and whether abatements are consistently applied.

SB/SE Division management has informed us they plan to submit a Request for Information Services (RIS)¹⁵ to place a systemic verification on the IRS computer system that would allow only specific secondary codes to be used with RC 062. They plan to submit the RIS in October 2005; the planned completion date is sometime in Calendar

¹⁴ Service = IRS.

¹⁵ A RIS is a request to change programming on IRS computer systems.

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Year 2007. If this is done, we believe it will considerably improve the controls over the coding process and the management information available on penalty abatements.

Recommendations

The Director, Campus Compliance Services, should:

2. Ensure managers perform the required reviews of reason code input until the new systemic controls are established.

Management's Response: The Director, Filing and Payment Compliance, will develop controls to ensure that Centralized Case Processing managers perform the required reviews of reasonable cause abatement requests to ensure the validity of the reason code input, and will update IRM procedures appropriately.

The Director, Examination, SB/SE Division, should:

3. Ensure the planned RIS is submitted for the systemic verification that allows only the proper secondary codes to be used with RC 062.

Management's Response: The Office of Penalty and Interest will submit the final RIS for implementation no later than February 2006 with the expectation that programming will be completed by January 15, 2007.

Office of Audit Comment: Although SB/SE Division management agreed with the recommendation, they did not agree that potentially \$10.8 million in revenue could be lost due to abatements not having supporting documentation available. While we agree that potentially the abatements could be proper, we think it is impossible to know they are proper without the supporting documentation being available. Therefore, there is a possibility that revenue within the range reported could be lost.

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the Collection Field function (CFf)¹ was effectively and consistently abating penalties based on reasonable cause. Specifically, we:

- I. Determined whether the CFf has effective procedures to ensure penalty abatements granted for reasonable cause to small business taxpayers are appropriate.
 - A. Obtained Internal Revenue Service (IRS) guidelines and procedures established for abating penalties for reasonable cause.
 - B. Discussed guidelines and expectations with Small Business/Self-Employed Division management. Also, interviewed designated contacts at the Philadelphia Campus² Compliance Services function and the Office of Penalty and Interest.
 - C. Determined whether there is a management information system used to monitor and track penalty abatements for reasonable cause and how it is used.
- II. Determined whether revenue officers (RO) made proper determinations when abating penalties for reasonable cause and whether the decisions were adequately documented.
 - A. Selected a sample of cases with penalties abated due to reasonable cause that had been processed in the CFf.
 1. Obtained the population of small business Employer's Quarterly Federal Tax Return (Form 941) penalty abatement cases processed from May 1, 2003, through April 30, 2004, for four types of penalties: Delinquency Penalty, Deposit Penalty, Miscellaneous Penalty, and Failure to Pay Tax Penalty. The population was 33,742 abatements; dollars abated totaled \$49,203,966.
 2. Validated the data received by matching taxpayer information and penalty abatements data from our extract to the IRS' computer system data.
 3. Selected a statistical sample of 226 penalty abatements using a 90 percent confidence level, a precision of ± 5 percent, and an expected error rate of 30 percent.

¹ The CFf is the unit in the Small Business/Self-Employed Division field offices consisting of revenue officers who have personal contacts with taxpayers to collect delinquent accounts or secure unfiled tax returns.

² 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.

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4. For the statistical sample selected in Step II.A.3, requested the Integrated Collection System (ICS)³ case history and the Request for Adjustment (Form 3870) documentation.
- B. Reviewed 156 abatements to determine whether there was an adequate explanation for the penalty abatement and the decision was proper. We selected a statistically valid sample of 226 abatements, but as we performed our review, we determined that not all these abatements originated from ROs, so we had to eliminate some cases. As a result, our final sample size for abatements made by ROs was 156 abatements totaling \$917,343.
1. Determined whether the correct Penalty Reason Code was used.
 2. Determined whether the taxpayer signed the Form 3870 or submitted a signed request.
 3. Determined whether the taxpayer provided proper documentation in support of the penalty abatement.
 4. Determined whether the decision was based on the criteria for reasonable cause.
 5. Determined whether the RO obtained managerial approval.
 6. Determined whether decisions in similar cases were consistent from one office to another.
 7. Determined whether the taxpayers had representatives, to determine whether taxpayers were treated consistently regardless of whether they had representatives.

³ The ICS is an IRS automated system used to control and monitor delinquent cases assigned to ROs in the IRS field offices.

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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:

- Increased Revenue – Potential; 7,315 abatements affected and \$10.8 million (see page 4).

Methodology Used to Measure the Reported Benefit:

For the period May 1, 2003, through April 30, 2004, we identified a population of 33,742 abatements due to reasonable cause for taxpayers that had cases showing on the Integrated Collection System (ICS).¹ From this population, we selected a statistically valid sample of 226 abatements based on a confidence level of 90 percent, a precision level of ± 5 percent, and an expected error rate of 30 percent.

Our review showed that there were 49 (21.68 percent) of the 226 abatements that did not have supporting documentation available. Although the abatements reviewed were generally proper, when the supporting documentation is not maintained in the file, we cannot be assured that the abatements had sufficient supporting documentation.

Therefore, based on the 49 abatements for which supporting documentation could not be provided, we estimate 7,315 cases may not have appropriate documentation for penalty abatements ($33,742 \times 21.68$ percent).²

We also calculated the dollar value of possibly affected abatements in the population. However, we cannot make a conclusion about the entire population because there was 1 very large abatement over \$700,000 in our sample that caused us to consider it separately in our projection of the dollar value affected. The remainder of our sample abatements (225) ranged from \$.01 to about \$35,600. Therefore, our projection of the dollar value of abatements affected in the population applies to only those abatements in the population that were similar in dollars (i.e., less than or equal to about \$35,600).

We estimate that approximately \$10.8 million of abatements granted from May 2003 through April 2004 could be affected. This is based on the average dollars per abatement without supporting documentation (\$300.18) multiplied by the number of cases in the population that involved penalties of less than or equal to about \$35,600 (33,653 abatements), which totals

¹ The ICS is an Internal Revenue Service (IRS) automated system used to control and monitor delinquent cases assigned to revenue officers in the IRS field offices.

² Using a 95 percent confidence interval, the lower limit for our estimate of potential abatements affected is 5,509 abatements and the upper limit is 9,122 abatements.

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approximately \$10.1 million. Then, we added back in the 1 large abatement of over \$700,000, without projecting it, for an expected dollar value of approximately \$10.8 million.³

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 46 abatements affected (see page 7).

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 226 abatements based on a confidence level of 90 percent, a precision level of ± 5 percent, and an expected error rate of 30 percent.

Our review of the abatements identified 46 instances of incorrect coding. There were 27 instances in which the code for reasonable cause abatements (RC 062) was used incorrectly; the actions should have been coded with reasons from the other penalty relief categories listed in Appendix V. Also, there were 19 instances in which either the secondary codes used were not valid for use with RC 062 or a different secondary code should have been used. Incorrect coding could lead to unreliable management information regarding abatements due to reasonable cause.

³ Using a 95 percent confidence interval, the lower limit of the dollar value is approximately \$6.6 million.

Four Categories for Relief From Penalties

Reasonable Cause: This is based on all the facts and circumstances in each situation and allows the Internal Revenue Service (IRS) to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining his or her tax obligations but is unable to comply with those obligations.

Statutory Exception: This is tax legislation, such as the Internal Revenue Code, that provides an exception to a penalty that otherwise would be assessed. The IRS may issue a News Release or other guidance with instructions for disposition of the penalties.

Administrative Waiver: The IRS may formally interpret or clarify a provision to provide administrative relief from a penalty that would otherwise be assessed. An Administrative Waiver may be addressed in a Policy Statement, News Release, or other formal communication stating that the policy of the IRS is to provide relief from a penalty under specific conditions. An Administrative Waiver may be necessary when there is a delay by the IRS in printing or mailing forms, publishing guidance, writing regulations, or other conditions.

Correction of IRS Error: This is any error made by the IRS in computing or assessing tax and crediting accounts. For example, processing errors include misapplied tax returns, extension requests, and payments.

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Appendix VI

Request for Adjustment (Form 3870)

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| 1. TIN | | Cross Reference TIN | | Department of the Treasury Internal Revenue Service request for adjustment Catalog No. 22515Q | | | |
| 2. Name | | 3. Originating Office | | | | | |
| Street Address | | TC <input type="checkbox"/> CC <input type="checkbox"/> | | | | | |
| City | State | Zip Code | Telephone Number () | | | | |
| 4. MFT | 5. Period Ending | 6. Assessment Date | | 7. Source TDA <input type="checkbox"/> Letter <input type="checkbox"/> Claim <input type="checkbox"/> Other _____ | | | |
| 8. DLN | | 9. Renumbered DLN | | 10. Personal Contact Yes <input type="checkbox"/> No <input type="checkbox"/> POA _____ | | | |
| 11. Reason for Adjustment | | | | | | | |
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| 12. I hereby request that the items indicated above be included or changed on my Federal Tax Return or account as identified. | | | | | | | |
| Signature of Taxpayer | | | | Date | | | |
| 13. Signature of Preparer | | Telephone (work) / (FAX) | | Date | | | |
| 14. Approving Official Signature and Title | | | | Date | | | |
| Assessment, Item, or Credit Adjustment Processing Information | | | | | | | |
| 15. Sequence Number | 16. Blocking Series | 17. Del. Int. to Date | 18. Source Code | 19. Reason Code | 20. Math Error Code | 21. Hold Code | 22. Other |
| 23. Priority Code | 24. Posting Delay Code | 25. Source Doc. Attached | 26. Other | | 27. | 28. | |
| 29. TC No. | Increase / Decrease | | Ref. No. | Item Adjustment | Ref. No. | Credit Adj. | |
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| 30. Remarks | | | | | | | |
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| 31. Terminal Operator's Number | | | Employee I.D. | | Date Input | | |

Management's Response to the Draft Report



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

RECEIVED
AUG 25 2005

August 22, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Collection Field Function Penalty
Abatements Need Proper Documentation and Coding
(Audit # 200430017)

We have reviewed your report and appreciate your recognition of the consistency and equity with which the Collection Field function (Cff) grants reasonable cause abatements. Your review of 156 cases showed that abatements were consistent among field offices and that taxpayers received similar consideration regardless of whether the taxpayers represented themselves or had a representative.

As stated in your report, reasonable cause relief is granted when the taxpayer exercises ordinary business care and prudence in meeting their tax obligations but is not able to comply with those obligations. We agree with your findings that we need to ensure supporting documentation for these abatements is prepared and maintained properly. Accordingly, we will issue a memorandum to remind Cff managers that supporting documentation must be reviewed when the Form 3870 (Request for Adjustment) is submitted for approval. In addition, we will revise the Internal Revenue Manual (IRM) to provide emphasis and clarification regarding the required supporting documentation for penalty abatement requests.

We are currently testing an Electronic 3870 processing system. With the electronic system, Cff managers will review the supporting documentation and electronically forward only the approved Form 3870 to Centralized Case Processing (CCP). The supporting documentation will be maintained in the case file. Upon successful completion of the testing, we will fully implement this system and revise the IRM with the new instructions. We will conduct annual reviews of this process to ensure that the supporting documentation is maintained properly.

Regarding the outcome measures, your report cites Cff's decisions regarding penalty abatements as generally proper (see Appendix IV). Accordingly, we believe it is improbable that revenue savings from increased documentation would be as high as projected, given the likelihood that a significant portion of these abatements were appropriate despite supporting documentation being unavailable for review.

Collection Field Function Penalty Abatements Need Proper Documentation and Coding

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Our comments on your recommendations follow:

RECOMMENDATION 1

The Director, Collection, Small Business/Self-Employed (SB/SE) Division, should ensure managers forward the required supporting documentation for abatements to the Case Processing function and coordinate with the Director, Campus Compliance Services, to ensure documentation is maintained properly.

CORRECTIVE ACTION

The Director, Collection Policy, will issue a memorandum to remind Collection field managers to review the required supporting documentation when the Form 3870 is submitted for approval. The approved Form 3870 will be electronically routed to Centralized Case Processing according to IRM procedures. We will update IRM 5.1.15 to include appropriate instructions to revenue officers.

The Director, Collection Business Reengineering, will develop controls to ensure that all supporting documentation is being maintained with the case file. We will conduct annual reviews to ensure that the supporting documentation is properly maintained.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Collection Policy, SB/SE Division and Director, Collection Business Reengineering, SB/SE Division.

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Case Resolution Alternatives, will advise the Director, Collection Policy, of any delays.

Program Manager, Collection Field Reengineering, will advise the Director, Collection Business Reengineering, of any delays.

RECOMMENDATION 2

The Director, Campus Compliance Services should ensure managers perform the required reviews of reason code input until the new systemic controls are established.

CORRECTIVE ACTION

The Director, Filing and Payment Compliance, will develop controls to ensure that Centralized Case Processing managers perform the required reviews of reasonable cause abatement requests to ensure the validity of the reason code input. We will update IRM procedures appropriately.

Collection Field Function Penalty Abatements Need Proper Documentation and Coding

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IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Filing and Payment Compliance, SB/SE Division.

CORRECTIVE ACTION MONITORING PLAN

Director, Case Processing, will advise the Director, Filing and Payment Compliance, of any delays.

RECOMMENDATION 3

The Director, Examination, SB/SE Division should ensure the planned Request for Information Services (RIS) is submitted for the systemic verification that allows only the proper secondary codes to be used with Reason Code 062.

CORRECTIVE ACTION

The Office of Penalty and Interest will submit the final RIS for implementation no later than February 2006, with the expectation that programming will be completed by January 15, 2007.

IMPLEMENTATION DATE

January 15, 2007

RESPONSIBLE OFFICIAL(S)

Director, Examination, SB/SE Division.

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Office of Penalty and Interest, will advise the Director, Examination, of any delays.

If you have any questions, please contact me at (202) 622-0600 or Brady R. Bennett, Director, Collection, SB/SE Division, at (202) 283-7660.