Treasury Inspector General for Tax Administration
Office of Audit

ADDITIONAL MANAGERIAL INVOLVEMENT IS NEEDED TO PROMOTE CONSISTENT USE OF ACCURACY-RELATED PENALTIES

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Highlights

Highlights of Report Number: 2009-30-124 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Promoting tax compliance fairly and equitably is of paramount importance to the Internal Revenue Service (IRS). Penalties are an important component of tax gap reduction efforts because they promote compliance with the tax laws by imposing an economic cost on taxpayers who choose not to comply voluntarily. Because TIGTA found that penalties were not always applied when warranted, the taxpaying public could perceive inequities in the examination process that penalize some but allow others to avoid penalties that otherwise should have been assessed.

WHY TIGTA DID THE AUDIT

The audit was initiated because our tax system is based on the public's willingness to voluntarily prepare an accurate tax return, file it timely, and pay any tax due on time. To encourage voluntary compliance, Congress placed numerous penalty provisions in the tax laws for the IRS to administer through its Examination Program and various other compliance programs. The overall objective of the review was to determine whether accuracy-related penalties are assessed during sole proprietor examinations in the Small Business/Self-Employed Division in accordance with IRS policies and procedures. This review was part of our Fiscal Year 2009 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

Despite having authority under Internal Revenue Code Section 6662 to impose accuracy-related penalties, as well as layers of management controls to guide the penalty-setting process, the IRS is missing opportunities to use penalties to better promote accurate reporting among sole proprietors. TIGTA selected a statistically valid sample of 356 sole proprietor examinations that were closed in Fiscal Year 2007 and found that in 84 cases (24 percent), IRS procedures were not followed in recommending accuracy-related penalties for assessment. Besides missing potential opportunities to enhance accurate reporting among sole proprietors, closing the gap between the accuracy-related penalties assessed and those that should be assessed would enhance revenue.

To estimate the potential amount of substantial understatement penalties and interest the 84 sole proprietors were not assessed through April 30, 2009, TIGTA followed IRS procedures for computing the substantial understatement penalty on the tax deficiencies, along with the amount of interest owed on each penalty. Overall, TIGTA estimated the 84 sole proprietors in our sample cases avoided penalties and interest totaling $354,539. When projected to our population of 4,772 returns, TIGTA estimated that over a 5-year period sole proprietors would avoid penalty and interest assessments totaling $24 million (plus or minus $9 million) that otherwise should have been assessed. TIGTA's projection is based on a 95 percent confidence level and assumed that the IRS would not reconsider and subsequently abate any of the assessments.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Examination, Small Business/Self-Employed Division, should require 1) group managers to provide more specific written feedback to examiners on the quality of their penalty determinations and incorporate the feedback into examiner midyear progress reports and annual appraisals when appropriate and 2) Territory managers to use their operational reviews to monitor and assess the written feedback given by group managers on the quality of their examiners' penalty determinations.

In their response to the report, IRS officials agreed with our recommendations and plan to implement corrective actions, but commented that our outcome measure calculation may be overstated because it did not consider the effect of subsequent reconsideration and abatements of penalties. While TIGTA acknowledges that some substantial understatement penalties could be abated in the future, our outcome measure estimates were based on the information available at the time of our review, and the IRS response did not provide an estimate of the amount of substantial understatement penalties that might be abated in future years. Also, publicly released IRS data on abatements does not separately report the amount of substantial understatement penalties abated each year, so TIGTA had no reliable basis to calculate an estimate of abated penalties.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

http://www.treas.gov/tigta/auditreports/2009reports/200930124fr.pdf.