



*Penalty Abatement Procedures Should Be Applied Consistently to All Taxpayers and Should Encourage Voluntary Compliance*

**September 19, 2012**

**Reference Number: 2012-40-113**

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.

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## HIGHLIGHTS

### **PENALTY ABATEMENT PROCEDURES SHOULD BE APPLIED CONSISTENTLY TO ALL TAXPAYERS AND SHOULD ENCOURAGE VOLUNTARY COMPLIANCE**

## Highlights

**Final Report issued on September 19, 2012**

Highlights of Reference Number: 2012-40-113 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

### **IMPACT ON TAXPAYERS**

The Internal Revenue Code imposes a Failure to File (FTF) penalty for failing to file a tax return and a Failure to Pay (FTP) penalty for failing to pay the tax shown on any tax return by the date prescribed. The IRS can abate both penalties under certain circumstances. If the IRS does not administer these and other penalties fairly and accurately, taxpayers' confidence in the tax system will be jeopardized.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated to determine whether abatements of the FTF and FTP penalties were applied consistently and accurately. This audit addresses the major management challenge of Providing Quality Taxpayer Service Operations.

### **WHAT TIGTA FOUND**

The IRS waives FTF and FTP penalties for some taxpayers who have demonstrated full compliance over the prior three years. The purpose for granting the waiver, called a First-Time Abate (FTA), is to reward past tax compliance and promote future tax compliance. However, most taxpayers with compliant tax histories are not offered and do not receive the FTA waiver.

TIGTA estimated that for Tax Year 2010, approximately 250,000 taxpayers with FTF penalties and 1.2 million taxpayers with FTP penalties did not receive penalty relief even though they qualified under FTA waiver criteria.

TIGTA estimated the unabated penalties totaled more than \$181 million. Further, the FTA waiver is not used to its full potential as a compliance tool because it is granted to taxpayers before they demonstrate full compliance by paying their current tax liability.

Taxpayer requests for penalty abatements were not always processed accurately. The IRS took immediate corrective action to address this issue.

In addition, taxpayers who qualify for penalty relief based on reasonable cause may receive FTA waivers instead, which can negatively affect some taxpayers.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the FTA waiver be better used as a compliance tool by ensuring taxpayers are aware of their potential to receive the waiver based on their past compliance history. Receipt of the waiver should be contingent upon taxpayers paying their current tax liability.

TIGTA also recommended that a process be developed to address the negative impact to taxpayers who qualify for abatement of the FTF and FTP penalties based on reasonable cause, but are given FTA waivers instead.

In their response to the report, IRS officials agreed with the recommendations. The IRS plans to study how best to use the FTA waiver as a compliance tool. It also plans to review the current process for application of an FTA waiver prior to reasonable cause and its impact on taxpayers who qualify for reasonable cause, but instead are given an FTA waiver.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 19, 2012

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

**FROM:** Michael E. McKenney  
Acting Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Penalty Abatement Procedures Should Be Applied  
Consistently to All Taxpayers and Should Encourage Voluntary  
Compliance (Audit # 201140026)

This report presents the results of our review to determine whether Failure to File and Failure to Pay penalty abatements were applied consistently and accurately. We focused our review on tax returns filed by individual taxpayers. This audit was included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Providing Quality Taxpayer Service Operations.

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

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 Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (770) 617-6434.



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*Abbreviations*

FTA	First-Time Abate
FTF	Failure to File
FTP	Failure to Pay
IRS	Internal Revenue Service



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## *Background*

The Internal Revenue Code imposes a penalty for failing to file a tax return<sup>1</sup> or to pay the tax shown on any tax return<sup>2</sup> by the date prescribed for filing (including extensions). Both the Failure to File (FTF) and Failure to Pay (FTP) penalties are calculated based on figures taken from the tax return. Therefore, neither penalty is assessed until after the tax return is filed. The purpose of these penalties is to promote compliance with tax laws. In administering these and all penalties, the Internal Revenue Service's (IRS) internal guidelines provide the following four principles:

- **Consistency:** The IRS should apply penalties equally in similar situations. Taxpayers base their perceptions about the fairness of the system on their own experience and the information they receive from the media and others. If the IRS does not administer penalties uniformly, overall confidence in the tax system is jeopardized.
- **Accuracy:** The IRS must arrive at the correct penalty decision. Accuracy is essential. Erroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS.
- **Impartiality:** IRS employees are responsible for administering the penalty statutes and regulations in an even-handed manner that is fair and impartial to both the Government and the taxpayer.
- **Representation:** Taxpayers must be given the opportunity to have their interest heard and considered. Employees need to take an active and objective role in case resolution so that all factors are considered.<sup>3</sup>

*To promote compliance with tax laws, the IRS administers a system of penalties. The IRS strives to ensure consistency, accuracy, impartiality, and representation when administering penalties.*

The FTF penalty is usually 5 percent of the unpaid taxes for each month or part of a month that a tax return is late. This penalty will not exceed 25 percent of the unpaid taxes. If a taxpayer files his or her tax return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of \$135 or 100 percent of the unpaid tax.

If a taxpayer does not pay all taxes owed by the due date, he or she will generally have to pay an FTP penalty of one-half of one percent of the unpaid taxes for each month or part of a month

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<sup>1</sup> I.R.C. §6651(a)(1).

<sup>2</sup> I.R.C. §6651(a)(2) and (3).

<sup>3</sup> Internal Revenue Manual 20.1.1.2.2.



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after the due date that the taxes are not paid. This penalty can be as much as 25 percent of the unpaid taxes. The FTP penalty will continue to accrue after the initial assessment if the taxpayer fails to pay the total tax due when the tax return was due.

The IRS can abate both penalties under certain circumstances. Relief from these penalties is generally granted to taxpayers who show they exercised ordinary care and prudence, and failure to file or pay was due to reasonable cause and not due to willful neglect.<sup>4</sup> However, beginning in Calendar Year 2001, the IRS began granting penalty relief under an Administrative Waiver<sup>5</sup> known as the First-Time Abate (FTA). Using the FTA waiver, the IRS grants relief to taxpayers who receive an FTF or FTP penalty but have a compliant tax history for the prior three years. The FTA waiver applies only to a single tax year.<sup>6</sup>

***Beginning in Calendar Year 2001, the IRS began granting the FTA waiver to taxpayers who receive an FTF or FTP penalty but have a compliant tax history for the prior three years. The FTA waiver applies only to a single tax year.***

This review was performed at the Office of Servicewide Penalties and the Accounts Management function in Atlanta, Georgia; Ogden, Utah; and Washington, D.C.; during the period May 2011 through July 2012. 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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<sup>4</sup> Penalty relief can also be granted for other reasons such as statutory exceptions or to correct IRS errors.

<sup>5</sup> The IRS may formally interpret or clarify a provision to provide administrative relief from a penalty that would otherwise be assessed.

<sup>6</sup> A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



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## *Results of Review*

### ***Not All Taxpayers With Compliant Tax Histories Received the First-Time Abate Waiver***

The FTA waiver is not being granted to most taxpayers who qualify for the waiver. From the IRS's Individual Master File,<sup>7</sup> we identified 278,840 taxpayers who had been assessed an FTF penalty and 1,367,750 taxpayers who had been assessed an FTP penalty for Tax Year 2010 and appeared to qualify for the FTA waiver because they:

- Had compliant tax histories for the three prior years.
- Had not been granted abatements of either penalty for Tax Year 2010.

From a statistically valid sample of 500 of these accounts – 250 assessed FTF penalties and 250 assessed FTP penalties – we found 225 (90 percent) and 231 (92 percent) of the taxpayers qualified for penalty relief under FTA criteria but were not granted waivers.

Taxpayers are not considered for FTF or FTP penalty relief under FTA criteria unless they request their penalties be abated. The IRS does not widely publicize the opportunity to request an FTA waiver. For example:

- Form 1040, *U.S. Individual Income Tax Return*, and its instructions do not include information on the FTA waiver.
- IRS.gov, the IRS's public Internet site, web page, **Eight Facts on Penalties**, does not state that the penalties are waived if the taxpayer has been compliant for three years. The eighth fact on the web page states:

*You will not have to pay a failure-to-file or failure-to-pay penalty if you can show that you failed to file or pay on time because of reasonable cause and not because of willful neglect.*

- The balance due notices do not include information on the FTA waiver.

One of the IRS's four principles when administering penalties is consistency – that penalties should be applied equally in similar situations. Additionally, the United States tax system is a system of self-assessment and payment is based on the principle of voluntary compliance. Compliant self-assessment requires a taxpayer to know the rules for filing returns and paying

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<sup>7</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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taxes. Penalty waivers should not be granted only to taxpayers or preparers with knowledge of IRS processes.

The penalties in our samples totaled approximately \$81,000 (\$60,000 in FTF penalties and \$21,000 in FTP penalties). Based on our sample results of Tax Year 2010 taxpayer accounts, we estimate that approximately 250,000 taxpayers with FTF penalties and 1.2 million taxpayers with FTP penalties did not receive penalty relief even though they qualified under FTA criteria. We estimate the unabated penalties totaled more than \$181 million (approximately \$67 million in FTF and \$114.5 million in FTP).<sup>8</sup>

**The FTA waiver could be better used to promote tax compliance**

Under the IRS's administrative authority, the IRS waives FTF and FTP penalties for taxpayers who have demonstrated full compliance over the prior three years. However, FTA waivers may be granted before the taxpayers actually pay their current tax liabilities.

IRS procedures state that if the tax is not paid in full on the tax period when the request for abatement is received, the employee is to allow the FTA on the amount assessed. The FTP penalty will start accruing again on the unpaid taxes and will continue until the tax is paid in full. After the tax is paid in full, the taxpayer may request reasonable cause abatement of the additional FTP penalty.<sup>9</sup>

In a statistically valid sample of 240 FTP penalty abatements, 222 taxpayers received FTA waivers. Of those 222, 33 (15 percent) received the FTA waivers prior to paying their current tax liabilities in full. More than half of these taxpayers had still not fully paid their taxes six months after receiving the FTA waivers and seven still owe taxes as of the date of our review. The purpose for granting the waiver is to reward past tax compliance and promote future tax compliance. Granting the FTA waiver before a taxpayer pays the current tax liability does not fully achieve this purpose.

**Recommendation**

**Recommendation 1:** The Commissioner, Small Business/Self-Employed Division, should better use the FTA waiver as a compliance tool by ensuring taxpayers are aware of their potential to receive an FTA waiver based on their past compliance history. Receipt of the waiver should be contingent upon taxpayers paying their current liability.

**Management's Response:** The Commissioner, Small Business/Self-Employed Division, agreed with this recommendation and will work with the Commissioner, Wage and Investment Division, to study how best to use the FTA waiver as a compliance tool,

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<sup>8</sup> See Appendix IV for details on these estimates.

<sup>9</sup> Internal Revenue Manual 20.1.1.3.6.1.



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including identifying ways to ensure taxpayers are aware of their potential to receive an FTA waiver based on their past compliance history and payment of their current liability within a specified time.

### ***Controls Were Not Adequate to Identify Employee Errors When Processing Abatement Requests***

For Tax Year 2009, the IRS abated 12,427 FTF and 8,864 FTP penalties, each more than \$100. From statistically valid samples of 383 taxpayer accounts<sup>10</sup> that contained sufficient information to make a determination, 63 (16 percent) abatements or denial determinations were made in error. For example:

- 13 taxpayers were appropriately granted penalty relief, but the amounts abated were inaccurate.
- 14 taxpayers were granted penalty relief; however, instead of being the FTA waiver, the taxpayer was granted penalty relief using other criteria, such as reasonable cause or statutory waiver.
- 15 taxpayers were denied penalty abatements for which they qualified.
- 21 taxpayers were granted penalty relief for which they did not qualify.

The IRS developed a tool called the Reasonable Cause Assistant to help its employees accurately process penalty abatement requests. However, the Reasonable Cause Assistant does not always provide employees with the appropriate penalty abatement determination. In these cases, IRS employees are instructed to override the Reasonable Cause Assistant and follow Internal Revenue Manual policies and procedures.

The Reasonable Cause Assistant made incorrect determinations for 56 of 63 (89 percent) cases sampled. None of the inaccurate determinations were corrected by employees. IRS employees accepted the Reasonable Cause Assistant determination even though it conflicted with Internal Revenue Manual penalty abatement procedures.

The IRS does not have adequate controls to ensure accurate penalty abatement determinations are consistently made. The IRS's internal guidelines state that the IRS must arrive at the correct penalty decision. Accuracy is essential. Erroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS.<sup>11</sup>

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<sup>10</sup> We selected samples of 242 FTF abatements, 240 FTP abatements, and 250 FTF and/or FTP abatement denials. Of those, only 117 FTF abatements, 130 FTP abatements, and 136 FTF and/or FTP abatement denials contained adequate documentation to determine the accuracy of the abatement determination.

<sup>11</sup> Internal Revenue Manual 20.1.1.2.2.





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**Taxpayers may be precluded from receiving an FTA waiver in the future**

In two statistical samples of 482 taxpayers who were granted penalty relief, 50 (10 percent) qualified for reasonable cause but were instead granted FTA waivers. This may preclude these taxpayers from being granted the FTA waiver in future years, and may reduce the portion of their penalties abated. For example:

*A taxpayer with a clean compliance history asks to have his FTP penalty abated in Tax Year 2010 for reasonable cause (serious illness). The IRS would first consider the FTA waiver and the taxpayer would be granted penalty relief under FTA criteria. The following year, the taxpayer is late paying his Tax Year 2011 taxes, but did not have reasonable cause. He will be assessed an FTP penalty, which could not be waived because he had been granted an FTA waiver for the prior tax year. Had the taxpayer been granted reasonable cause for late payment for Tax Year 2010, the taxpayer would qualify for an FTA waiver for the FTP penalty for Tax Year 2011.*

IRS guidelines state that the IRS should apply penalties equally in similar situations. Further, taxpayers must be given the opportunity to have their interests heard and considered.<sup>13</sup> However, taxpayers' requests for reasonable cause are not always considered.

Taxpayers base their perceptions about the fairness of the system on their own experience and the information they receive from the media and others. If the IRS does not administer penalties uniformly, taxpayers confidence in the tax system can be affected.

**The portion of the FTP penalty abated under the FTA waiver could be less than the portion abated under reasonable cause**

Four (8 percent) of the 50 taxpayers sampled who were granted FTA waivers when they also qualified for abatements for reasonable cause had less of their penalties abated than they would have had they been granted reasonable cause. This happened because FTP penalty abatements under the FTA waiver include the assessed amounts but not accrued amounts, whereas FTP penalties abated for reasonable cause include the assessed *and* accrued amounts. For example:

*A taxpayer timely filed a Tax Year 2010 return with a tax of \$8,000, but only submits \$4,000 with his tax return. At the time the return is processed, an initial \$40 FTP penalty was assessed and additional amounts accrue. The taxpayer had reasonable cause for his failure to pay the full amount and provided the IRS with a written request in May 2012 to abate the FTP penalty. Upon receiving the taxpayer's request, the IRS granted the taxpayer an FTA waiver and abated the \$40 FTP penalty. However, the taxpayer is required to request reasonable cause (a second time) or pay the \$230 of accrued FTP as well as any additional FTP accruals until the tax is paid in full. If the IRS had abated the*

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<sup>13</sup> Internal Revenue Manual 20.1.1.2.2.



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*penalty under reasonable cause procedures, the initial \$40 and the subsequent \$230 in accruals would have been abated.<sup>14</sup>*

The FTP penalty generally accrues at a rate of one-half of one percent per month on the unpaid tax and continues to accrue until the penalty reaches a maximum of 25 percent. This penalty is charged only on the unpaid tax and not on unpaid penalties and interest.

Most calculations and assessments for the FTP penalty are systemically calculated and posted to a taxpayer's account. The computer makes an initial assessment of the penalty to the taxpayer's account on the Master File at the time the original tax liability is assessed. The penalty continues to accrue but is assessed only periodically, and the full amount of accrued penalty is not assessed until the unpaid tax is paid in full and there is a credit balance available on the taxpayer's account to be applied to accrued amounts.<sup>15</sup> In other words, the computer keeps track of how much FTP penalty the taxpayer owes, but most of the penalty is never officially assessed to the taxpayer's account on the Master File until there are funds in the account to pay all or part of the accrued penalty.

The IRS is responsible for administering penalty statutes and regulations in a manner that is fair and impartial to both the Government and the taxpayer. Administering penalties in a way that causes unnecessary burden to taxpayers who have reasonable cause for filing or paying late does not achieve this.

## ***Recommendation***

***Recommendation 2:*** The Commissioner, Small Business/Self-Employed Division, should develop a process to address the negative impact to taxpayers who qualify for abatement of the FTF and FTP penalties based on reasonable cause, but are given FTA waivers instead.

***Management's Response:*** The Commissioner, Small Business/Self-Employed Division, agreed with this recommendation and will work with the Commissioner, Wage and Investment Division, to review the current process for application of the FTA waiver prior to reasonable cause and its impact on taxpayers who qualify for reasonable cause, but instead are given an FTA waiver. Any proposed changes will consider resource constraints.

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<sup>14</sup> See Appendix V for a more detailed explanation of this example.

<sup>15</sup> An amount is not considered assessed until it is officially recorded as a liability on a taxpayer's account on the Master File.



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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to determine whether FTF and FTP penalty abatements were applied consistently and accurately. We focused our review on tax returns filed by individuals with FTF and FTP penalty abatements. To accomplish this objective, we:

- I. Determined what procedures and guidelines used for processing FTF and FTP penalty abatements were available and whether these procedures were adequate for properly working penalty abatement cases.
  - A. Researched IRS publications, the Internal Revenue Manual, training information, and Treasury Inspector General for Tax Administration and Government Accountability Office audit reports relating to FTF and FTP penalty abatements.
  - B. Held interviews/discussions with IRS personnel associated with processing abatements of FTF and FTP penalties.
- II. Determined the volume of FTF and FTP penalty abatements.
  - A. Obtained a computer extract from the Data Center Warehouse<sup>1</sup> for all FTF and FTP penalty abatements present on the Individual Master File<sup>2</sup> as of December 31, 2010.
  - B. Selected a random sample of 30 FTF and 30 FTP penalty records and validated that the information from the computer extract was accurate. This was done by comparing the information from the computer extract to information found on the Integrated Data Retrieval System.<sup>3</sup>
- III. Determined if returns with FTF and FTP penalty abatements were consistently and accurately worked at the IRS campuses nationwide.

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<sup>1</sup> A collection of IRS databases containing various types of taxpayer account information that is maintained by the Treasury Inspector General for Tax Administration for the purpose of analyzing data for ongoing audits.

<sup>2</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>3</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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- A. Selected two statistical samples of Tax Year<sup>4</sup> 2009 taxpayer accounts from the Individual Master File containing an FTF or FTP manual penalty abatement,<sup>5</sup> selected two statistical samples of Tax Year 2010 taxpayer accounts from the Individual Master File potentially meeting FTA criteria,<sup>6</sup> and selected a statistical sample of Tax Year 2010 taxpayer accounts from the Individual Master File potentially containing an FTF or FTP penalty denial.<sup>7</sup>
- B. From the Tax Year 2009 sample, reviewed the FTF and FTP abatements on the Integrated Data Retrieval System and taxpayer correspondence from the IRS Correspondence Imaging System to identify issues related to the consistent and accurate abatement of the FTF and FTP penalties contained on the accounts.
- C. From the Tax Year 2010 sample of accounts potentially meeting FTA criteria, reviewed the taxpayers' compliance history on the Integrated Data Retrieval System to determine the number of taxpayers who would have qualified for an FTA waiver had they asked for penalty relief.
- D. From the Tax Year 2010 sample of accounts potentially containing a penalty denial, reviewed the Integrated Data Retrieval System and taxpayer correspondence from the IRS Correspondence Imaging System to first identify whether the account contained an FTF or FTP penalty denial and second to determine whether the penalty denial was justified on the accounts.

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<sup>4</sup> A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

<sup>5</sup> We selected a statistical sample of 242 taxpayer accounts from a population of 12,427 accounts containing an FTF manual penalty abatement of more than \$100. We also selected a sample of 240 taxpayer accounts from a population of 8,864 accounts containing an FTP manual penalty abatement of more than \$100. Our sample sizes were based on a 95 percent confidence level, an expected error rate of 20 percent, and a precision of  $\pm 5$  percent.

<sup>6</sup> We selected a statistical sample of 250 taxpayer accounts from a population of 278,840 accounts containing an FTF penalty and potentially meeting FTA criteria. We also selected a sample of 250 taxpayer accounts from a population of 1,367,750 accounts containing an FTP penalty and potentially meeting FTA criteria. Our sample sizes were based on a 95 percent confidence level, an expected error rate of 20 percent, and a precision of  $\pm 5$  percent.

<sup>7</sup> We selected a statistical sample of 250 taxpayer accounts from a population of 9,270 accounts containing a potential FTF or FTP penalty abatement denial. Our sample sizes were based on a 95 percent confidence level, an expected error rate of 20 percent, and a precision of  $\pm 5$  percent.



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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: the IRS's policies, procedures, and practices related to abating FTF and FTP penalties, and identification of potential erroneous abatements or denial of abatements of these penalties. We assessed these controls through interviews with IRS management, analysis of IRS policies and procedures, and review of penalty cases abated by the IRS.



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## **Appendix II**

### *Major Contributors to This Report*

Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)

Kyle R. Andersen, Director

Larry Madsen, Audit Manager

Annette Bates, Lead Auditor

Laura Paulsen, Senior Auditor

Johnathan D. Elder, Auditor

Nathan J. Smith, Auditor



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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, Services and Operations, Wage and Investment Division SE:W  
Director, Customer Account Services, Wage and Investment Division SE:W:CAS  
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM  
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
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  
    Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI



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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 outcome measure is based on specific cases identified through our statistically valid samples and is projected to the overall population of taxpayers who were not given FTA waivers. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Taxpayer Rights and Entitlements – Potential; \$181,547,944 in FTF and FTP penalties were issued to 1,514,757 taxpayers even though these taxpayers qualified for an FTA waiver under clean compliance history criteria (see page 3).

#### **Methodology Used to Measure the Reported Benefit:**

We obtained from the IRS Individual Master File<sup>1</sup> a computer extract of Tax Year<sup>2</sup> 2010 accounts that contained FTF and FTP penalties. From this extract, we wrote computer programs to identify only those accounts that appeared to qualify for an FTA waiver. The result included 1,646,590 accounts which we separated into two files: 278,840 accounts with FTF penalty assessments and 1,367,750 accounts with FTP penalty assessments. From each of the files, we randomly selected a statistically valid sample of 250.

We reviewed a statistically valid sample of 250 of the 278,840 accounts with FTF penalty assessments and found that 225 (90 percent) qualified for an FTA waiver but did not receive it because it was not requested by the taxpayer. By multiplying 0.90 by the population of 278,840 accounts with FTF penalty assessments, we estimated that 250,956<sup>3</sup> qualified taxpayers were not given FTA waivers.

We determined that the 225 accounts in our FTF sample totaled \$60,033.46 and divided by the sample size of 250, resulted in a sample average of \$240.13. By multiplying \$240.13 by the

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

<sup>2</sup> A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

<sup>3</sup> Our estimate is based on a 95 percent confidence level and a precision (range) of  $\pm 10,386$  (240,570 – 261,342).



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population of 278,840, we projected that \$66,957,849<sup>4</sup> in FTF penalties were assessed to taxpayers who qualified for FTA waivers.

We reviewed a statistically valid sample of 250 of the 1,367,750 accounts with FTP penalty assessments and found that 231 (92.4 percent) qualified for an FTA waiver but did not receive it because it was not requested by the taxpayer. By multiplying 0.924 by the population of 1,367,750 accounts with FTP penalty assessments, we estimated that 1,263,801<sup>5</sup> qualified taxpayers were not given FTA waivers.

We determined that the 231 accounts in our FTP penalty sample totaled \$20,944.33 and divided by the sample size of 250, resulted in a sample average of \$83.78. By multiplying \$83.78 by the population of 1,367,750, we projected that \$114,590,095<sup>6</sup> in FTP penalties were assessed to taxpayers who qualified for FTA waivers.

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<sup>4</sup> Our estimate is based on a 95 percent confidence level and a precision (range) of  $\pm$  \$17,689,593 (\$49,268,256 – \$84,647,442).

<sup>5</sup> Our estimate is based on a 95 percent confidence level and a precision (range) of  $\pm$  45,016 (1,218,785 – 1,308,817).

<sup>6</sup> Our estimate is based on a 95 percent confidence level and a precision (range) of  $\pm$  \$26,234,304 (\$88,355,791 – \$140,824,399).



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## Appendix V

### *Individual Master File<sup>1</sup> Transcript for Computer Assessed Failure to Pay Tax Penalty*

ACCOUNT NO 123-45-6789

NAME CONT- ABCD

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\* TAX PERIOD 30 201012 \*

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ASSESSED BAL:	3,030.00	
FTP TOTAL:	230.00	← 05162012
FTP ASSESSED-	0.00	←

150	04152011		8,000.00	
806	04152011		4,000.00-	
276	05302011		40.00	←
196	05302011		30.00	
670	03312012		1,000.00-	
271	03312012		40.00-	

This figure is the assessed module balance. It is the sum of the six assessed transactions below. The transaction codes (TC) represent the following:

- 150 – Tax Liability
- 806 – Withholding Credit
- 276 – Computer Assessed Failure to Pay Tax Penalty
- 196 – Computer Assessed Interest
- 670 – Payment
- 271 – Manual Abatement of Failure to Pay Tax Penalty

The \$230 figure is the total assessed and accrued FTP tax penalty. Prior to the TC 271 abatement, this figure was \$270. The \$0 figure is the assessed FTP penalty. Prior to the TC 271 abatement, this figure was \$40.

This specific \$40 transaction is the initial assessed FTP tax penalty. As the penalty accrues (grows) after the initial assessment, it is reflected in the accrued penalty figure (the FTP TOTAL amount).

This is a simulated IRS taxpayer account transcript. Although the taxpayer data are fictitious, the transcript illustrates how the IRS computer accrues and assesses FTP penalties. In this

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



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example, the taxpayer did not pay the amount due with his or her return. The IRS computer assessed an FTP tax penalty of \$40 at the time the return was processed. After that initial assessment, the FTP tax penalty amount grew an additional \$230. The \$230 difference between FTP TOTAL and FTP ASSESSED is the amount of penalty accrued but not yet assessed. The number 05162012 signifies that the \$230 in accruals is computed to May 16, 2012. In some cases, this accrued amount could be assessed at the time an annual balance due notice is issued, but not all taxpayers are sent this notice. Additional FTP penalty will continue to accrue until the tax is fully paid or the 25 percent maximum penalty is reached. The accrued amount will not be assessed until there are funds in the account to pay all or part of the penalty. For example, if a payment of \$3,230.00 was made, \$200.00 ( $\$3,230 - \$3,030 = \$200$ ) in FTP penalty would be assessed and the accrued amount would be reduced to \$30.



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**Appendix VI**

*Management's Response to the Draft Report*

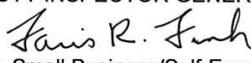


COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

AUG 29 2012

MEMORANDUM FOR MICHAEL E. MCKENNEY  
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink   
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report - Penalty Abatement Procedures Should Be  
Applied Consistently to All Taxpayers and Should Encourage  
Voluntary Compliance (Audit # 201140026)

Thank you for the opportunity to review the draft report titled "Penalty Abatement Procedures Should Be Applied Consistently to All Taxpayers and Should Encourage Voluntary Compliance". As noted in your report, there are a number of challenging issues associated with First Time Abatement (FTA) and Reasonable Cause. We are pleased your report notes the steps taken by the IRS to promote consistent and fair abatement decisions by developing the Reasonable Cause Assistant.

Our policy on FTA was initially developed to both reduce burden on taxpayers with a history of compliance as well as conserve IRS resources. We, therefore, designed our process to first consider FTA so further detailed information and analysis would not be required as it is when making a reasonable cause determination.

We will continue to review our policies for the application of FTA and Reasonable Cause to determine the best ways to assist taxpayers with their federal tax payment obligations. This includes ensuring appropriate communication to taxpayers.

We understand outcome measures for the category of "Taxpayer Rights and Entitlements" do not include costs associated with implementing any proposed changes. For this reason, while we agree the measure is accurately calculated, our concern is the measure does not consider other aspects of penalty abatement, such as implementation costs or lost opportunity costs.



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Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or a member of your staff may contact, Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at 859-669-5526.

Attachment



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**Attachment**

**RECOMMENDATION 1:**

The Commissioner, Small Business/Self Employed Division, should better use the FTA as a compliance tool by ensuring taxpayers are aware of their potential to receive an FTA waiver based on their past compliance history. Receipt of the waiver should be contingent on taxpayers paying their current liability within a specified time period.

**CORRECTIVE ACTION:**

The Commissioner, Small Business/Self-Employed Division will work with the Commissioner, Wage and Investment Division, to study how best to use FTA as a compliance tool to include identifying ways to ensure taxpayers are aware of their potential to receive an FTA waiver based on their past compliance history and payment of their current liability within a specified time.

**IMPLEMENTATION DATE:**

September 15, 2015

**RESPONSIBLE OFFICIAL(S):**

Director, Examination Policy, Small Business/Self Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this corrective action as part of our internal monitoring system.

**RECOMMENDATION 2:**

The Commissioner, Small Business/Self Employed Division, should develop a process to address the negative impact to taxpayers who qualify for abatement of the FTF and FTP penalties based on reasonable cause, but are given FTA waivers instead.

**CORRECTIVE ACTION:**

The Commissioner, Small Business/Self-Employed Division will work with the Commissioner, Wage and Investment Division to review the current process for application of FTA prior to reasonable cause and its impact on taxpayers that qualify for reasonable cause, but instead are given FTA. Any proposed changes will consider our resource constraints.

**IMPLEMENTATION DATE:**

September 15, 2015

**RESPONSIBLE OFFICIAL(S):**

Director, Examination Policy, Small Business/Self Employed Division



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**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this corrective action as part of our internal monitoring system.