



*Additional Managerial Involvement
Is Needed to Promote Consistent Use
of Accuracy-Related Penalties*

September 11, 2009

Reference Number: 2009-30-124

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.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 11, 2009

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Managerial Involvement Is Needed to
Promote Consistent Use of Accuracy-Related Penalties
(Audit # 200830053)

This report presents the results of our review to determine whether accuracy-related penalties are assessed during sole proprietor examinations in the Small Business/Self-Employed Division in accordance with Internal Revenue Service (IRS) policies and procedures. This audit is included in our Fiscal Year 2009 Annual Audit Plan coverage under the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

Promoting tax compliance fairly and equitably is of paramount importance to the 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 we 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.

Synopsis

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. We selected a statistically valid sample of 356 sole proprietor examinations that



Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties

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.

Although each case in our population met the minimum threshold (a tax understatement of \$5,000 or more) for considering the substantial understatement penalty, examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that penalties were considered. Moreover, we found no documentation of managerial involvement in 67 of the 105 penalty decisions, despite an Internal Revenue Manual requirement for such involvement in cases where the substantial understatement penalty should be considered.

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 overstatement penalties and interest the 84 sole proprietors were not assessed through April 30, 2009, we followed IRS procedures for computing the substantial understatement penalty on the tax deficiencies, along with the amount of interest owed on each penalty. Overall, we estimate the 84 sole proprietors in our sample cases avoided penalties and interest totaling \$354,539. When projected to our population of 4,772 returns, we estimate 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. Our projection is based on a 95 percent confidence level and we assumed that the IRS would not reconsider and subsequently abate any of the assessments.

Recommendations

We 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.

Response

IRS management agreed with our recommendations. The Director, Examination Policy, Small Business/Self-Employed Division, will enhance the guidance regarding managerial documentation of examiners' penalty determinations in the document *Examination Quality Review System – Multi-Case Review Guidance for Field and Office Examination*. The Director, Examination Policy, will also include an article in the managerial guidance document *Examination Quality Review System – Performance Perspective* that addresses the importance of managerial documentation regarding penalty determinations. Finally, the Director, Examination



Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties

Policy, will enhance the guidance on group operational reviews in the *Examination Quality Review System Field and Office Examination Quality Guide for Operational Reviews* to include review of the group manager's oversight of examiners' penalty determinations. However, IRS management commented that our outcome measure calculation may be overstated because it did not consider the effect of subsequent reconsideration and abatement of penalties. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment

While we acknowledge that some penalties may be abated in the future, our outcome measure was calculated only for returns that met the requirements for the substantial understatement penalty. 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 data on abatements, such as the IRS Data Book, does not separately report the amount of substantial understatement penalties abated each year, so we have no reliable basis to calculate an estimate of abated penalties.

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 Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Table of Contents

BackgroundPage 1

Results of ReviewPage 2

 Management Controls Are in Place to Guide Examiners Through
 the Penalty-Setting Process.....Page 2

 The Gap Between the Number of Accuracy-Related Penalties
 Assessed and the Number Warranted Is ConsiderablePage 5

Recommendations 1 and 2:Page 9

Appendices

 Appendix I – Detailed Objective, Scope, and MethodologyPage 10

 Appendix II – Major Contributors to This ReportPage 13

 Appendix III – Report Distribution ListPage 14

 Appendix IV – Outcome MeasurePage 15

 Appendix V – Overview of Selected Penalties Applicable to
 Examinations of Sole ProprietorsPage 17

 Appendix VI – Management’s Response to the Draft ReportPage 19



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Abbreviations

FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed Division
TIGTA	Treasury Inspector General for Tax Administration



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Background

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 Internal Revenue Service (IRS) to administer through its Examination Program and various other compliance programs.

Despite numerous management controls, the gap between the number of accuracy-related penalties assessed and the number that should be assessed is considerable.

Spread across the IRS' four operating divisions, the Examination Program is one of the agency's largest compliance programs. Its examiners are primarily responsible for determining the correct liabilities for taxpayers, including their liabilities for penalties. During an examination of a tax return, such as one filed by a sole proprietor, examiners are required to consider a number of penalties when recommending adjustments to tax liabilities. The numerous penalties generally fall into two broad categories: delinquency and accuracy-related. Delinquency penalties are intended to encourage the timely filing of income tax and information returns, while accuracy-related penalties promote the preparation and submission of complete and correct information on tax returns.

According to our analysis of underlying information from the 2008 IRS Data Book,¹ the IRS assessed individual taxpayers with 2,881,085 delinquency penalties and 343,295 accuracy-related penalties. Additional information on various penalties within these two broad categories is included in Appendix V.

This review was performed in the IRS Small Business/Self-Employed (SB/SE) Division Headquarters Office in New Carrollton, Maryland, during the period October 2008 through April 2009. Except for auditing IRS databases to validate the accuracy and reliability of the information,² this performance audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹ The IRS Data Book is published annually by the IRS and contains statistical tables and organizational information on a fiscal year basis.

² The accuracy of the data was verified to individual recipients during our case review.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Results of Review

Despite numerous management controls to guide the penalty-setting process, the gap between the number of accuracy-related penalties assessed and the number warranted is considerable. As a result, we are recommending additional managerial involvement in the administration of these penalties.

Management Controls Are in Place to Guide Examiners Through the Penalty-Setting Process

Ultimately, the IRS relies on examiners and their group managers to properly consider and assess penalties during examinations. To assist examiners and group managers in meeting these responsibilities, the IRS has an array of policies, procedures, and techniques (management controls) that are in line with the Government Accountability Office’s *Standards for Internal Control in the Federal Government*.

At the agency level, there is a broad policy statement on penalties that was revised in June 2004 to provide guidance for examiners, as well as other IRS personnel, and included overall goals for implementing the policy. The policy statement underscores the role penalties play in promoting compliance with and fairness of the tax system by imposing an economic cost on those who do not voluntarily comply with tax laws. In implementing the revised policy, the IRS provided an agencywide training session on penalty administration and augmented the training by developing a comprehensive audit technique guide and making it available to examiners throughout the agency. Figure 1 provides an overview of the goals reflected in the IRS’ penalty policy.

Figure 1: Goals of the IRS Penalty Policy

Goals	Policy Overview
Enhance and encourage compliance.	Penalties provide an important tool to promote compliance and fairness in the tax system by increasing the costs for those who do not timely and accurately comply with the tax laws.
Curb the use of abusive tax transactions.	Accuracy-related penalties combat the undermining effect abusive transactions have on the tax system.
Promote sound and efficient tax administration.	Penalties may occasionally be waived as part of a strategy to encourage prompt resolution of tax issues.
Promote consistency in applying penalties.	The IRS Office of Penalty Administration reviews and approves changes to its Penalty Handbook, which all agency employees are to use and follow.
Demonstrate fairness of the tax system.	Provide taxpayers with opportunities to provide reasons why penalties should not be assessed by considering evidence in favor of not assessing penalties.

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



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

At the division level, Quality Assurance staffs review samples of examinations and assess the degree to which examiners comply with standards, including those related to penalties. The reviews serve as a mechanism for measuring and evaluating the quality of examinations and penalty determinations, communicating areas of concern up the chain of command, identifying potential training needs, and improving work processes. In addition to reviews by Quality Assurance staffs, mid-level managers may evaluate how well examiners are developing penalty issues during their operational reviews. As conducted by Examination function Territory managers, operational reviews are performed on group managers and their respective teams at least annually to ensure work is being done in conformance with procedures.

At the group level, the Internal Revenue Manual (IRM) serves as the official compilation of procedures and detailed instructions that govern examinations and the penalty-setting process. According to the IRM, an examiner's primary responsibility is to determine the correct income tax liability during an examination. However, they are also required to document examination case files with the factors considered in determining a taxpayer's liability for applicable penalties.

To assist examiners in considering the penalties that could apply to a return under examination, the SB/SE Division developed a Penalty Approval Form, shown in Figure 2 below, that is required to be included in the workpapers for every examination.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Figure 2: IRS Penalty Approval Form

Penalty Approval Form					
IRC	Penalty	IRM	Assert Penalty		Reference
			Yes	No	
Penalties Not Requiring Group Managerial Approval					
6651(a)(1)	Failure to File	20.1.2.3			
6651(a)(2)	Failure to Pay	20.1.2.4			
6654	Estimated Tax – Individual	20.1.3.1.1			
6655	Estimated Tax – Corporate	20.1.3.5			
Penalties Requiring Group Managerial Approval					
6651(f)	Fraudulent Failure To File, Civil	20.1.2.7			
6662(c)	Negligence	20.1.5.7			
6662(d)	Substantial Understatement <i>*Lead Sheet Available</i>	20.1.5.8			
6662(b)	Other Accuracy Related	20.1.5.1			
6662(h)	Gross Valuation Misstatement	20.1.5.9			
6662A	Accuracy Related Penalty on Understatements with Respect to Reportable Transactions (RT)	20.1.5.13			
6707A	Failure to Include Reportable Transactions RT Information with Return or Statement	20.1.5.2			
6663	Fraud	20.1.5.12			
	Alternative Penalty Position	20.1.5.12.2			
Consideration of Preparer / Promoter / Material Advisor Penalties			Consider Penalty		Reference
			Yes	No	
6694(a)	Preparer Penalties - Negligent	20.1.6.3.5			
6694(b)	Preparer Penalties - Willful	20.1.6.3.5			
6700	Promoting Abusive Tax Shelters	20.1.6.1			
6701	Aiding & Abetting understatement of Tax Liability	20.1.6.1			
6707	Failure to Furnish Information regarding RT	20.10			
6708	Failure to Maintain Lists of Advisees with respect to RT (Formerly Failure to Maintain Lists of Investors in Potentially Abusive Tax Shelters)	20.10			
Reason(s) for Non-Assertions of Penalty(s)					
	No Change or Refund Case				
	Other: Penalty considerations are to be addressed in all examinations and workpapers should be prepared. When adjustments would appear to warrant a penalty, but it is not asserted, the applicable exceptions to the penalty must be documented in the file. W/P Reference _____ IRM 20.1.5.4.(2)				
Group Manager Approval to Assess Penalties Identified Above (Not required on automatic penalties/No Change/Refund cases)					
Group Manager Signature: _____			Date: _____		

Source: SB/SE Division Workpaper 300-1.1, dated May 2007.

Besides documenting penalty decisions, the IRM requires group managers to review the examiner’s decision not to assert the substantial understatement penalty when the criteria of Internal Revenue Code (I.R.C.) Section 6662(d) is met, including the applicable exception to the penalty. This is an important control component in the penalty-setting process because group



Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties

managers are responsible for the quality of work performed by the examiners they supervise. To ensure that examiners' work is meeting acceptable quality standards, including penalty considerations, SB/SE Division group managers use a variety of other techniques to ensure quality examinations are performed. These other techniques include observing and discussing examination work with examiners, reviewing in-process and closed examinations, and providing feedback through SB/SE Division's Embedded Quality Review System.³

The Gap Between the Number of Accuracy-Related Penalties Assessed and the Number Warranted Is Considerable

Despite having authority under I.R.C. Section 6662 to impose accuracy-related penalties, as well as numerous management controls to guide the penalty-setting process, the IRS is missing opportunities to use penalties to better promote accurate reporting among sole proprietors. As shown in Figure 3, we selected a statistically valid sample of 356 sole proprietor returns from a population of 4,772 sole proprietor returns with examinations closed in Fiscal Year (FY) 2007. All returns in our population met the minimum threshold (a tax understatement of \$5,000 or more for an individual return) for considering the substantial understatement penalty. We reviewed each selected return using the IRS Integrated Data Retrieval System⁴ and eliminated 175 returns that had an accuracy-related penalty assessed by the examiner. We then ordered the administrative case files (examination workpapers) for the 181 returns that did not have an accuracy-related penalty assessed and were able to obtain workpapers for 105 returns. For these 105 returns, we found 84 (24 percent of the 356 returns sampled) in which IRS procedures were not followed in recommending accuracy-related penalties for assessment.

³ The Embedded Quality Review System allows field managers to provide timely feedback to individual employees through performance case reviews.

⁴ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

**Figure 3: Review of Accuracy-Related Penalties for
Sole Proprietor Examinations Closed in FY 2007**

	<i>Number</i>	<i>Percentage of Sample</i>
Number of sole proprietor returns selected for sample.	356	100 %
Sole proprietor returns with an accuracy-related penalty assessed by examiner.	175	49 %
Sole proprietor returns without an accuracy-related penalty with examination workpapers ordered by the TIGTA.	181	51%
Sole proprietor returns without an accuracy-related penalty with examination workpapers received and reviewed by the TIGTA.	105	29%
Sole proprietor returns without an accuracy-related penalty reviewed by the TIGTA in which IRS procedures were <u>not</u> followed.	84	24%
Sole proprietor returns without an accuracy-related penalty reviewed by the TIGTA in which IRS procedures were followed.	21	6%

Source: TIGTA analysis of 356 sole proprietor examinations closed in FY 2007.

Although each case in our population met the minimum threshold for considering the substantial understatement penalty, examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that penalties were considered. The majority of cases we reviewed did not entail complicated tax law issues and did not appear to meet any of the IRM exceptions that allow for the abatement of an accuracy-related penalty. Except for a few instances, IRS officials who also reviewed a large group of our case reviews agreed with our conclusions.

We also found no documentation of managerial involvement in 67 of the penalty decisions (19 percent of the 356 returns sampled and 64 percent of the 105 case files reviewed) despite an SB/SE Division requirement of such involvement in cases where adjustments warrant the substantial understatement penalty. For example, we found 30 cases for which well over \$10,000 of income tax was not reported and there was no evidence of managerial involvement. The absence of this involvement in these cases is of particular concern because the IRS requires more detailed documentation of managerial involvement in examinations involving unreported income of \$10,000 or more. At a minimum, the documentation in these cases should show that the manager and examiner jointly developed an action plan to obtain and document potential fraudulent activities that may be needed in a referral to the IRS Criminal Investigation Division for possible criminal prosecution.



Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties

Examiners and group managers need to be held accountable for considering and assessing accuracy-related penalties

We believe there is a combination of factors causing the concerns identified in our case reviews and that there is no easy and quick solution to the problem. Overall, management controls are in place to assist examiners and managers in meeting their responsibilities for considering and assessing penalties when warranted. Also, IRS guidance and directions to examiners and group managers is detailed and adequate. Despite the controls that are in place, some examiners and group managers may be placing too high a value on obtaining agreement to examination results and using penalties as a bargaining chip to obtain agreement. For example,

1

This type of action is strictly prohibited by IRS procedures.

As we have reported previously, the performance management process can be an effective tool in helping examiners understand and meet their responsibilities.⁵ It also provides opportunities to give meaningful and constructive feedback on performance, pinpoint and address performance gaps, and hold examiners accountable for results. According to the United States Merit Systems Protection Board, continually monitoring and providing feedback to employees is perhaps the most important component of managing performance. In a 2003 report to the President and Congress, the United States Merit Systems Protection Board stated:

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

In response to our 2005 report on penalty determinations in corporate examinations,⁶ the SB/SE Division agreed it would issue performance management reminders to Examination function personnel about the need to provide examiners with specific written feedback on the quality of their penalty determinations. Although the Director, Examination, SB/SE Division, issued a memorandum on November 25, 2005, to Examination function area directors, we were unable to determine whether this guidance was communicated to front line Examination function personnel. Moreover, we researched the Embedded Quality Review System to determine if

⁵ *Performance Management in the Large and Mid-Size Business Division's Industry Case Program Needs Strengthening* (Reference Number 2005-30-084, dated May 27, 2005).

⁶ *The Strategy to Reemphasize Penalties in Corporate Examinations Could Be Enhanced* (Reference Number 2005-30-123, dated August 23, 2005).



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

group managers provided performance feedback to 21 examiners involved in 25 of the cases we reviewed and found considerable evidence that suggests the need for group managers to take better advantage of written feedback to hold examiners more accountable for their penalty determinations. Although all 21 examiners failed to follow IRS procedures in considering accuracy-related penalties, 6 (29 percent) of the 21 examiners had not received any narrative feedback on the importance of making quality penalty determinations in workload reviews, midyear progress reports, and annual performance appraisals they received in the Embedded Quality Review System in FY 2008.

Although the performance management process for group managers is somewhat different from the process for examiners, it can be used in much the same way to hold managers accountable for results. One difference is that group managers develop commitments at the beginning of the fiscal year that supplement their critical job responsibilities and can be specifically tailored to meet improvement opportunities. Another important difference is that SB/SE Division Territory managers are responsible for managing and evaluating the performance of group managers. Among the tools used by Territory managers to meet this responsibility are operational reviews, which can be used to better ensure that group managers are providing specific written feedback to examiners on the quality of their penalty determinations.

Promoting tax compliance fairly and equitably is of paramount importance to the 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 we 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.

In addition to enhancing accurate reporting among sole proprietors, closing the gap between the number of accuracy-related penalties assessed and the number 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, we followed IRS procedures for computing the substantial understatement penalty on the tax deficiencies, along with the amount of interest owed on each penalty. Overall, we estimate the 84 sole proprietors in our sample cases were not assessed penalties and interest totaling \$354,539. When projected to our population of 4,772 cases, we estimate that 1,126 sole proprietors (plus or minus 203 sole proprietors) avoided penalty and interest assessments of \$4.8 million per year (plus or minus \$1.8 million). Our projection is based on a 95 percent confidence level and assumes that the IRS will not reconsider and abate any of the penalties.⁷ When projected over a 5-year period, we

⁷ The IRS Taxpayer Advocate's 2008 Annual Report to Congress noted that 11 percent of all accuracy-related penalties assessed were abated after several years, comprising 37 percent of the dollars assessed. However, this amount includes both individual and corporate examinations with any amount assessed, while our sample included only sole proprietors with more than \$5,000 assessed. Also, our outcome measure only includes the substantial understatement accuracy-related penalty.



Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties

estimate with a 95 percent degree of confidence that sole proprietors would avoid penalty and interest assessments totaling \$24 million (plus or minus \$9 million) that otherwise should have been assessed.

Recommendations

To promote additional managerial involvement in the administration of penalties, we recommend that the Director, Examination, SB/SE Division, require:

Recommendation 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 performance appraisals when appropriate.

Management's Response: IRS management agreed with this recommendation. The Director, Examination Policy, SB/SE Division, will enhance the guidance regarding managerial documentation of examiners' penalty determinations included in the document *Examination Quality Review System – Multi-Case Review Guidance for Field and Office Examination*. The Director, Examination Policy, will also include an article in the managerial guidance document *Examination Quality Review System – Performance Perspective* that addresses the importance of managerial documentation regarding penalty determinations.

Recommendation 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.

Management's Response: IRS management agreed with this recommendation. The Director, Examination Policy, SB/SE Division, will enhance the guidance on group operational reviews in the *Examination Quality Review System Field and Office Examination Quality Guide for Operational Reviews* to include review of the group manager's oversight of examiners' penalty determinations.

Although agreeing with our recommendations, IRS management commented that our outcome measure calculation may be overstated because it did not consider the effect of subsequent reconsideration and abatements of penalties.

Office of Audit Comment: As noted in Appendix IV, our outcome measure was calculated only for returns that met the requirements for the substantial understatement penalty. While we acknowledge that some of these penalties could be abated in the future, our outcome measure estimates were based on 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 data on abatements, such as the IRS Data Book, does not separately report the amount of substantial understatement penalties abated each year, so we have no reliable basis to calculate an estimate of abated penalties.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether accuracy-related penalties are assessed during sole proprietor examinations in the SB/SE Division in accordance with IRS policies and procedures. To accomplish our objective, we:

- I. Selected a statistically valid sample of 356 closed examined sole proprietorship returns using a confidence level of 95 percent, a precision rate of plus or minus 5 percent, and an expected error rate of 50 percent. The returns were selected from the population of 4,772 sole proprietor returns meeting our criteria on the Audit Information Management System¹ Closed Case data file maintained on the TIGTA's Data Center Warehouse. The selection criteria included examinations that were closed as "agreed" between October 1, 2006, and September 30, 2007, had a understatement of tax meeting the minimum threshold of \$5,000 for considering the substantial understatement penalty, and involved non-farm businesses with total gross receipts of \$100,000 or more with total positive income of less than \$200,000. We conducted limited data validation testing by matching the universe of sole proprietor examinations on the Audit Information Management System to the IRS Data Book² and selecting a judgmental³ sample of 20 examinations on the Audit Information Management System and verifying selected taxpayer information to the Integrated Data Retrieval System.⁴
- II. Conducted research using the Integrated Data Retrieval System on the sample identified in Step I to identify the returns that appeared to meet the criteria for the imposition of accuracy-related penalties (at least \$5,000 in additional tax assessed) but do not have a Transaction Code 240 with a Reference Number 680 on the taxpayer's account (indicating the imposition of an accuracy-related penalty). Using the Integrated Data Retrieval System, we determined that the accuracy-related penalty was applied in 175 of the examinations, while the remaining 181 examinations had no accuracy-related penalty applied. We requested the examination workpapers for the 181 returns and any related tax return years and received workpapers for 105 returns.

¹ A computer system used by the SB/SE Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.

² The IRS Data Book provides information on returns filed and taxes collected, enforcement, taxpayer assistance, the IRS budget and workforce, and other selected activities.

³ Judgmental sampling was used because of limited resources and time available to complete the audit in a reasonable time period.

⁴ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

- III. Reviewed the examination workpapers for the 105 closed sole proprietor returns to determine whether examiners followed IRS procedures in recommending accuracy-related penalties for assessment. We estimated the potential revenue that could be generated over a 5-year period if examiners properly considered and assessed penalties by applying the error rates and penalty amounts determined in the cases reviewed against examinations in our population having similar deficiencies and characteristics, but no accuracy-related penalties applied.
- IV. Evaluated the adequacy of controls for ensuring accuracy-related penalties are properly considered and applied during sole proprietor examinations by documenting the applicable I.R.C. sections, Treasury Regulations, IRM (policy and procedural) sections, management directives, examiner training materials, and IRS public announcements and notices that provide the authority and reasons for assessing the penalty.
- V. Used the results from FYs 2007 and 2008 quality reviews (National Quality Review System⁵ and Embedded Quality Review System)⁶ to identify weaknesses in the use of accuracy-related penalties and assess the effectiveness of corrective actions taken in response to the weaknesses identified.
- VI. Evaluated the extent of training that group managers and examiners received on considering and applying accuracy-related penalties by reviewing the FYs 2007 and 2008 training records of the managers and examiners included in our case reviews.
- VII. Assessed how well Territory managers are holding group managers accountable for ensuring the examiners they supervise are properly considering accuracy-related penalties by evaluating FY 2008 operational reviews, midyear appraisals, and annual appraisals they provided to the group managers for cases included in our review.
- VIII. Assessed how well group managers are holding examiners accountable for properly considering accuracy-related penalties by evaluating the FY 2008 workload reviews (on-the-job visits, etc.), midyear appraisals, and annual appraisals they provided to the examiners for cases included in our review.
- IX. Determined the number of accuracy-related penalties that were assessed in sole proprietor examinations in FYs 2006, 2007, and 2008 by analyzing the IRS Statistics of Income data files that support the number and amount of these penalties in the corresponding IRS Data Books.
- X. Assessed the status of ongoing changes to improve the administration of penalties by interviewing SB/SE Division management and program analysts in its Offices of

⁵ The National Quality Review System conducts closed case reviews and provides quality measurement results for the SB/SE Division.

⁶ The Embedded Quality Review System allows field managers to provide timely feedback to individual employees through performance case reviews.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Examination Policy and Penalties and Interest to identify ongoing changes, such as policy and procedural changes, examiner training, stakeholder outreach activities, and IRS public notices and announcements that are aimed at enhancing administration of penalties. We assessed the effectiveness of any ongoing changes identified.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Robert Jenness, Audit Manager
Debra Mason, Lead Auditor
Earl Charles Burney, Senior Auditor
William Tran, Senior Auditor
Ali Vaezazizi, Auditor



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Examination, Small Business/Self-Employed Division SE:S:E
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Appendix IV

Outcome Measure

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 Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$4.8 million per year (plus or minus \$1.8 million), or \$24 million (plus or minus \$9 million), over 5 years. The potential revenue increase is related to 1,126 sole proprietors who were not assessed an accuracy-related penalty that was warranted (see page 5). In making the projection, we assumed that the IRS would not reconsider and subsequently abate any of the assessments.

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with closing the gap between the number of accuracy-related penalties assessed and the number warranted in sole proprietor examinations, we:

1. Analyzed a statistically valid sample of 356 examinations from a population of 4,772 returns with the potential for accuracy-related penalties closed in FY 2007 for which sole proprietors agreed with the IRS that they understated their tax liabilities by more than \$5,000 but avoided an accuracy-related penalty.
2. Used the sample occurrence rate (of missed opportunities for applying the accuracy-related penalty) of 23.60 percent (84 divided by 356) from the results of our case review samples to project that as many as 1,126 (23.60 percent multiplied by 4,772) sole proprietors were not assessed an accuracy-related penalty that was warranted, plus or minus 203 sole proprietors.
3. Followed the IRS procedures for computing the substantial understatement penalty related to the deficiencies owed to calculate that accuracy-related penalties of \$307,440 were not assessed on the 84 returns.
4. Used IRS computer programs with the applicable Federal interest rate to calculate that \$47,099 of interest would have been owed on the penalties for the 84 returns through April 30, 2009.
5. Used variable sampling techniques based on the amount of penalties and interest that should have been assessed for the 84 cases (\$354,539) to determine the estimated amount



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

of penalties and interest per case to be \$4,221 (\$354,539 divided by 84). Applied the per case estimate to the projected number of sole proprietors not assessed the penalty to determine that the amount of missed penalty and interest opportunities for our population was \$4.8 million per year (\$4,221 multiplied by 1,126), plus or minus \$1.8 million.

6. Shared our sampling methodology with an outside statistical expert who confirmed the accuracy of our methodology and projection.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Appendix V

*Overview of Selected Penalties Applicable to
Examinations of Sole Proprietors*

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

Selected Penalties Considered During a Sole Proprietor Examination		
Delinquency Penalties		
Title	I.R.C. Section(s)	Overview
Failure to File	6651(a)(1)	If an examination results in a tax deficiency and the tax return was not filed by the prescribed due date (or extended due date), a failure to file penalty can be applied on the tax deficiency from the tax return due date (or extended due date) until paid or until the maximum penalty is applied.
Failure to File Information Returns	6721, 6722, 6723, 6679, 6038(b), 6038A(d)	Sole proprietors are required to file certain information returns and/or furnish certain statements to payees under various sections of the I.R.C. Information return reporting penalties can involve amounts ranging from \$50 up to \$250,000.
Accuracy-Related Penalties		
Negligence	6662(c)	Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records. The penalty is 20 percent of the portion of the underpayment attributable to negligence.
Substantial Understatement	6662(d)	The substantial understatement penalty may be applied when an understatement exceeds \$5,000 or 10 percent of the tax required to be shown for the tax year, whichever is greater. The penalty is equal to 20 percent of the underpayment of tax attributable to the understatement.
Substantial Valuation Misstatement	6662(e)	The substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 150 percent or more of the amount determined to be the correct amount of such value or adjusted basis. The penalty is 20 percent of the underpayment of tax.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Gross Valuation Misstatement	6662(h)	The gross valuation misstatement penalty exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the corrected amount; or if the price for any property or service (or for the use of property) claimed on a return is 400 percent or more (or 25 percent or less) of the amount determined under I.R.C. Section 482 to be the correct price; or if the net section 482 adjustment exceeds the lesser of \$20,000,000 or 20 percent of the taxpayer's gross receipts. The penalty is 40 percent of the underpayment of tax.
Fraud	6663(a)	If any underpayment of tax is due to fraud, a penalty may be imposed equal to 75 percent of the portion of the underpayment due to fraud. Although the I.R.C. does not define the term fraud, most courts define fraud as the "intent to evade tax."

Source: TIGTA analysis of selected sections of the I.R.C.



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

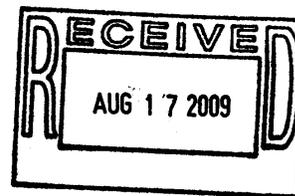
Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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



August 17, 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report - Additional Managerial Involvement is
Needed to Promote Consistent Use of Accuracy-Related
Penalties (Audit No. 200830053)

We have reviewed your report "Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties." Penalties provide an important tool in promoting compliance and fairness in the tax system. We agree with the recommendations contained in your report and concur that managerial oversight of examiners' consideration of the application of penalties is important for ensuring compliance and fairness.

We appreciate you acknowledging that the guidance previously provided to group managers was detailed, adequate and meets the standards set forth in the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government*. We agree that an outcome measure should be computed for this audit but we believe your calculation should consider the effect of subsequent reconsideration and abatement of penalties. By not including this factor in the calculation, there is a potential that the outcome measure may be overstated.

Attached is a detailed response outlining our corrective actions. If you have questions, please call me at (202) 622-0600 or Monica Baker, Director, Examination at (202) 283-2659.

Attachment



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

Attachment

RECOMMENDATION 1:

To promote additional managerial involvement in the administration of penalties, we recommend that the Director, Examination, SB/SE Division, require 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 performance appraisals when appropriate.

CORRECTIVE ACTION:

1. We will enhance the guidance already included in the "Examination Quality Review System (EQRS) – Multi-Case Review Guidance for Field and Office Examination" regarding managerial documentation of examiners' penalty determinations.
2. We will include an article in the managerial guidance document, "EQRS Performance Perspective" that addresses the importance of managerial documentation regarding penalty determinations.

IMPLEMENTATION DATE:

1. March 15, 2010
2. March 15, 2010

RESPONSIBLE OFFICIAL:

Director, Examination Policy SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination Policy will monitor the status and will advise the Director, Examination of any delays in completing the corrective action.

RECOMMENDATION 2:

To promote additional managerial involvement in the administration of penalties, we recommend that the Director, Examination, SB/SE Division, require 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.

CORRECTIVE ACTION:

We will enhance the guidance on group operational reviews already included in the "EQRS Field and Office Examination EQ Guide for Operational Reviews" to include review of the group manager's oversight of examiners' penalty determinations.

IMPLEMENTATION DATE:

March 15, 2010

RESPONSIBLE OFFICIAL:

Director, Examination Policy SB/SE Division



*Additional Managerial Involvement Is Needed to Promote
Consistent Use of Accuracy-Related Penalties*

2

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination Policy will monitor the status and will advise the Director, Examination of any delays in completing the corrective action.