



*Accuracy-Related Penalties
Are Seldom Considered Properly
During Correspondence Audits*

June 4, 2010

Reference Number: 2010-30-059

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.



HIGHLIGHTS

ACCURACY-RELATED PENALTIES ARE SELDOM CONSIDERED PROPERLY DURING CORRESPONDENCE AUDITS

Highlights

Final Report Issued on June 4, 2010

Highlights of Reference Number: 2010-30-059 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

The accuracy-related penalty is designed to promote voluntary compliance by imposing an economic cost on taxpayers who choose not to comply with the tax law. Because penalties are not always considered and applied when warranted, the Internal Revenue Service (IRS) may be missing opportunities to further promote voluntary compliance and enhance revenue for the Department of the Treasury.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the accuracy-related penalty was assessed during correspondence audits in accordance with IRS policies and procedures. The audit was conducted as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

Despite an emphasis on case file documentation and layers of management controls, additional steps must be taken to ensure procedures are followed in considering and recommending the accuracy-related penalty during correspondence audits. A review of a statistical sample of 229 correspondence audits closed in Fiscal Year 2008 found 211 (92 percent) audits for which penalties were not considered and assessed in accordance with IRS policies and procedures.

As a result, opportunities may have been missed to promote compliance among an estimated 1,851 taxpayers in the population reviewed and

to enhance penalty and interest revenue by an estimated \$3.5 million. Because the audits reviewed were conducted through the mail, they did not entail complicated areas of tax law. Each of the audits also resulted in the taxpayer agreeing they owed additional taxes of at least \$5,000. The \$5,000 threshold is important because it allowed TIGTA to review audits for which examiners were required to consider assessing an accuracy-related penalty.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Campus Compliance Services, Small Business/Self-Employed Division, and the Director, Compliance, Wage and Investment Division, follow through to ensure planned training is completed by all correspondence examiners and their managers and that the training specifically addresses when the accuracy-related penalty is applicable, how case files should be documented, and when managerial approval is required. They should also require managers and examiners to properly complete the accuracy-related penalty lead sheets for all applicable audits.

IRS management agreed with the recommendations and plans to take appropriate corrective actions. The Director, Campus Compliance Services, Small Business/Self-Employed Division, and the Director, Compliance, Wage and Investment Division, plan to conduct accuracy-related penalty training and emphasize managerial reviews for penalty assertion/nonassertion. Also, IRS management plans to submit a programming request to add the penalty lead sheets to the Campus Report Generating System and ensure the accuracy-related penalty is considered in Program Analysis System quality reviews.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 4, 2010

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

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Accuracy-Related Penalties Are Seldom
Considered Properly During Correspondence Audits
(Audit # 200930033)

This report presents the results of our review to determine whether the accuracy-related penalty was assessed during correspondence audits in accordance with Internal Revenue Service policies and procedures. This audit was conducted as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VII.

Copies of this report are also being sent to the Internal Revenue Service 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.



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Abbreviations

FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



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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 audit and various other compliance programs.

To encourage voluntary compliance, Congress placed numerous penalty provisions in the tax laws for the Internal Revenue Service to administer.

Spread across the four operating divisions, the IRS audit program is one of its largest compliance programs. IRS examiners are primarily responsible for determining the correct liabilities for taxpayers by conducting audits. Audits of individual taxpayers can range from reviewing their tax returns and resolving questionable items by corresponding with them through the mail to a detailed face-to-face examination of a taxpayer's financial records at his or her place of business. In contrast to the more labor-intensive face-to-face examination, the correspondence audit process is less intrusive, more automated, and conducted by examiners who are trained to deal with and focus on less complex tax issues. Importantly, correspondence audits also enable the IRS to reach more taxpayers at a lower cost.

During audits, examiners are also responsible for considering the accuracy-related penalty when recommending adjustments to tax liabilities. This penalty, which includes negligence and substantial understatement, is designed to promote the preparation and submission of complete and correct information on tax returns, as well as impose an economic cost on taxpayers who choose not to comply with the tax law.

Examiners may recommend imposing the negligence penalty when a taxpayer fails to make a reasonable attempt to comply with the tax law or exercise ordinary and reasonable care in preparing his or her return. Taxpayers may also be assessed a negligence penalty if they do not keep adequate books and records. On the other hand, the substantial understatement penalty can be assessed against individual taxpayers who understate their tax by 10 percent of the tax required to be shown on their return and the understatement is also equal to or greater than \$5,000. The penalty for both the negligence and substantial understatement penalty is 20 percent of the underpayment.

This review was performed at the Small Business/Self-Employed (SB/SE) Division Headquarters Office in New Carrollton, Maryland; Wage and Investment Division Headquarters Office in Atlanta, Georgia; the SB/SE Division Campus Examination function in Philadelphia, Pennsylvania; and the Wage and Investment Division Compliance Examination Discretionary Programs function in Fresno, California, during the period July 2009 through February 2010.



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We conducted this performance audit 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.



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Results of Review

Despite an emphasis on documentation and layers of management controls, additional steps must be taken to ensure procedures are followed in considering and recommending the accuracy-related penalty during correspondence audits. A review of a statistical sample of 229 correspondence audits closed in Fiscal Year (FY) 2008 found 211 (92 percent) audits for which penalties were not considered and assessed in accordance with IRS policies and procedures.

A Number of Management Controls Have Been Developed to Help Guide the Penalty-Setting Process

The IRS ultimately relies on its examiners to properly consider and assess penalties when warranted during audits. In accordance with the Government Accountability Office's *Standards for Internal Control in the Federal Government*,¹ the IRS has developed a number of management controls to assist examiners in meeting this responsibility. For example, there is a broad policy statement on penalties that provides guidance nationwide to examiners and other IRS personnel who are involved in IRS programs and activities. As outlined in Figure 1, the policy statement contains goals that underscore the role penalties play in promoting compliance with, and fairness in, the tax system by imposing an economic cost on those who do not voluntarily comply with the tax laws.

¹ GAO/AIMD-00-21.3.1, November 1999.



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Figure 1: IRS Penalty Policy Goals

Goals	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 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 Servicewide Penalty organization residing in the SB/SE Division 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: Our analysis of IRS Policy Statement 20-1.

The IRS uses its Internal Revenue Manual (IRM) to support and elaborate upon the goals in the penalty policy. From a control perspective, the IRM serves to provide detailed instructions and explanations to examiners of the statutory and administrative procedures to follow in considering and recommending penalty assessments. Throughout the IRM, as well as in management directives, training materials, and the quality measurement standards, examiners are instructed to properly document in case files all aspects of their work during an audit including penalty considerations and assessments.

Proper case file documentation is important because it provides the principal evidence that procedures were followed, as well as the foundation for other control processes such as managerial reviews and quality measurement systems. When a taxpayer challenges a penalty determination, the documentation becomes especially crucial. In these instances, the facts and circumstances developed and documented by the examiner are used in deciding whether the penalty should be upheld. Consequently, according to IRS procedures, documenting statements such as “no penalties applicable” or “the taxpayer did not appear to have intentional disregard for the law” are unacceptable and should not be used without additional supporting information.

At the divisional level, the quality measurement staff reviews samples of examination cases to assess the degree to which examiners comply with the policy and procedures for considering and assessing penalties during audits. In addition to reviews by the quality measurement staff, mid-level managers may evaluate ongoing work in open audits during their operational reviews. Operational reviews are required to be performed at least annually to ensure work is being done



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in conformance with procedures. These processes serve as a quality control by identifying managerial, technical, and procedural problems and providing a basis for corrective actions.

At the examiner level, first-line managers are an important control component because they are responsible for the quality of work performed by the examiners they supervise. They use a variety of techniques to ensure examiners' work is meeting acceptable standards and procedures are followed in considering, documenting, and assessing penalties. These techniques include observations and discussions with examiners and reviews of work during audits and after they are closed. Through the observations, discussions, and reviews, first-line managers attempt to identify problems so examiners can take prompt corrective actions.

A Substantial Number of Accuracy-Related Penalties Were Not Applied When Warranted

Despite the IRS' emphasis on case file documentation and layers of management controls, additional steps must be taken to ensure procedures are properly followed in considering and recommending the accuracy-related penalty during correspondence audits. We evaluated a statistical sample of 229 correspondence audits that were closed in FY 2008 and found 211 (92 percent) audits involving 209 taxpayers where penalties were not considered and assessed in accordance with IRS policies and procedures.

As a result, opportunities may have been missed to promote voluntary compliance among the 209 taxpayers and enhance Federal revenue from penalties and interest by approximately \$395,000. When projected to the 2,012 taxpayers involved in our universe of 2030 audits, we estimate that 1,851 taxpayers should have been assessed approximately \$3.5 million in penalties and interest.² When projected over a 5-year period, we estimate the IRS may miss the opportunity to promote compliance among 9,255 taxpayers and enhance revenue by \$17.5 million.

The audits we reviewed were conducted through the mail and, accordingly, did not entail complicated areas of tax law. Each of the audits also resulted in the taxpayer agreeing he or she owed additional taxes of at least \$5,000. The \$5,000 threshold is important to note because it allowed us to review cases where examiners were required to consider assessing the substantial understatement penalty. Moreover, IRS officials who reviewed our work agreed with our conclusions.

For example, in 19 audits, taxpayers could not substantiate their employee business expenses and were assessed additional tax of \$137,617. In another 43 audits, taxpayers agreed that they omitted more than \$356,210 in alternative minimum taxes when they filed their tax returns.

² We projected to the universe of taxpayers from which we selected our statistical sample using a 95 percent confidence level, a precision of ± 5 percent, and an error rate of 79 percent.



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Although the IRS considers the substantial overstatement of deductions a potential fraud indicator, there was no documentation that indicated the manager and examiner developed an action plan in the case files as required. In addition, the accuracy-related penalty was not applied even though we did not find any obvious reasons why they should not have been applied.

Prior reviews identified similar problems with considering and recommending penalties during audits

Our results in this review are consistent with prior reports we have issued³ and with findings IRS officials continue to identify through their control processes. For example, we reported that IRS field examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that applicable penalties were considered in 35 of 45 corporate audits reviewed.

To improve how penalties are considered and assessed during audits, we made a number of recommendations that included establishing a requirement for first-line managers to approve examiner decisions not to assess the substantial understatement penalty. IRS executives agreed with the recommendation and, in July 2008, updated the IRM to require managerial approval of decisions not to assess the penalty. However, despite the corrective action taken, we identified 14 cases in this review that were opened and closed after the requirement was established in which examiners decided not to assess the substantial understatement penalty and none of the decisions were approved by managers.

National quality analysts conducted quality reviews of closed cases and identified problems with accuracy-related penalty determinations. As a result, a Quality Alert notice was issued reminding examiners of their responsibility to assess the accuracy-related penalty, when applicable, and the documentation requirements. In FY 2009, mid-level manager operational reviews also identified concerns with examiners properly following the IRS' penalty-setting process during correspondence audits. To resolve current findings, IRS officials told us they are planning to provide examiners with training that would emphasize the use of the accuracy-related penalty whenever applicable and remind examiners and their managers about the documentation required in case files. While we agree that additional training is needed, existing lead sheets could be used more consistently to reinforce training as well as guide and document penalty decisions.

³ *The Strategy to Reemphasize Penalties in Corporate Examinations Could Be Enhanced* (Reference Number 2005-30-123, dated August 23, 2005).



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Existing accuracy-related penalty lead sheets need to be a mandatory tool used in correspondence audits.

As discussed earlier in this report, the IRS has layers of management controls to help ensure correct decisions are made and documented in case files. However, the fact that 92 percent of the cases we sampled had penalty errors indicates that correct penalty decisions should be a very serious concern in correspondence audits.

During our case reviews, we used the IRS' administrative lead sheets⁴ to evaluate whether the penalties were assessed in accordance with IRS policies and procedures. While these lead sheets are designed to guide and document penalty decisions, examiners are not required to use them during correspondence audits. As a result, we did not see these tools being used despite the fact that the lead sheets were well-designed and easily accessible electronically through the IRS intranet.

Notably, the lead sheets solicit answers to important statutory, procedural, and process questions, as well as references to where supporting documentation for the answers are located in the case file. The lead sheets also solicit managerial review of decisions not to assess the substantial understatement penalty. In instances when taxpayers do not agree with an examiner's penalty determination, the documents seek written documentation outlining the reasons for the disagreement.

Seeking written documentation for disagreements can be especially useful when there is a substantial understatement given that the standard for assessing the penalty contains objective criteria. In effect, a substantial understatement penalty generally should apply in an examination when an understatement exceeds 10 percent of the tax required to be shown on the return and is also equal to or greater than \$5,000. While the penalty can be avoided, certain conditions must first be met and the burden of proof for meeting those conditions is on the taxpayer.

Recommendations

The Director, Campus Compliance Services, SB/SE Division, and the Director, Compliance, Wage and Investment Division, should:

Recommendation 1: Follow through to ensure planned training is completed by all correspondence examiners and their managers. The training should specifically address when the accuracy-related penalty is applicable, how case files should be documented, and when managerial approval is required.

Management's Response: IRS management agreed with this recommendation. The Director, Campus Compliance Services, SB/SE Division, and the Director, Compliance, Wage and Investment Division, will conduct accuracy-related penalty training, which

⁴ See Appendices V and VI for examples of administrative lead sheets.



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will include the penalty criteria, case file documentation, and the requirement for managerial approval for penalty assertion/nonassertion.

Recommendation 2: Require that managers and examiners properly complete the accuracy-related penalty lead sheets for all applicable audits.

Management's Response: IRS management agreed with this recommendation. The Director, Campus Compliance Services, SB/SE Division, and the Director, Compliance, Wage and Investment Division, will submit a programming request to add penalty lead sheets to the Campus Report Generating System. They will emphasize the importance of managerial reviews and ensure that the accuracy-related penalties are being considered in Program Analysis System quality reviews.



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Appendix I

Detailed Objective, Scope, and Methodology

The objective of the review was to determine whether the accuracy-related penalty was assessed during correspondence audits in accordance with IRS policies and procedures. To accomplish our objective, we:

- I. Reviewed a statistical sample of 229 correspondence audits closed in FY 2008 using a confidence level of 95 percent, a precision level of ± 5 percent, and an error rate of 79 percent. A statistical sample was taken because we wanted to estimate the number of audits and amount of dollars associated with not properly considering the accuracy-related penalty during correspondence audits for a population of 2,030 audits involving 2,012 taxpayers.
 - A. Obtained an extract from the Audit Information Management System¹ closed case data file to identify the population of FY 2008 audits of individual income tax returns filed by high-income taxpayers (more than \$200,000 containing Activity Codes 279, 280, and 281) and taxpayers reporting sole proprietor operations (Activity Codes 276 and 277) who agreed to additional tax assessments of \$5,000 or greater.
 - B. Matched the above extract to the IRS Master File² and identified a universe of 2,030 audits which did not reflect an accuracy-related penalty in the related taxpayer's account. We validated the reliability of computer-processed data by reviewing the Integrated Data Retrieval System³ for each audit in our sample.
 - C. Obtained and reviewed correspondence case files and tax returns for all 229 audits to determine whether or not the accuracy-related penalty was properly considered and if managerial approval was obtained for nonassertion of the substantial understatement penalty when warranted.
 - D. Secured agreement to the case review results from Headquarters analysts in the SB/SE and Wage and Investment Divisions.
 - E. Worked with an outside statistical expert who confirmed the accuracy of our methodology and the potential revenue that could be generated for the entire universe

¹ 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 IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

³ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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- of 2,030 audits for 1-year and 5-year periods if examiners properly considered and assessed the accuracy-related penalty.
- F. Used the Integrated Data Retrieval System to calculate the applicable Federal interest rate from the date of the tax assessment to December 31, 2009, for the 211 of 229 audits sampled for which the accuracy-related penalty should have been asserted.
- II. Evaluated the adequacy of internal controls for ensuring the accuracy-related penalty is properly considered and applied during correspondence audits.
- A. Reviewed available documentation applicable in the Internal Revenue Code, Department of the 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.
- B. Determined the adequacy of available training courses to correspondence tax examiners regarding the accuracy-related penalty from FYs 2007 through 2009.
- C. Used the results from FY 2009 quality reviews (National Quality Review System⁴ and Embedded Quality Review System)⁵ to identify weaknesses in the use of the accuracy-related penalty and assessed the effectiveness of corrective actions taken in response to the weaknesses identified.
- D. Determined how correspondence examination first-line managers hold tax examiners accountable for making proper penalty determinations by reviewing IRM reporting requirements and additional procedures provided by SB/SE Division Headquarters management.
- E. Determined how department managers hold front-line managers accountable for ensuring penalties are properly assessed by reviewing results of the FY 2009 operational review and procedures for department manager reviews for front-line managers.
- III. Assessed the status of ongoing changes to learn about efforts to improve the administration of the accuracy-related penalty in correspondence audits by interviewing SB/SE Division management and program analysts.

⁴ The National Quality Review System conducts closed case reviews and provides quality measurement results for the SB/SE Division.

⁵ The Embedded Quality Review System allows field managers to provide timely feedback to individual employees through performance case reviews.



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Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for assessing the accuracy-related penalty in correspondence audits and the quality review system in place to evaluate the accuracy of penalty determinations. We evaluated these controls by reviewing source materials, interviewing management, and reviewing correspondence audit case files and quality review results.



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Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
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Carole Connolly, Lead Auditor
Debra Mason, Senior Auditor
Linda Foye, Auditor
Richard Hillelson, Information Technology Specialist



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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
Deputy Commissioner, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Campus Reporting Compliance, Small Business/Self-Employed Division SE:S:CCS
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Communications and Liaison, Wage and Investment Division SE:W:C
Director, Compliance, Wage and Investment Division SE:W:CP
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 Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Wage and Investment Division SE:W



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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; \$17.5 million from additional taxes and interest owed by 9,255 taxpayers over a 5-year period (see page 5).

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with the difference between the number of accuracy-related penalties assessed and the number that should be assessed in sole proprietor and high-income taxpayer audits, we:

1. Analyzed a statistical sample of 229 audits (involving 226 taxpayers) from a population of 2,030 audits (involving 2,012 taxpayers) closed in FY 2008 using a confidence level of 95 percent, precision level of ± 5 percent, and an error rate of 79 percent. The review of 229 audits found 211 (92 percent) audits involving 209 taxpayers where penalties were not considered and assessed in accordance with IRS policies and procedures.
2. Used the results from our sample to project that 1,851 taxpayers (92 percent of the universe of 2,012 taxpayers) may have avoided an accuracy-related penalty that otherwise should have been assessed.
3. Shared our sampling methodology with an outside statistical expert who confirmed the accuracy of our methodology and projection.
4. Followed IRS procedures for computing the substantial understatement and negligence penalties related to the deficiencies owed by the 209 taxpayers involved in the 211 audits.
5. Used IRS computer programs to calculate the applicable Federal interest rate to apply the amount of interest owed on the penalties not asserted on the 211 audits.
6. To estimate the amount of additional taxes and interest owed by sole proprietors and high-income taxpayers that we estimate avoided an accuracy-related penalty that otherwise should have been assessed over 5 years if the IRS does not change its procedures, we multiplied the total amount of additional taxes and interest we estimated is owed for the



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examination cases closed in FY 2008 by 5 to obtain the amount of taxes and interest [$\$3,499,756 \times 5 = \$17,498,780$].

7. To estimate the number of taxpayers who avoided an accuracy-related penalty that otherwise should have been assessed over 5 years if the IRS does not change its procedures, we multiplied the number of these taxpayers by 5 [$1,851 \times 5 = 9,255$].



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Appendix V

Negligence Penalty Lead Sheet

Negligence or Disregard of the Rules or Regulation Lead Sheet 6662(c)					
Conclusion: <i>(Reflects the final determination on the issue.)</i>					
Audit Steps: <i>(Document audit steps taken or to be taken.)</i>					Workpaper Reference
The Negligence or Disregard of Rules or Regulations Penalty is 20 percent of the understatement as defined under IRC section 6662(a). (IRM 20.1.5.7).					
	Penalty Determination Process	Yes	No	Instructions	
1	<p style="text-align: center;">General Process</p> <p>If a tax deficiency exists, the penalty for negligence or disregard of rules or regulations must be considered for each item adjusted.</p> <p>A. Did the taxpayer fail to make a reasonable attempt to comply with Internal Revenue laws?</p> <p>B. Did the taxpayer fail to exercise ordinary and necessary care in the preparation of the return?</p> <p>C. Did the taxpayer fail to keep adequate books and records or to substantiate items properly?</p> <p>D. Did the taxpayer's position lack a reasonable basis?</p>			<p>If the response to any of these questions is yes, the negligence penalty is applicable unless the taxpayer qualifies for the reasonable cause exception.</p> <p>If the response to all of these questions are no, then negligence penalty is not applicable. Regardless of whether the negligence penalty applies, go to Step 2 to determine if disregard of the rules and regulations applies.</p> <p>NOTE: By definition, the negligence penalty may not be avoided by disclosure. Therefore, a distinction between the negligence and disregard of rules and regulations must be made. (IRM 20.1.5.7)</p>	



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Negligence or Disregard of the Rules or Regulation Lead Sheet 6662(c)					
2	<p style="text-align: center;">Disregard of Rules and Regulations</p> <p>A. Was the taxpayer careless? (The taxpayer did not exercise reasonable diligence to determine the correctness of a position that is contrary to a rule or regulation.)</p> <p>B. Was the taxpayer reckless? (The taxpayer made little or no effort to determine whether a rule or regulation exists under the circumstances of the case.)</p> <p>C. Was the taxpayer's disregard intentional? (The taxpayer knew of the rule or regulation that is disregarded.)</p>			<p>If all answers in Step 2 are no, the disregard of rules or regulations penalty is not applicable. <i>Document relevant facts below.</i> If negligence is applicable, go to Step 4.</p> <p>If any of the questions in Step 2 are answered yes, go to Step 3 to consider "adequate disclosure."</p>	
3	<p style="text-align: center;">Disregard of Rules and Regulations Exception - Adequate Disclosure</p> <p>A. Did the taxpayer file Form 8275 or 8275-R? (Regulation 1.6662-4(f))</p> <p>B. Does the item or position on the return under consideration have a realistic possibility of being sustained on its merits?</p>			<p>If the response to either of these questions is no, the disregard of rules and regulations portion of the penalty may be applicable unless the taxpayer qualifies for the reasonable cause exception. <i>Document relevant facts below.</i></p>	
4	<p style="text-align: center;">Reasonable Cause</p> <p>Based upon the examiner's examination of this case does the taxpayer meet penalty relief? (IRM 20.1.5.6) (IRC 6664).</p>			<p>If no, the penalty will apply.</p> <p>If yes, the penalty will not apply. <i>Document relevant facts below.</i></p>	
Facts: <i>(Document the relevant facts.)</i>					
Law: <i>(Tax Law, Regulations, court cases, and other authorities. If Unagreed, add Argument.)</i>					
IRC Section: § 6662(c)					
Specific citations:					
Taxpayer Position: <i>(If applicable)</i>					

Source: SB/SE Division Servicewide Penalty Program web site.



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Substantial Understatement Penalty 6662(d)	
<p>5. Tax Shelter Exceptions: In general, no taxpayer may reduce an understatement for an item attributable to a tax shelter for taxable years beginning after October 22, 2004. A non-corporate taxpayer for taxable years beginning on or before October 22, 2004, may reduce the amount of an understatement with a tax shelter item when: There is substantial authority for the treatment of the item. Also, the taxpayer reasonably believed that the tax treatment of the item was more than likely the proper treatment. (6662(d)(2)(C)(i)(ii))</p> <p>A corporate taxpayer may reduce an understatement by a tax shelter amount if the corporation has reasonable cause and acted in good faith.</p>	
<p>6. Additional Documentation:</p> <p>a. Preparer penalties under IRC section 6694 must be considered and documented for all substantial understatement penalty cases. IRM 20.1.6 and 4.32</p> <p>b. Identify the penalty attributable to each adjustment in the report, explain each penalty by name, Code Section, and calculated penalty amount.</p> <p>c. When the accuracy-related penalty attributable to a substantial understatement of income tax is not asserted due to the assertion of negligence or disregard of rules or regulations any unagreed report will include the substantial understatement penalty as an alternative position.</p>	
<p>7. Nonassertion of 6662(d) Penalty:</p> <p>a. When the understatement is substantial but the penalty is not asserted the examiner must explain the applicable exceptions and the reasons for the nonassertion.</p> <p>b. To ensure consistency in penalty development and determination the nonassertion of the substantial understatement penalty is subject to managerial review.</p>	
<p>Facts: <i>(Document the relevant facts.)</i></p>	
<p>Law: <i>(Tax Law, Regulations, court cases, and other authorities. If Unagreed, add Argument)</i></p>	
<p>IRC Section: §</p>	
<p>Specific citations:</p>	
<p>Taxpayer Position: <i>(If applicable)</i></p>	
<p> </p>	

Source: SB/SE Division Servicewide Penalty Program web site.



*Accuracy-Related Penalties Are Seldom
Considered Properly During Correspondence Audits*

Appendix VII

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

May 13, 2010

RECEIVED
MAY 14 2010

BY: *DAS*

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Accuracy-Related Penalties Are Seldom
Considered Properly During Correspondence Audits
(Audit No. 200930033)

Thank you for the opportunity to review your draft report titled: "Accuracy-Related Penalties Are Seldom Considered Properly During Correspondence Audits."

We appreciate your review of this issue and agree with your findings. These penalties were not always consistently applied on campus cases, due in part to our highly automated processes, which do not always result in taxpayer contact. We identified this issue in our Fiscal Year 2009 Operational Reviews and determined that it should be addressed during this year's Continuing Professional Education training, which is currently being conducted.

We are submitting a programming request to add penalty lead sheets to our automated report system. We will continue to emphasize the penalty in Headquarters Operational Reviews, and ensure it is covered in managerial and Program Analysis System quality reviews.

We agree with the outcome measure included in your report.

Attached is a detailed response outlining our corrective actions. If you have any questions, please call me at (202) 622-0600, or members of your staff may contact Cheryl Sherwood, Director, Campus Compliance Services, at (202) 283-2200.

Attachment



*Accuracy-Related Penalties Are Seldom
Considered Properly During Correspondence Audits*

Attachment

RECOMMENDATION 1:

Follow through to ensure planned training is completed by all correspondence examiners and their managers. The training should specifically address when accuracy-related penalties are applicable, how case files should be documented, and when managerial approval is required.

CORRECTIVE ACTION:

We agree with this recommendation. The Director, Campus Compliance Services, SB/SE Division and the Director, Compliance, Wage and Investment Division will conduct accuracy-related penalty training, which will include the penalty criteria, case file documentation and the requirement for managerial approval of penalty assertion/non-assertion.

IMPLEMENTATION DATE:

Implementation Date: 7/15/2010

RESPONSIBLE OFFICIAL:

The Director, Campus Compliance Services, SB/SE Division and the Director, Compliance, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

Require that managers and examiners properly complete the accuracy-related penalty lead sheets for all applicable audits.

CORRECTIVE ACTION:

We agree with this recommendation. The Director, Campus Compliance Services, SB/SE Division and the Director, Compliance, Wage and Investment Division will submit a programming request to add penalty lead sheets to the Campus Report Generating System. We will emphasize the importance of managerial reviews and ensure that the Accuracy Related Penalties are being considered in Program Analysis System quality reviews.

IMPLEMENTATION DATE:

Implementation Date: 11/15/2010



*Accuracy-Related Penalties Are Seldom
Considered Properly During Correspondence Audits*

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RESPONSIBLE OFFICIAL:

The Director, Campus Compliance Services, SB/SE Division, and the Director, Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.