TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Improvements Are Needed to Ensure That Tax Accounts on the Automated Non-Master File Are Accurately Processed

May 25, 2017

Reference Number: 2017-40-037

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IMPROVEMENTS ARE NEEDED TO ENSURE THAT TAX ACCOUNTS ON THE AUTOMATED NON-MASTER FILE ARE ACCURATELY PROCESSED

Highlights

Final Report issued on May 25, 2017

Highlights of Reference Number: 2017-40-037 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The amount of unpaid tax, penalties, and interest associated with Automated Non-Master File accounts is significant. The Automated Non-Master File provides information regarding individual and business taxpayer accounts that, because of system limitations, cannot be managed through the Master File. As of September 29, 2015, the Automated Non-Master File contained 9,145 open accounts with unpaid tax, penalties, and interest totaling more than $4.5 billion.

WHY TIGTA DID THE AUDIT

The IRS relies on manual processes to establish Automated Non-Master File accounts and process account activity. The need to manually transfer information between the Master File and the Automated Non-Master File increases the risk of errors. The overall objective of this review was to evaluate the accuracy of processing tax accounts on the Non-Master File.

WHAT TIGTA FOUND

Calculation errors on Automated Non-Master File accounts resulted in the incorrect assessment of penalties. Specifically, the IRS did not assess Failure to File penalties totaling more than $1.7 million on 85 open accounts. The IRS also overassessed Failure to Pay penalties totaling $88,576 on 153 accounts and underassessed Failure to Pay penalties totaling $354,153 on 227 accounts.

In addition, processes are needed to ensure that credits and payments are correctly applied to accounts with a balance due. TIGTA identified four open Automated Non-Master File accounts with $122,041 in credits that were erroneously refunded back to the taxpayer despite the taxpayer having unpaid tax liabilities on another Automated Non-Master File account. TIGTA also identified 420 open Automated Non-Master File accounts and 399 closed Automated Non-Master File accounts for which the IRS did not correctly apply $1.4 million in payments. The IRS instead posted the payments to the taxpayers' other Master File accounts with a balance due.

Finally, processes need to be established to ensure the accuracy of Automated Non-Master File accounts. TIGTA identified 360 accounts in which the Collection Statute Expiration Dates did not match information on the Master File; 560 accounts in which the address did not match; and 116 accounts in which the taxpayers' designated representative information did not match. These discrepancies can result in taxpayers and their representatives not receiving notices as required or the IRS accepting a payment for a balance due that is no longer legally owed.

WHAT TIGTA RECOMMENDED

TIGTA made six recommendations that included correcting Automated Non-Master File computation of Failure to File and Failure to Pay penalty and assessment programming errors, establishing processes to ensure that payments are correctly applied to Automated Non-Master File accounts, and establishing processes to periodically verify the accuracy of taxpayer information on the Automated Non-Master File to the information on the Master File.

IRS management agreed with all of TIGTA's recommendations. The IRS plans to request programming changes to improve the accuracy of the Automated Non Master File computation of Failure to File and Failure to Pay penalties. The IRS also updated its guidance to improve manual processes such as penalty computations and research procedures to ensure the accuracy of taxpayer information. These procedures will be emphasized in required annual refresher employee training.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 25, 2017

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
                 Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed to Ensure That Tax
                 Accounts on the Automated Non-Master File Are Accurately Processed
                 (Audit # 201640008)

This report presents the results of our review to evaluate the accuracy of processing tax accounts on the Non-Master File. This audit was included in our Fiscal Year 2016 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. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).

Table of Contents

Abbreviations

ANMF   Automated Non-Master File

CSED   Collection Statute Expiration Date

IRS   Internal Revenue Service

NMF   Non-Master File

TIGTA   Treasury Inspector General for Tax Administration

Background

Prior to 1962, the Internal Revenue Service (IRS) maintained all individual and business taxpayer accounts on manual ledger cards.[1] The creation of the Master File[2] in 1962 enabled the IRS to automate individual and business taxpayer account processing. Although the Master File was an improvement over the manual system, Master File system limitations prevent the IRS from processing all taxpayer accounts on the Master File. For example, the Master File cannot process Forms 1040, *U.S. Individual Income Tax Return*, in which the taxpayer's balance due, *i.e.,* amount owed the IRS, is $1 billion or more. The Master File also has a file size limitation and for those accounts with tax transactional activity that exceeds this file size, the Master File is no longer able to post transactions to the account. Accounts that exceed this file limitation are referred to as overflow accounts and must be processed manually. As such, the IRS continued to maintain some tax accounts on ledger cards until 1991. The IRS refers to these accounts as Non-Master File (NMF) accounts.

In 1991, the IRS automated the processing and monitoring of NMF accounts. The IRS refers to this automated system as the Automated Non-Master File (ANMF). The ANMF is an independent research database that acts as a system of accounting. The ANMF provides information regarding individual and business taxpayers' outstanding tax liabilities as well as return and tax adjustment processing for taxpayer accounts that cannot be managed through the Master File.

Structure of the ANMF

Unlike the Individual Master File[3] and the Business Master File[4] in which all assessments for the same tax period are posted to one tax account, a separate ANMF account is established for each taxpayer assessment, *i.e.,* one ANMF account equals one assessment. Because a separate ANMF account is established for each assessment, a taxpayer may have multiple accounts for the same tax period. All transactions related to a specific assessment are recorded in the assessment account. Figure 1 illustrates the difference between a Master File and an ANMF account.

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[1] A ledger card is a paper account record that contains account balances as well as all account transactions related to a tax liability.
[2] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[3] The IRS database that maintains transactions or records of individual tax accounts.
[4] The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

Figure 1: Differences Between a Master File and ANMF Account

Taxpayer A files an individual income tax return for Tax Year[5] 2014. After processing the return, the IRS adjusts the return to assess additional tax owed on two separate occasions.			
Master File Account		*ANMF Account*	
Number of Accounts	**Description of Information in the Account**	**Number of Accounts**	**Description of Information in Each Account**
1	All transactions related to the Tax Year 2014 tax return.	3	One account for the tax liability from the original filed return with a separate account for each of the subsequent assessments. Each account contains the specific transactions related to a single assessment associated with the Tax Year 2014 tax return.

Source: Hypothetical illustration.

The ANMF contains both open and closed tax accounts. Open accounts are generally those accounts in which the individual or business has an outstanding balance due. Closed accounts are accounts that have been full paid or are no longer considered to have balances due (such as those that have been written off due to an expired statute). An account will remain open on the ANMF for 30 calendar days after the balance due has been satisfied before it is moved to a closed status. As of September 29, 2015, there were 3,649 unique individuals and 2,353 unique businesses with at least one open account on the ANMF. There were 9,145 open ANMF accounts associated with these individuals and businesses with account balances totaling more than $4.5 billion. Of the 9,145 open accounts:

- 7,497 accounts had an outstanding balance due.

- 253 accounts had a credit balance.

- 1,395 accounts had the balance due full paid and the account was awaiting closure.

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[5] 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.

Processing of ANMF accounts

All ANMF processing is centralized in the ANMF Processing function in the Cincinnati Submission Processing Campus[6] located in Covington, Kentucky. All actions taken by the ANMF Processing function are based on request documents provided from various IRS functional areas.[7] These IRS functions include Accounts Management, Collection, Appeals, Tax Exempt/Government Entities, or Examination. For example, a functional area will submit documentation to request the establishment of an ANMF account. Upon receipt of this documentation, the ANMF Processing function will manually establish the account on the ANMF. Additional actions that can be requested include the assessment of tax liability, including penalty and interest, and the recording of payments.

Between October 1, 2014, and September 29, 2015, the ANMF Processing function processed 38,964 source documents requesting 292,905 transactions. While most processing for accounts on the ANMF is still manual, some activities are systemic such as the computation and assessment of penalties and interest for accounts with a balance due. In addition, accounts with***2***********************************
*******************2********************8 *******9 The ANMF also generates taxpayer notices for accounts that have a balance due. However, generation of the wording in the notice is dependent on the manual entry of the notice type into the account, and the notices, once generated, must be manually mailed to taxpayers by ANMF Processing function employees.

This review was performed at the Cincinnati Submission Processing Campus in Covington, Kentucky, during the period February through December 2016. 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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[6] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

[7] See Appendix V for examples of source documents.

[8] The CSED is the date beyond which the IRS can no longer collect an unpaid tax debt. Internal Revenue Code Section 6502 provides that the length of the period for collection after assessment of a tax liability is 10 years.

[9] **************************************2**
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Results of Review

Calculation Errors Resulted in the Incorrect Assessment of Penalties

Our analysis of the 9,145 open ANMF accounts as of September 29, 2015, identified errors in the formula the ANMF uses to calculate penalties. As a result, the IRS did not assess Failure to File penalties totaling more than $1.7 million on 85 open accounts. In addition, the IRS overassessed Failure to Pay penalties totaling $88,576 on 153 open accounts and underassessed Failure to Pay penalties totaling $354,153 on 227 accounts.

The IRS has the authority to assess a Failure to File penalty on taxpayers who do not timely file their tax return or Failure to Pay penalty on taxpayers who do not timely pay their tax liability.

- *Failure to File penalty* – is equal to 5 percent of the taxpayer's unpaid tax and is generally assessed for each month or part of a month that the taxpayer has not filed the required return up to five months.[10]

  IRS management agreed that the Failure to File penalty was not correctly computed on the 85 accounts we identified. IRS management indicated that ANMF programming did not compute the penalty relating to the filing of Form 1040NR, *U.S. Nonresident Alien Income Tax Return,* with an Employer Identification Number.[11] Each of these 85 accounts is associated with a Form 1040NR filed using an Employer Identification Number.[12] IRS management indicated that the IRS is developing processes to assess the Failure to File penalty for Form 1040NR.

- *Failure to Pay penalty* – is equal to 0.5 percent of the unpaid liability and is generally assessed on the unpaid liability remaining at the end of each month until the tax is paid.[13] A reduced rate of 0.25 percent is applicable to those individuals who have been granted and continue to remain current with an installment agreement. However, individuals for whom the IRS issues a Notice of Intent to Levy are subject to a 1 percent Failure to Pay penalty on unpaid balances remaining after issuance of the levy notice.

  For 338 of the 380 accounts we identified, IRS management indicated that the formula the ANMF uses to compute the Failure to Pay penalty did not include all of the elements

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[10] The penalty is reduced by the amount of the Failure to Pay penalty for any month in which both penalties apply.

[11] A unique nine-digit number used to identify a taxpayer's business account. Forms 1040NR filed for an estate or trust must be filed using the Employer Identification Number of the estate or trust.

[12] Forms 1040NR filed for an estate or trust must be filed using the Employer Identification Number of the estate or trust.

[13] The penalty is assessed each month until the tax is paid in full or the total penalty on the tax reaches an aggregate 25 percent of the unpaid tax.

needed to correctly compute the penalty for accounts in Status 60, *Installment Agreement*. IRS management also stated that ANMF programming was incorrectly using the date the tax return posted to the ANMF rather than the tax return due date (including extensions) when computing the Failure to Pay penalty for Forms 1040NR. Further analysis showed that 41 of the 380 accounts are associated with a Form 1040NR. At the time of this report, IRS management was still researching the 42 accounts we identified in which no Failure to Pay penalty was assessed to determine why the ANMF programming did not correctly compute the penalty.

Management noted that they are correcting computer programming to include the tax return due date and the return received date in the computation of the Failure to Pay penalty for Forms 1040NR. IRS management also sent an inquiry along with a sampling of the ANMF transcripts for the accounts we identified to the ANMF Development team to alert them that the ANMF is not computing Failure to Pay Penalties on some accounts. In addition, management stated that the IRS will review the 380 accounts we identified to ensure that the ANMF status is updated for those accounts that no longer have an installment agreement. Once the account status has been updated, the IRS will recompute the Failure to Pay penalty on these accounts.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Correct ANMF programming to compute and assess the Failure to File penalty on Form 1040NR accounts in which the Taxpayer Identification Number is an Employer Identification Number.

> **Management's Response:** The IRS agreed with this recommendation. Management plans to submit a Unified Work Request for the requisite programming changes by June 2017.

Recommendation 2: Correct ANMF programming to use the correct date when computing the Failure to Pay penalty. In addition, programming should be corrected to ensure that the proper penalty rate is used to compute the penalty amount.

> **Management's Response:** The IRS agreed with this recommendation. Management plans to submit a Unified Work Request for the requisite database structure and programming changes. In addition, the IRS implemented improvements to manual processes that are not dependent on programming updates. On March 30, 2017, the IRS updated Internal Revenue Manual 3.17.46, *Automated Non-Master File Accounting*, which provides procedural guidance to employees manually calculating penalties recorded on the NMF.

Recommendation 3: Review the 85 accounts we identified in which the Failure to File penalty and the 380 accounts in which the Failure to Pay penalty were not correctly assessed to ensure that the correct penalty amounts are assessed on all accounts in which the CSED remains open.

> **Management's Response:** The IRS agreed with this recommendation.

Processes Are Needed to Ensure That Credits and Payments Are Correctly Applied to Accounts With a Balance Due

Our review of open and closed ANMF accounts as of September 29, 2015, identified four accounts with $122,041 in credits on the ANMF that were refunded back to the taxpayer despite the taxpayer having unpaid tax liabilities on another ANMF account. When a taxpayer has an account on the ANMF with a credit balance, IRS guidelines require ANMF Processing function employees to research the ANMF for other unpaid accounts the taxpayer may have before refunding the credits. When we shared our results with IRS management, they stated that one of the four refund checks we identified had expired without being cashed. The remaining erroneous refunds resulted from inadequate employee research to identify other ANMF accounts with a balance due.

Payments were not always correctly applied to ANMF accounts

Our analysis of open and closed ANMF accounts as of September 29, 2015, identified 420 open accounts and 399 closed accounts for which the IRS did not apply $1.4 million in payments. Each of these accounts was added to the ANMF from a corresponding Master File account as an overflow account, *i.e.* the tax transactional activity exceeded the file size limitation of a tax account on the Master File. We found that once the account was transferred to the ANMF, subsequent payments were not applied to the ANMF account that had the balance due. Instead these payments were applied to the taxpayers' other Master File accounts with a balance due. It should be noted that the ANMF account had the oldest balance due CSED.

Each tax assessment has a CSED. According to IRS guidelines, payments should be applied to the balance due account with the oldest CSED first.[14] This includes proceeds from seizures, levies, installment agreements, and other undesignated voluntary payments. When we notified IRS management of our concerns, management indicated that the ANMF Processing function does not control how payments are applied. The ANMF Processing function receives source documents from other IRS functions telling it where payments are to be applied. The ANMF Processing function is just the input function for those source documents.

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[14] An imminent CSED is any CSED with 12 months or less remaining on the collection statute.

Recommendations

The Commissioner, Wage and Investment Division, should establish processes to:

Recommendation 4: Ensure that employees properly research ANMF accounts to identify whether the taxpayer has other balance due ANMF accounts to which credits can be transferred prior to refunding them to taxpayers.

> **Management's Response:** The IRS agreed with this recommendation. The IRS responded that in addition to updating Internal Revenue Manual 3.17.46, as previously noted, correct procedures will be reviewed during annual refresher training.

Recommendation 5: Ensure that payments are correctly applied to overflow ANMF accounts in situations in which the taxpayer has balance due accounts on both the ANMF and the Master File.

> **Management's Response:** The IRS agreed with this recommendation. The IRS responded that procedures will be reviewed for accuracy and emphasized during annual refresher training.

Processes Need to Be Established to Ensure the Accuracy of Automated Non-Master File Tax Accounts

Our analysis of open ANMF accounts as of September 29, 2015, found inconsistencies between taxpayer information on the ANMF and the Master File which could affect a taxpayer's rights. Specifically, we found:

- 360 accounts in which the CSED on the ANMF did not match the CSED on the Master File for the same delinquent tax module. It should be noted that the CSED is reflected in the taxpayer's account on both the Master File and the ANMF if the taxpayer should have accounts on both. Our review of both Master File and ANMF accounts for the 360 ANMF accounts found that the CSED on the Master File was more current than the one on the ANMF for all 360 accounts. An incorrect CSED in the ANMF increases the risk that the IRS will inappropriately write-off outstanding liabilities before the CSED actually expires. In addition, when an account with an expired CSED is not properly closed on the ANMF, it increases the risk that the IRS will inappropriately accept and apply a payment to a balance that is no longer legally owed.

- 560 accounts in which the address on the ANMF did not match the taxpayer's address on the Master File. The address discrepancy between the ANMF and the Master File can result in notices not being sent to the taxpayer's most current address.

- 116 accounts in which an ANMF notice was not sent to the taxpayer's designated representative, *e.g.*, power of attorney, as required. Further analysis of these accounts found that the taxpayer representative information on the ANMF and the Master File did

not match. As a result, the ANMF Processing function was not always aware that the taxpayer had a designated representative when issuing notices.

In response to a 1999 Treasury Inspector General for Tax Administration (TIGTA) report,[15] the IRS stated that it established a cross-functional team to review all NMF accounts before issuance of the annual notices of delinquency.[16] However, during our walkthrough of ANMF processing, IRS officials were unaware of the results of the previous audit containing the corrective actions taken including the establishment of the cross-functional teams. IRS management noted that the prior report was issued to the IRS before the current teams were established and many of the individuals working for the IRS at the time of the report are either no longer with the IRS or have moved to other areas.

When we notified IRS management of our concerns with inconsistencies between the ANMF and the Master File, management generally agreed with our findings. However, management again reiterated that the ANMF Processing function is just the input function. The ANMF Processing function is not aware that information on the ANMF such as a taxpayer's address, representative information, or CSED needs updated unless a functional area outside the ANMF Processing function instructs it to update information on the ANMF. IRS management also indicated that the accuracy of the information in the ANMF, such as the CSED, is dependent on the accuracy of the source documents provided by other IRS functions.

Annual reminder notices required by law were not always sent

In addition to the previously mentioned accounts, we also identified 92 open accounts for which there was no annotation in the ANMF account history that the IRS sent the taxpayer an annual "currently not collectible" notice (Form 9774, *Annual Reminder Notice for ANMF/NMF*) as required by Internal Revenue Code Section 7524. The ANMF automatically generates these notices. However, the annual "currently not collectible" notices must be manually mailed to the taxpayer. Internal guidelines also require 5 percent of generated notices be reviewed prior to mailing. ANMF Processing function employees generally make a notation in the ANMF account history when a notice is reviewed showing that the notice was in fact sent. For the 92 accounts, no such notation was included confirming the mailing of the annual notice.

When we discussed our concerns with IRS management, management agreed that these accounts did not contain a notation that the annual "currently not collectible" notice was sent to the taxpayer. IRS management indicated that they will revise procedures to require tax examiners to notate the date the notice is sent in the account history. In response to our concerns, IRS management stated that the IRS has revised procedures to require review of all annual "currently not collectible" notices prior to their being mailed. In addition, the IRS is revising procedures

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[15] TIGTA, Ref. No. 093103, *Limitations of the Automated Non-Master File and the Impact on the Internal Revenue Service* (Sept. 1999).
[16] The IRS sends an annual notice of delinquency to taxpayers once a year to remind them of a balance due, including penalties and interest.

for all notices, including the annual "currently not collectible" notice, to require ANMF tax examiners who review notices to research the Master File for taxpayer representative data to ensure that a copy of the notice is mailed to the representative when required.

Manual processing increases the risk of errors in ANMF accounts

Since the implementation of the ANMF, the IRS has continued to make changes to the Master File to decrease the number of accounts that must be maintained on the ANMF. Although the number of accounts on the ANMF continues to decrease, the amount of unpaid tax, penalties, and interest associated with these accounts remains significant. As we previously noted, as of September 29, 2015, the ANMF contained 9,145 open accounts with unpaid tax, penalties, and interest totaling more than $4.5 billion. The IRS relies on manual processes to establish ANMF accounts and process account activity. The need to manually transfer information between the Master File and the ANMF increases the risk of errors in ANMF accounts. In addition, the accuracy of ANMF accounts is often dependent upon employees in other IRS functions notifying the ANMF Processing function when information in the ANMF account needs to be updated. For example, an IRS employee must prepare an input document and submit it to the ANMF Processing function to update the taxpayer's address when a more current address is identified or when the CSED is modified.

The most efficient way to address the errors we identified in the ANMF is to continue to enhance the Master File to further reduce the need to manually maintain taxpayer accounts on a separate taxpayer account system. Until additional enhancements can be made, the IRS should establish processes to periodically verify the accuracy of ANMF accounts.

Recommendation

Recommendation 6: The Commissioner, Wage and Investment Division, should establish processes to periodically verify the accuracy of taxpayer information on the ANMF, including the taxpayer's address, designated representative, and the CSED, to the information posted to the Master File and make adjustments to the ANMF or Master File as needed to ensure that both the Master File and the ANMF contain the most current information available.

> **Management's Response:** The IRS agreed with this recommendation. The IRS updated Internal Revenue Manual 3.17.46.7.9, *NMF Address Transcripts*, on October 17, 2016, to provide improved guidance on retrieving and processing Master File address change transcripts and to ensure that required changes to the NMF are made expeditiously. Several changes were also made to Internal Revenue Manual 3.17.46.7, *Instructions for NMF Notice Research*, that improved the instructions provided to employees in researching the NMF and correcting information found to be in error. In addition, the review requirement of Form 9774 was also increased from a 5 percent to a 100 percent sample.

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the accuracy of processing tax accounts on the NMF. To accomplish our objective, we:

I.   Determined whether the IRS implemented corrective actions to address prior TIGTA and Government Accountability Office recommendations and assessed the effectiveness of the actions taken. We interviewed IRS management to determine the status of prior report recommendations.

II.   Determined if NMF transactions were accurately and timely recorded on the ANMF between October 1, 2014, and September 29, 2015.

    A. Determined if the ANMF accurately computes and assesses applicable penalties on open accounts. We calculated penalty amounts using Integrated Data Retrieval System[1] command code COMPAF. We compared our results to the ANMF computer extracts and identified accounts with incorrect penalty computations.

    B. Evaluated the effectiveness of the IRS's processes to ensure that credit balances from NMF accounts accurately offset to other outstanding accounts of the same taxpayer and spouse, if applicable.

        1. Reviewed the Internal Revenue Manual, policy, documents, *etc.* to identify the IRS's process for offsetting refunds to other tax modules with outstanding tax debt.

        2. Analyzed ANMF computer extracts to identify accounts with refunds issued as of September 29, 2015. We obtained Transaction Category Report[2] computer extracts from the TIGTA Data Center Warehouse[3] and determined if the refunds issued from NMF accounts should have been offset with other NMF accounts and/or other Master File[4] tax modules.

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[1] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

[2] The Transaction Category Report Files are created as part of the IRS's Accounts Receivable Dollar Inventory. The files identify all accounts with a balance due and also show the collection status of the accounts.

[3] A collection of IRS databases containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits.

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

III.   Evaluated efforts by the IRS to reduce ANMF taxpayer burden and protect taxpayer rights.

   A. Assessed the timeliness and accuracy of the IRS's issuance of NMF notices.

       1. Evaluated the IRS's process to match Master File addresses to NMF addresses to identify all address updates.

       2. Identified accounts that have been in currently not collectible status and determined if the IRS timely issued the annual reminder notice (Form 9774, *Annual Reminder Notice for ANMF/NMF*).

   B. Analyzed the CSED on the ANMF and matched it against the CSED on the Integrated Data Retrieval System. We determined if the dates agree. If the dates did not agree, we determined which date was correct and the reason for the discrepancy.

Data validation methodology

We relied on the data validity and reliability assessments of the ANMF extracts obtained from the IRS that were performed by TIGTA's Applied Research Technology group. We also relied on extracts from the IRS's Individual Master File[5] and Business Master File[6] databases for all tax years that were available on TIGTA's Data Center Warehouse. Before relying on those data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System. Based on the results of our testing, we believe that the data used in our review were reliable.

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 that the following internal controls were relevant to our audit objective: 1) procedures that ensure that NMF transactions were accurately and timely recorded on the ANMF; 2) procedures that ensure that credit balances from NMF accounts accurately offset to other outstanding NMF and/or Master File accounts of the same taxpayer; and 3) procedures to reduce ANMF taxpayer burden and protect taxpayer rights. We evaluated the controls by reviewing the IRS's Internal Revenue Manuals, interviewing employees and management, performing case reviews, and reviewing data files related to the accuracy of the processing of tax accounts on the ANMF.

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[5] IRS database that maintains transactions or records of individual tax accounts.
[6] IRS database that maintains transactions or records of business tax accounts. These include employment taxes, income taxes on businesses, and excise taxes.

Major Contributors to This Report

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)
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Appendix III

<u>*Report Distribution List*</u>

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Operations Support
Deputy Commissioner for Services and Enforcement
Deputy Commissioner, Operations, Wage and Investment Division
Director, Customer Account Services, Wage and Investment Division
Director, Submission Processing, Wage and Investment Division
Director, Office of Audit Coordination

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $1,755,556 Failure to File penalties that were not assessed on 85 taxpayer accounts associated with Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, with an Employer Identification Number[1] (see page 4).

Methodology Used to Measure the Reported Benefit:

We obtained a complete extract of the ANMF system. Our review of open accounts as of September 29, 2015, identified 238 taxpayer accounts associated with Forms 1040NR transactions recorded in the ANMF between October 1, 2014, and September 29, 2015. From the 238 taxpayer accounts, we identified 85 taxpayer accounts for which: 1) the Form 1040NR was filed late by taxpayers, 2) the return has unpaid tax, and 3) the taxpayer account had no Failure to File penalty assessed by the IRS.

We calculated Failure to File penalties totaling $1,755,556 on 85 taxpayer accounts based on the following assumptions:

- The Failure to File penalty is equal to 5 percent of the taxpayer's unpaid tax and is assessed for each month or part of a month that the taxpayer has not filed the required return up to five months.[2]

- For returns due after December 31, 2008,[3] the minimum penalty is the lesser of $135 or 100 percent of the unpaid tax.

- The maximum penalty is 25 percent of the unpaid tax on the payment due date, unless the minimum penalty applies.

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[1] A unique nine-digit number used to identify a taxpayer's business account.
[2] The penalty is reduced by the amount of the Failure to Pay penalty for any month where both penalties apply.
[3] For return due before January 1, 2009, the minimum penalty is the lesser of $100 or 100 percent of the unpaid tax.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $354,153 in Failure to Pay penalties that were not assessed on 227 taxpayer accounts (see page 4).

Methodology Used to Measure the Reported Benefit:

We obtained a complete extract of the ANMF system. Our review of open accounts as of September 29, 2015, identified 544 accounts that had systemic Failure to Pay penalties assessed by the ANMF system. We matched the 544 accounts to the Individual Master File[4] to identify those individuals who have been granted and continue to remain current with an installment agreement. For penalty months beginning after December 31, 1999, Internal Revenue Code 6651(h) limits the Failure to Pay penalty for individuals who file a tax return on or before the due date (including extensions) to one-half the initial rate or 0.25 percent (initial rate is 0.5 percent) for any month in which an installment agreement is in effect.

We also matched the 544 accounts to the Individual Master File and the Business Master File to identify taxpayers for whom the IRS issued a Notice of Intent to Levy. The Failure to Pay penalty increases to 1 percent if a Notice of Intent to Levy is issued and payment is not received within 10 calendar days of the date of the notice.

We manually recomputed the Failure to Pay penalty using Integrated Data Retrieval System command code COMPAF and identified 380 accounts in which the IRS did not correctly assess the Failure to Pay penalty. From these 380 accounts, the IRS underassessed penalties totaling $354,153 on 227 accounts.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $88,576 in Failure to Pay penalties that were incorrectly assessed on 153 taxpayer accounts (see page 4).

Methodology Used to Measure the Reported Benefit:

We obtained a complete extract of the ANMF system. Our review of open accounts as of September 29, 2015, identified 544 accounts that had systemic Failure to Pay penalties assessed by the ANMF system. We matched the 544 accounts to the Individual Master File to identify those individuals who have been granted and continue to remain current with an installment agreement. For penalty months beginning after December 31, 1999, Internal Revenue Code 6651(h) limits the Failure to Pay penalty for individuals who file a tax return on or before the due date (including extensions) to one-half the initial rate or 0.25 percent (initial rate is 0.5 percent) for any month in which an installment agreement is in effect.

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[4] The IRS database that maintains transactions or records of individual tax accounts.

We also matched the 544 accounts to the Individual Master File and the Business Master File to identify taxpayers for whom the IRS issued a Notice of Intent to Levy. The Failure to Pay penalty increases to 1 percent if a Notice of Intent to Levy is issued and payment is not received within 10 calendar days of the date of the notice.

We manually recomputed the Failure to Pay penalty using Integrated Data Retrieval System command code COMPAF and identified the IRS overassessed the Failure to Pay penalty totaling $88,576 on 153 accounts.

Examples of Non-Master File Source Documents

Generally, employees outside of the NMF group(s) prepare source documents for submission to the ANMF Processing function in Covington, Kentucky, who establish the accounts on the system. The following list includes examples of source documents (not all inclusive):

- Action memorandum based on a court order

- Various NMF returns, *i.e.*, Form 1040NR, *U.S. Nonresident Alien Income Tax Return;* Form 706-A, *United States Additional Estate Tax Return;* Form 990-BL, *Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Person*, *etc*.

- Form 843, *Claim for Refund and Request for Abatement*

- Form 1296, *Assessment Against Transferee of Fiduciary*

- Form 1331, *Notice of Adjustment*

- Form 1331B, *Notice of Adjustment*

- Form 2158, *Credit Transfer Voucher*

- Form 2363, *Master File Entity Change*

- Form 2424, *Account Adjustment Voucher*

- Form 2644, *Recommendation for Jeopardy/Termination Assessment*

- Form 2749, *Request for Trust Fund Recovery Penalty Assessment*

- Form 2859, *Request of Quick or Prompt Assessment*

- Form 3244, *Payment Posting Voucher*

- Form 3809, *Miscellaneous Adjustment Voucher*

- Form 4881, *Chapter 42 Taxes-Disqualified Person/Foundation Manager*

- Form 5147, *IDRS Transaction Record*

- Form 5344, *Examination Closing Record*

- Form 5403, *Appeals Closing Record*

- Form 5599, *TE/GE Examined Closing Record*

- Form 5650, *EP Examined Closing Record*

- Form 5734, *Non-Master File Assessment Voucher*

- Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

MAY 1 2 2017

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin
                  Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Improvements Are Needed to Ensure Tax
                  Accounts on the Automated Non-Master File Are Accurately
                  Processed (Audit # 201640008)

Thank you for the opportunity to review and provide comments on the subject draft
report and its recommendations. As noted in the report, the Master File, which is the
IRS' official system of record for tax assessments, has origins dating back to 1962. The
Master File is a sequential database that is subject to systemic and design limitations
affecting the number of transactions that can be posted to individual tax periods
recorded under each taxpayer's account and the maximum dollar value of specific
transactions. The Automated Non-Master File (ANMF) plays an important role in
addressing the limitations of the Master File. Many of the processes in ANMF are
performed manually, and the audit team has accurately identified the challenges
associated with such a manually-intensive system. While programming changes will be
requested to improve the accuracy of automated computations within the ANMF, it is
important to note that the IRS is progressing toward replacement of the Master File as
its official system of record. The Customer Account Data Engine 2, which is a relational
database, will permanently resolve these current constraints when it becomes
operational.

Currently, a transaction is entered on Master File accounts that have a corresponding
ANMF account, which serves as an indicator that the ANMF record must be researched
for appropriate action when posting payments, applying overpayments, and ensuring
refunds are processed correctly. By its nature, having the possibility of multiple ANMF
accounts for the same taxpayer and/or tax period(s), thorough research must be
conducted on the ANMF to ensure all balances due are properly considered. Some of
this research was not adequately performed and will be addressed during employee
refresher training each year.

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As noted in the report, programming changes will be necessary for correcting many of the conditions identified during the review. However, the IRS has taken actions to implement immediate improvements to manual processes that are not dependent on programming updates. On March 30, 2017, the IRS issued updated guidance to employees that communicated changes made to Internal Revenue Manual 3.17.46, *Automated Non-Master File Accounting*, that are intended to address the control weaknesses identified in the report. The changes include establishing requirements for NMF training for new hires reporting to NMF units, within 30 days of their assignment, and provides for required refresher training for current employees at their managers' discretion. The revised guidance also addresses procedural changes to manual processes such as penalty computations, the notification of changes required on the NMF by requesting functions, and improved guidance on NMF research procedures. We agree with the outcome measures cited in the report.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or a member of your staff may contact James P. Clifford, Acting Director, Customer Account Services, Wage and Investment Division, at (470) 639-3504.

Attachment

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1
Correct ANMF programming to compute and assess the Failure to File penalty on Form 1040NR accounts in which the Taxpayer Identification Number is an Employer Identification Number.

CORRECTIVE ACTION
We agree with this recommendation. By June 2017, a Unified Work Request (UWR) will be submitted for the requisite programming changes. Programming changes are subject to limited resources and competing priorities. Consequently, we cannot provide an implementation date at this time.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division
CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2
Correct ANMF programming to use the correct date when computing the Failure to Pay penalty. In addition, programming should be corrected to ensure that the proper penalty rate is used to compute the penalty amount.

CORRECTIVE ACTION
We agree with this recommendation and will submit a UWR for the requisite database structure and programming changes. Programming changes are subject to limited resources and competing priorities. Consequently, we cannot provide an implementation date at this time. On March 30, 2017, Interim Procedural Update 17U0590 was issued to transmit permanent changes to Internal Revenue Manual (IRM) 3.17.46, *Automated Non-Master File Accounting*, which provides procedural guidance to employees manually calculating penalties recorded on the Non-Master File.

IMPLEMENTATION DATE
Procedural Updates to IRM 3.17.46 – Implemented
Programming changes to the Automated Non-Master File System – N/A

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RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
Procedural Updates to IRM 3.17.46 – N/A.
Programming changes to the Automated Non-Master File System – We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3
Review the 85 accounts we identified in which the Failure to File penalty and the 380 accounts in which the Failure to Pay penalty were not correctly assessed to ensure that the correct penalty amounts are assessed on all accounts in which the CSED remains open.

CORRECTIVE ACTION
We agree with this recommendation.

IMPLEMENTATION DATE
October 15, 2017

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 4
Ensure that employees properly research ANMF accounts to identify whether the taxpayer has other balance due ANMF accounts to which credits can be transferred prior to refunding them to taxpayers.

CORRECTIVE ACTION
We agree with this recommendation. In addition to updating IRM 3.16.47, as previously noted, correct procedures will be reviewed during annual refresher training**.**

IMPLEMENTATION DATE
October 15, 2017

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

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CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5
Ensure that payments are correctly applied to overflow ANMF accounts in situations in which the taxpayer has balance due accounts on both the ANMF and the Master File.

CORRECTIVE ACTION
We agree with this recommendation. Procedures will be reviewed for accuracy and emphasized during annual refresher training.

IMPLEMENTATION DATE
October 15, 2017

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

Recommendation

RECOMMENDATION 6
The Commissioner, Wage and Investment Division, should establish processes to periodically verify the accuracy of taxpayer information on the ANMF, including the taxpayer's address, designated representative, and the CSED, to the information posted to the Master File and make adjustments to the ANMF or Master File as needed to ensure that both the Master File and the ANMF contain the most current information available.

CORRECTIVE ACTION
We agree with this recommendation. On October 17, 2016 IRM 3.17.46.7.9, *NMF ADDRESS Transcripts*, was updated to provide improved guidance on retrieving and processing Master File address change transcripts, and to ensure required changes to the NMF are made expeditiously. On October 24, 2016, several changes were made to IRM 3.17.46.7, *Instructions for NMF Notice Research*, that improved the instructions provided to employees in researching the NMF and correcting information found to be in error. The review requirement of Form 9774, *Annual Reminder Notice For ANMF/NMF*, was also increased from a five percent to a 100 percent sample.

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IMPLEMENTATION DATE
Implemented

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
N/A