

**Management Advisory Report:
Ineffective Administration of the Individual
Taxpayer Penalty Program Creates Inequity**

April 2001

Reference Number: 2001-40-069

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.



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 18, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

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

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report - Ineffective Administration
of the Individual Taxpayer Penalty Program Creates Inequity

This report presents the results of our review of the Internal Revenue Service's (IRS) process to administer penalties (assessments and abatements) affecting individual taxpayers. In summary, we found that the IRS is unable to effectively administer the individual taxpayer penalty program, resulting in inequitable treatment of taxpayers.

We recommended that the IRS designate an executive in each business unit to coordinate with the Office of Interest and Penalty Administration to ensure functional compliance with the IRS' penalty policy. In addition, the IRS needs to provide sufficient resources and to develop a management information system, a recommendation analysis and implementation system, and a formal review program to assess its compliance with the penalty policy.

Management agreed to the recommendations we presented. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

**Management Advisory Report: Ineffective Administration of the
Individual Taxpayer Penalty Program Creates Inequity**

Table of Contents

Executive Summary	Page i
Objective and Scope	Page 1
Background	Page 1
Results	Page 3
Ineffective Administration of the Individual Taxpayer Penalty Program Results in Inequitable Treatment of Taxpayers.	Page 4
Conclusion	Page 9
Appendix I – Detailed Objective, Scope, and Methodology	Page 10
Appendix II – Major Contributors to This Report	Page 11
Appendix III – Report Distribution List	Page 12
Appendix IV – Penalty Policy Statement (P-1-18)	Page 13
Appendix V – Management’s Response to the Draft Report	Page 15

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

Executive Summary

The purpose of penalties in tax administration is to punish noncompliant taxpayers and to deter compliant taxpayers from noncompliant behavior. Despite the impact that penalties have on individual taxpayers, the Internal Revenue Service (IRS) cannot ensure that penalties are fairly, accurately, or consistently assessed and/or abated.

In Tax Year (TY) 1996,¹ approximately 1.4 million individual taxpayers were assessed penalties totaling almost \$1.3 billion. However, over 417,000 of the 1.4 million taxpayers had over \$250 million of their penalties abated.²

In both Fiscal Years 1998 and 1999, the Taxpayer Advocate reported to the Congress that penalty administration was the fifth most serious problem facing taxpayers. According to the Taxpayer Advocate, “Penalty administration is inconsistent....”

The overall objective of this audit was to determine if the IRS had an effective process to administer penalties affecting individual taxpayers.

Results

The IRS needs to improve its administration of the individual taxpayer penalty program to ensure equitable treatment of taxpayers. Individuals who are assessed penalties by the IRS cannot be assured that the IRS will consistently address their requests for abatements of those penalties. In fact, the IRS does not know why 29 percent of the penalties that were assessed for TY 1996 were later abated for these same taxpayers. The IRS also does not know if these penalty abatements were fairly, accurately, or consistently performed.

Insufficient and inconsistent management oversight of penalty administration, unclear lines of accountability and responsibility, lack of available or accurate data to evaluate penalty administration, and scarce resources along with competing priorities contributed to the ineffectiveness of the IRS’ administration of the individual taxpayer penalty program.

¹ TY 1996 is the latest complete penalty assessment and abatement data available. This is because the IRS can assess penalties up to 3 years after the due date of the return or 3 years after the IRS received date, whichever is later.

² An “abatement” occurs when an assessed monetary penalty amount is reduced or eliminated.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

Some of the issues presented in this report have been repeatedly brought to the IRS' attention during the last 10 years with little or no action being taken by the IRS to correct the identified problems.

Ineffective Administration of the Individual Taxpayer Penalty Program Results in Inequitable Treatment of Taxpayers

The IRS cannot ensure that penalties for individual taxpayers are fairly, accurately, or consistently assessed and/or abated. Statistical and demographic information captured by the IRS was not used to evaluate the impact of the individual taxpayer penalty program on compliance. In addition, recommendations³ made to revise the individual taxpayer penalty program to ensure consistent and accurate penalty assessments and abatements were not implemented.

Without effective administration of the individual taxpayer penalty program, the IRS does not know if the penalties assessed on approximately 1.4 million individual taxpayers or the penalties abated for over 417,000 of these individual taxpayers for TY 1996 were done appropriately and consistently. Although IRS does not know whether penalties overall are being applied consistently, a recent Treasury Inspector General for Tax Administration audit report⁴ involving one type of penalty found that taxpayers were being assessed penalties inconsistently.

Summary of Recommendations

To ensure equitable treatment of taxpayers and effective penalty administration, the IRS needs to designate an executive in each business unit to coordinate with the Office of Interest and Penalty Administration to ensure functional compliance with the IRS' penalty policy. In addition, the IRS needs to provide sufficient resources and to develop a management information system, a recommendation analysis and implementation system, and a formal review program to assess its compliance with the penalty policy.

Management's Response: IRS management agreed with our recommendations. The IRS plans to select liaisons within the various operating divisions, fill vacancies and determine the need for additional resources, use a management information system to develop reports by business unit, and begin periodic reviews of the penalty program. It

³ Recommendations were from internal and external sources, including IRS Task Force studies, a Treasury Department review, and a review that was part of the Vice President's National Partnership on Reinventing Government.

⁴ *Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity* (Reference Number 2000-30-112, dated August 2000).

**Management Advisory Report: Ineffective Administration of the
Individual Taxpayer Penalty Program Creates Inequity**

also recently developed a database that includes a catalog of recommendations from various sources.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

Objective and Scope

The objective of this audit was to determine if the IRS had an effective process to administer penalties affecting individual taxpayers.

The objective of this audit was to determine if the Internal Revenue Service (IRS) had an effective process to administer penalties (assessments and abatements¹) affecting individual taxpayers. To accomplish our objective, we reviewed documentation and interviewed IRS management officials and personnel involved with penalty administration.

We conducted work at the National Headquarters from December 1999 through October 2000. Our review was performed in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*.

Details of our objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The purpose of penalties in tax administration is to punish noncompliant taxpayers and to deter compliant taxpayers from noncompliant behavior. Despite the impact that penalties have on individual taxpayers, the IRS cannot ensure that penalties are fairly, accurately, or consistently assessed and/or abated.

Penalties constitute one important tool for the IRS in collecting the proper amount of tax revenue at the least cost.

Penalties constitute one important tool for the IRS in collecting the proper amount of tax revenue at the least cost. The IRS uses penalties to encourage voluntary compliance by:

- Helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not.

¹ An "abatement" occurs when an assessed monetary penalty amount is reduced or eliminated.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

- Deterring noncompliance by imposing costs on it.
- Establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.

The Congress establishes laws for assessing monetary penalties on individual taxpayers. The IRS is responsible for the development and administration of a penalty policy that complies with the laws.

Responsibility for the penalty program is assigned to the OIPA.

In response to an IRS task force recommendation, the IRS created the Office of Interest and Penalty Administration (OIPA) in 1992. The OIPA oversees the individual taxpayer penalty program. This responsibility includes developing and implementing a comprehensive strategy for penalty administration and administering the IRS' Penalty Policy (P-1-18), which sets forth the objectives and the manner in which the IRS will administer its individual taxpayer penalty program fairly and consistently (see Appendix IV).

Most penalty assessments for individuals are computer generated, including when the IRS detects that a tax return has not been timely filed or when an individual has not provided full payment of taxes when the tax return is filed. The IRS has procedures in place that allow individuals to request that an assessed penalty be abated (monetary amount will be reduced or eliminated). The IRS grants penalty abatements for various reasons, including the taxpayer showing legitimate, uncontrollable reasons why the situation occurred that led to the penalty assessment.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

As noted in Table 1, in TY 1996,² approximately 1.4 million individual taxpayers had almost \$1.3 billion in penalties assessed. Of these, over 417,000 individual taxpayers had over \$250 million of their penalties abated.

Table 1

Tax Year 1996		
Individual Taxpayer Penalty Assessments/Abatements		
Type of Penalty Action	Total Taxpayers	Total Dollars
Penalty Assessments	1,445,188	\$1,298,262,724
Penalty Abatements	417,465	\$254,856,162

Source: Data extract from the IRS TY 1996 Masterfile.

In both Fiscal Years 1998 and 1999, the Taxpayer Advocate reported to the Congress that penalty administration was the fifth most serious problem facing taxpayers. According to the Taxpayer Advocate, "Penalty administration is inconsistent...."

Results

The IRS' administration of the individual taxpayer penalty program does not ensure equitable treatment of taxpayers.

The IRS needs to improve its administration of the individual taxpayer penalty program to ensure equitable treatment of taxpayers. Individuals who are assessed penalties by the IRS cannot be assured that the IRS will consistently address their requests for abatements of those penalties.

Some of the issues presented in this report have been brought to the IRS' attention repeatedly during the last 10 years. The IRS has taken little or no action to correct the identified problems because IRS management has not developed a system to track and monitor these recommendations. As part of the current reorganization

² TY 1996 is the latest complete penalty assessment and abatement data available. This is because the IRS can assess penalties up to 3 years after the due date of the return or 3 years after the IRS received date, whichever is later.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

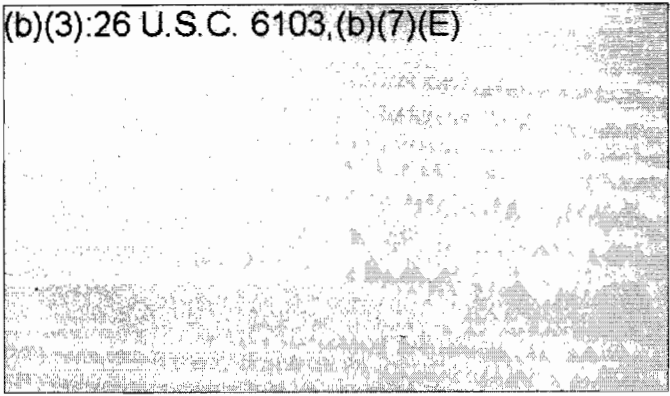
of the IRS into separate business units by type of taxpayer, it is imperative that penalty administration maintains a focus on individual taxpayers, where there is a large potential impact.

Ineffective Administration of the Individual Taxpayer Penalty Program Results in Inequitable Treatment of Taxpayers

Without effective administration of the individual taxpayer penalty program, the IRS does not know if the penalties assessed on approximately 1.4 million individual taxpayers or the penalties abated for over 417,000 of these individual taxpayers for TY 1996 were applied appropriately and consistently. For example:

- In August 2000, we issued a Limited Official Use audit report³ that detailed inconsistencies in the assessment of the estimated tax (ES) penalty.

(b)(3):26 U.S.C. 6103,(b)(7)(E)



In addition, over 417,000 (29 percent) of the 1.4 million individual taxpayers received abatements of over \$250 million. The IRS does not know if these penalty abatements were fairly, accurately, or consistently performed.

³ *Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity* (Reference Number 2000-30-112, dated August 2000).

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

An example of the inconsistency in abatements involves those made due to reasonable cause. As a hypothetical example:

- Taxpayer #1 is assessed a failure to file penalty (tax return was not filed with the IRS when due). The taxpayer calls his/her local IRS office to have the penalty abated because the taxpayer was unable to timely file his/her tax return due to a serious illness in his/her family. The taxpayers' request is denied. The IRS employee reviewing this request concludes that the taxpayer should have been able to comply with the timely filing of the tax return.
- Taxpayer #2, with the same circumstances as above, gets the failure to file penalty abated. This taxpayer calls an IRS office other than the one above, and the IRS employee reviewing the request concludes that the taxpayer had reasonable cause to not timely file his/her tax return and abates the penalty.

According to IRS statistics, only 54 percent of reasonable cause abatements are accurately based on IRS' abatement criteria.

As detailed in the example above, penalty abatements can result in different outcomes depending on the opinion of the IRS employee working the case. According to IRS statistics, only 54 percent of reasonable cause abatements are accurately based on IRS' abatement criteria.⁴ As a result, the IRS cannot ensure that penalties for individual taxpayers are fairly, accurately, or consistently assessed and/or abated.

The Taxpayer Advocate has noted that, "...the imposition or abatement of a penalty is a judgement call, which often translates into lack of consistency when applying criteria." Charles Shewbridge of the Tax Executives Institute, Inc., stated that, "To further the goal of consistency, Tax Executives Institute recommends that some form of coordinated review of penalty application be established, perhaps in conjunction with the new IRS business units."

⁴ Internal Revenue Manual 120.1.1.3, Penalty Handbook

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

IRS policy requires the collection of statistical and demographic information to evaluate penalties and penalty administration and how they relate to the goal of compliance.

In an attempt to ensure the consistency of penalty abatements, the IRS has developed the Reasonable Cause Assistant (RCA) computer system that is designed to assist IRS employees in delivering a fair and consistent approach to penalty abatements. The IRS intends to begin implementation of the RCA in April 2001.

The IRS is required to follow Policy P-1-18, Penalty Policy Statement, which provides that the IRS will collect statistical and demographic information to evaluate penalties and penalty administration and how they relate to the goal of compliance. The Policy also requires that the IRS maintain an ongoing effort to develop, monitor, and revise programs designed to assist taxpayers in complying with legal requirements and thus avoid penalties (see Appendix IV).

Contributing factors

The IRS is unable to effectively administer the individual taxpayer penalty program for several reasons, including:

- Scarce resources, competing priorities, and a lack of management continuity. The OIPA stated, and we agree, that OIPA has struggled to balance scarce resources with competing priorities and has focused on higher priority issues such as new legislation affecting penalties. For example, business taxpayer penalty issues have had greater program emphasis than individual taxpayer issues. Also, the OIPA has had 5 directors in just over 2 years (April 1998 to October 2000).
- Unclear lines of accountability and responsibility. The OIPA does not have direct authority over the functional areas that perform penalty assessments and abatements. Therefore, the OIPA does not have the authority to ensure that the functional areas comply with established penalty policy procedures

The OIPA does not have direct authority over the functional areas performing penalty assessments and abatements.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

and guidelines. For example, penalty guidelines⁵ require functional areas to input a code describing the reason why a penalty is abated. We found that in the majority of cases, the functional areas were not entering this code.

- Lack of available data to evaluate penalty administration. Statistical and demographic information captured by the IRS was not used to evaluate the impact of the individual taxpayer penalty program on compliance. The OIPA was not aware that functional areas, such as Correspondence Examination and Customer Service, collect quality information on penalty abatements, including the accuracy of penalty adjustments and reason codes.
- Limited information captured was inaccurate and was not used. For example:
 1. Our analysis showed that information available to the OIPA on the reasons why penalties were abated was inaccurate because in 70 percent of the cases there was no reason input for the penalty abatement.
 2. Information on the number of penalties assessed and abated is generated quarterly. However, the OIPA last requested this information in March 2000.
- Lack of a system to monitor and track recommendations. Over the past 10 years, internal and external reviews have resulted in 124 administrative⁶ recommendations, many of which, if implemented, would improve the consistency and

⁵ Internal Revenue Manual 120.1.1.5.1, Penalty Handbook, and Memorandum issued by the Chief Operating Officer, dated 8/14/98.

⁶ “Administrative” refers to recommendations from internal and external sources (such as IRS Task Force studies, a Treasury Department review, and a review that was part of the Vice President’s National Partnership on Reinventing Government) that do not require legislation to complete. It does not include individual employee or taxpayer recommendations.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

accuracy of penalty administration. Four recommendations related to the need for the IRS to develop a penalty management information system. One of the four recommendations was made as early as 1989. Three other recommendations identified the need for the IRS to develop a system to monitor the quality of penalties.

When taxpayers become aware of the IRS' inconsistencies in assessing and abating penalties, voluntary compliance may be affected. The IRS' lack of understanding of the effect of penalty administration does not serve all taxpayers fairly. The IRS is inappropriately placing burden on some taxpayers in the abatement of some penalties.

Recommendations

1. The IRS should strengthen management oversight and accountability of the individual taxpayer penalty program by designating executives in each business unit to coordinate with the OIPA to ensure functional compliance with the IRS' penalty policy.
2. Management's Response: The IRS responded that, "To ensure consistent and accurate treatment for all taxpayers, the Office of Penalties and Interest will be the primary point of guidance on issues involving penalty and interest. Within this fiscal year, they will select liaisons within the other operating divisions to implement approved policy/guidance."
2. The IRS should provide sufficient resources and develop a management information system, a recommendation analysis and implementation system, and a formal review program to assess its compliance with the penalty policy.

Management's Response: The IRS responded that,

- (a) "The Office of Penalties and Interest is filling all current vacancies. When they are filled, we will

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

review their workload and decide if they need additional resources.”

- (b) “The Office of Penalties and Interest recently identified the requirements for a management information system using data from the Enforcement Revenue Information System (ERIS). We expect to start receiving data by July 1, 2001 and developing reports by business operating divisions by the first quarter of FY 2002.”
- (c) “The Office of Penalties and Interest recently developed a database that includes a catalog of recommendations from various internal and external sources. The database also includes responses or actions the Office of Penalties and Interest has taken to address many of the recommendations.”
- (d) “The Office of Penalties and Interest plans to begin periodic reviews of the penalty program after we start receiving statistical data and developing reports.”

Conclusion

Penalty administration affects over 1 million individual taxpayers each year and has received considerable attention by the Taxpayer Advocate. Despite this, the IRS is still unable to effectively administer the penalty program affecting individual taxpayers, and it cannot ensure that taxpayers are being treated consistently.

Additionally, the IRS does not know if the individual taxpayer penalty program is achieving its objective of encouraging voluntary compliance.

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) had an effective process to administer penalties (assessments and abatements¹) affecting individual taxpayers. To accomplish this objective, we:

- I. Determined if penalty administration responsibilities were effectively organized to ensure effective program oversight and accountability.
 - A. Determined if the Office of Interest and Penalty Administration (OIPA) had a mission or functional statement that clearly identified its role and responsibilities.
 - B. Determined if the OIPA had an effective process to ensure a consolidated and consistent approach to penalty administration.
 - C. Determined if the OIPA had the authority to ensure that the policies and procedures over penalties for individual taxpayers were followed.
- II. Determined if the IRS had an effective process to monitor, evaluate, and improve the penalty administration process to ensure consistency and accuracy in the administration of penalties for individual taxpayers.
 - A. Determined if the OIPA had an effective process to ensure that Penalty Reason Codes² were used on all individual taxpayer cases.
 - B. Determined if the OIPA had an effective program in place to measure the quality of the penalty program affecting individual taxpayers.
 - C. Determined if the OIPA had an effective and efficient process in place to evaluate recommendations (from both internal and external sources) affecting individual taxpayers.
 - D. Determined if the OIPA had an effective process in place to improve penalty administration affecting individual taxpayers.
 - E. Determined if the OIPA had an effective management information system to track and monitor penalty assessments and abatements for individual taxpayers.

¹ An “abatement” occurs when an assessed monetary penalty amount is reduced or eliminated.

² Penalty Reason Codes are intended to provide the IRS with an explanation as to why a penalty abatement was performed.

**Management Advisory Report: Ineffective Administration of the
Individual Taxpayer Penalty Program Creates Inequity**

Appendix II

Major Contributors to This Report

Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)

Michael Phillips, Director

Donald Butler, Audit Manager

Russell Martin, Audit Manager

Edith Lemire, Senior Auditor

John Picuch, Senior Auditor

Grace Terranova, Auditor

Kevin O’Gallagher, Computer Specialist

**Management Advisory Report: Ineffective Administration of the
Individual Taxpayer Penalty Program Creates Inequity**

Appendix III

Report Distribution List

Commissioner N:C
Director, Compliance S:C
Director, Compliance Policy S:C
Director, Reporting Compliance S:C
Director, Office of Interest and Penalty Administration S:C:CP:CR:IP
Director, Strategy and Finance W:S
Director, Legislative Affairs CL:LA
Chief Counsel CC
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O

Penalty Policy Statement (P-1-18)

Penalties constitute one important tool of the Internal Revenue Service (IRS) in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the IRS' mission only if they enhance voluntary compliance. Even though other results, such as raising of revenue, punishment, or reimbursement of the costs of enforcement, may also arise when penalties are asserted, the IRS will design, administer, and evaluate penalty programs solely on the basis of whether it does the best possible job of encouraging compliant conduct.

In the interest of an effective tax system, the IRS uses penalties to encourage voluntary compliance by:

- (1) Helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not.
- (2) Deterring noncompliance by imposing costs on it.
- (3) Establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer.

To this end, the IRS administers a penalty system that is designed to:

- Ensure consistency.
- Ensure accuracy of results in light of the facts and the law.
- Provide methods for the taxpayer to have his/her interests heard and considered.
- Require impartiality and a commitment to achieve the correct decision.
- Allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate.
- Ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.

The IRS maintains an ongoing effort to develop, monitor, and revise programs designed to assist taxpayers in complying with legal requirements and, thus, avoid penalties.

To ensure consistency, the IRS prescribes and uses a single set of guidelines in a Penalty Handbook which will be followed by all operational and processing functions. Prior to implementation, changes to the Penalty Handbook must be reviewed for consistency with IRS policy and approved by the Office of Interest and Penalty Administration.

**Management Advisory Report: Ineffective Administration of the
Individual Taxpayer Penalty Program Creates Inequity**

The IRS collects statistical and demographic information to evaluate penalties and penalty administration and how they relate to the goal of voluntary compliance. The IRS continually evaluates the impact of the penalty program on compliance and recommends changes when the statutes or administration of penalties are not effectively promoting voluntary compliance.

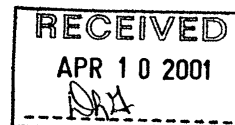
Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

Appendix V

Management's Response to the Draft Report



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



April 9, 2001

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM:

JG Joseph G. Kehoe *Joe F. Kehoe*
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Treasury Inspector General for Tax Administration (TIGTA)
Draft Management Advisory Report – Ineffective
Administration of the Individual Taxpayer Penalty Program
Creates Inequity (Reference #1999-40-113)

Thank you for the opportunity to respond to your March 7, 2001 draft management advisory report on the ineffective administration of the individual taxpayer penalty program, resulting in inequitable treatment to taxpayers.

We appreciate the fact that you incorporated into your draft report comments regarding our efforts to deploy the Reasonable Cause Assistant Program. We believe that this program will go a long way to increase consistency in the penalty abatement process. Additionally, we would like to state that the Penalty Reason Codes (PRC) mandatory requirements were operational on January 1, 2001. We believe that data from both of these efforts will allow us to better administer the penalty program.

IDENTITY OF RECOMMENDATIONS/FINDINGS #1

1. To ensure equitable treatment of taxpayers and effective penalty administration, the IRS needs to designate an executive in each business unit to coordinate with the Office of Penalties and Interest to ensure functional compliance with the IRS' penalty policy.

RESPONSE

The mission of the Office of Penalties and Interest, under the Compliance Policy, within SBSE, is to develop and implement Service-wide policies and strategies for penalties and interest. Please see Corrective Action Item 1 below.

CORRECTIVE ACTION #1

To ensure consistent and accurate treatment for all taxpayers, the Office of Penalties and Interest will be the primary point of guidance on issues involving penalty and interest. Within this fiscal year, they will select liaisons within the other operating divisions to implement approved policy/guidance.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

IMPLEMENTATION DATE

Corrective Action 1 – September 30, 2001

RESPONSIBLE OFFICIAL

Commissioner of SB/SE

CORRECTIVE ACTION (S) MONITORING PLAN

The HQ Program Manager of the Office of Penalties and Interest will prepare a quarterly briefing for the Commissioner of Small Business/Self Employed.

IDENTITY OF RECOMMENDATIONS/FINDINGS #2

2. The IRS needs to provide:
 - (a) Sufficient resources
 - (b) develop a management information system
 - (c) a recommendation analysis and implementation system
 - (d) a formal review program to assess its compliance with the penalty policy.

RESPONSE

2(a) We agree the Office of Penalties and Interest has struggled to balance scarce resources with competing priorities such as implementing new legislation affecting penalties.

2(b) We agree we need to develop a management information system to provide statistical information on the administration of penalties and interest assessments and abatements.

2(c) We agree the Office of Penalties and Interest did not use its resources to monitor and track recommendations made in the past 10 years from external and internal reviews. Our scarce resources were focused on higher priorities such as implementing new legislation.

2(d) We agree program reviews are necessary to determine whether we are achieving the overall policies of penalty administration programs.

CORRECTIVE ACTION #2

2(a) The Office of Penalties and Interest is filling all current vacancies. When they are filled, we will review their workload and decide if they need additional resources.

2(b) The Office of Penalties and Interest recently identified the requirements for a management information system using data from the Enforcement Revenue Information System (ERIS). We expect to start receiving data by July 1, 2001 and developing reports by business operating divisions by the first quarter of FY 2002.

Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity

2(c) The Office of Penalties and Interest recently developed a database that includes a catalog of recommendations from various internal and external sources. The database also includes responses or actions the Office of Penalties and Interest has taken to address many of the recommendations.

2(d) The Office of Penalties and Interest plans to begin periodic reviews of the penalty program after we start receiving statistical data and developing reports.

IMPLEMENTATION DATE

Corrective Action 2 (a) – September 30, 2001

Corrective Action 2(b) – December 15, 2001

Corrective Action 2 (c) – On going

Corrective Action 2 (d) – On going

RESPONSIBLE OFFICIAL

Corrective Actions 2 (a through d) – Commissioner of SB/SE

CORRECTIVE ACTION (S) MONITORING PLAN:

The HQ Program Manager of the Office of Penalties and Interest will brief the Commissioner of Small Business/Self Employed quarterly on the status of each of the corrective actions.

If you have any questions about our response, please contact me at (202) 622-0600.