



*Improvements Are Needed in Assessing
and Enforcing Internal Revenue Code
Section 6694 Paid Preparer Penalties*

September 9, 2013

Reference Number: 2013-30-075

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED IN ASSESSING AND ENFORCING INTERNAL REVENUE CODE SECTION 6694 PAID PREPARER PENALTIES

Highlights

**Final Report issued on
September 9, 2013**

Highlights of Reference Number: 2013-30-075 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

More than half of all taxpayers pay someone else to prepare their Federal income tax returns. When paid preparers take an unreasonable position or intentionally prepare inaccurate tax returns, Internal Revenue Code (I.R.C.) Section (§) 6694 provides penalty standards for paid preparers to discourage further fraudulent or unscrupulous behavior.

WHY TIGTA DID THE AUDIT

The IRS Oversight Board requested that TIGTA determine how effective the IRS is in using the existing requirements and penalty regime that applies to unenrolled paid tax return preparers. Our overall objective was to determine whether controls are in place to ensure that the IRS effectively enforces and applies penalties to paid preparers as required by I.R.C. § 6694.

WHAT TIGTA FOUND

TIGTA reviewed a statistical sample of 98 closed I.R.C. § 6694 preparer penalty cases from a population of 2,345 cases with penalties totaling \$9.35 million that were closed during Fiscal Years 2009 through 2011. Our results showed that in eight cases the immediate managers did not properly approve \$19,000 in preparer penalty assessments as required. I.R.C. § 6751(b) requires that the initial determination of a penalty assessment be personally approved in writing by the immediate supervisor. Lack of proper approval could hinder the IRS's ability to successfully litigate

these penalty assessments in court if necessary.

When this issue was brought to their attention, IRS officials took immediate corrective actions by emphasizing the importance of properly approving, in writing, preparer penalty assessments.

TIGTA also analyzed the IRS's quality reviews for civil penalty determinations to evaluate whether preparer penalties were properly considered and documented. IRS quality reviewers found that examiners did not always adequately document the examination case files with the facts that supported whether or not they considered paid preparer penalties. This appeared to be attributable to management's interpretation of procedures regarding proper documentation in the examined cases.

In addition, TIGTA analyzed the Master File to determine whether the IRS is effectively enforcing paid preparer penalties. Our results showed that current enforcement practices do not treat paid preparers with unpaid penalties as a priority, which could impact whether penalties achieve their intent of changing preparer behavior and increasing voluntary compliance.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS update the Internal Revenue Manual and implement improvements to ensure that managers and employees adhere to internal procedures for documenting actions and results in preparer penalty case files. TIGTA also recommended that the IRS develop procedures to expedite assigning I.R.C. § 6694 preparer penalty tax accounts to a revenue officer as well as to give more consideration before suspending collection actions on these types of accounts.

IRS officials agreed with all of our recommendations and plan to take appropriate corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 9, 2013

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

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

SUBJECT: Final Audit Report – Improvements Are Needed in Assessing and
Enforcing Internal Revenue Code Section 6694 Paid Preparer Penalties
(Audit # 201130038)

This report presents the results of our review to determine whether controls are in place to ensure that the Internal Revenue Service (IRS) effectively enforces and applies penalties to paid preparers as required by Internal Revenue Code Section 6694. We conducted this audit at the suggestion of the IRS Oversight Board, which requested that we determine how effectively the IRS is using the existing requirements and penalty regime that applies to unenrolled return preparers. This audit is included in our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

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

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 Nancy A. Nakamura, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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Abbreviations

I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
NQRS	National Quality Review System
PTIN	Preparer Tax Identification Number
SB/SE	Small Business/Self-Employed



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Background

The U.S. Federal tax system is based on the public's willingness to prepare an accurate tax return, file it timely, and pay any taxes due. Every year, more than half of all taxpayers pay someone else to prepare their Federal income tax returns. In Calendar Year 2012, more than 700,000 tax return preparers registered with the Internal Revenue Service (IRS) and obtained a Preparer Tax Identification Number (PTIN)¹ so that they could prepare and file Federal tax returns for someone else.

Registering tax preparers was the first step in the IRS's plan to regulate tax preparers. Prior to Calendar Year 2011, preparers did not have any national standards that they were required to satisfy before selling tax preparation services to the public. Anyone, regardless of training, experience, skill, or knowledge, was allowed to prepare Federal income tax returns for others for a fee.

Important! All paid preparers must register with the IRS and obtain a PTIN.

[SIGN UP NOW >>](#)

During Calendar Year 2012, more than 700,000 paid tax return preparers registered with the IRS and obtained a PTIN.

Starting January 1, 2011, the IRS required all paid tax return preparers to register and obtain a unique PTIN and use it to sign all returns they prepare, both paper and electronic. Paid preparers can be self-employed or may work for accounting firms, tax preparation services, or law firms. Additionally, the IRS issued final regulations making return preparers who are not attorneys, certified public accountants, or enrolled agents subject to Treasury Department Circular 230, *Regulations Governing Practice before the Internal Revenue Service*,² and requiring them to pass a qualifying exam, pay an annual fee, and take 15 hours of continuing education courses each year.

However, three tax return preparers brought suit in Federal court seeking injunctive and declaratory relief and moved for a summary judgment. As a result, on January 18, 2013, the U.S. District Court for the District of Columbia enjoined the IRS from enforcing the regulatory requirements for registered tax return preparers. On February 1, 2013, the Court modified its order to clarify that the order does not affect the requirement for all paid tax return preparers to obtain a PTIN.³

¹ See Appendix VII for a glossary of terms.

² Department of the Treasury, Treasury Department Circular No. 230, *Regulations Governing Practice before the Internal Revenue Service* (Rev. 8-2011).

³ *Loving*, No. 12-385 (D.D.C. Jan. 18, 2013).



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The Court stated that IRS regulations would displace other statutes spread throughout Title 26 of the United States Code that create a “careful, regimented schedule of penalties for misdeeds by tax-return preparers.” Furthermore, the Court stated:

...Congress has already enacted a relatively rigid penalty scheme to punish misdeeds by tax-return preparers. Title 26, in fact, has at least ten penalties specific to tax-return preparers, each of which targets particular conduct related to preparing and filing tax returns, and each of which comes with a specific fine...

These penalties include Internal Revenue Code (I.R.C.) Section (§) 6694, *Understatement of taxpayer’s liability by tax return preparer*.

I.R.C. § 6694⁴

I.R.C. § 6694 provides the primary penalty standards for paid preparers and includes guidance to discourage fraudulent and unscrupulous behavior. In May 2007, Congress passed the Small Business Work Opportunity Tax Act.⁵ Section 8246 of this act revised I.R.C. § 6694 to include an increase in the preparer penalty amount from \$250 to a minimum of \$1,000 under I.R.C. § 6694(a) and from \$1,000 to a minimum of \$5,000 under I.R.C. § 6694(b). Specifically:

- If the understatement is due to an unreasonable position that was based on the preparer’s advice, I.R.C. § 6694(a) allows for a minimum penalty of \$1,000 to be assessed. If the preparer can prove he/she acted in good faith and that the understatement was due to a reasonable cause, the IRS will waive the penalty.
- If the understatement is due to the preparer’s willful attempt to understate the tax liability, or reckless or intentional disregard of rules or regulations, I.R.C. § 6694(b) allows for a minimum penalty of \$5,000 to be assessed.

The Office of Servicewide Penalties, part of the Small Business/Self-Employed (SB/SE) Division’s Examination Policy function, is responsible for administering all penalty programs, policies, and procedures throughout the IRS’s operating divisions. There are specific procedures regarding when to impose a preparer penalty. If revenue agents or tax compliance officers (hereafter referred to as examiners) identify an understatement during the regular course of an audit, then examiners are to interview the taxpayer about the paid preparer’s involvement in the tax understatement. The examiners will also interview the paid preparer to determine whether any known violations transpired during the tax return preparation.

The taxpayer’s oral and written responses and the information obtained from the paid preparer help examiners and their managers determine the extent of the professional relationship. In addition, this information helps the IRS determine the taxpayer’s and paid preparer’s knowledge of tax law, education, and levels of sophistication in relationship to the understatement. If there

⁴ See Appendix V for the complete I.R.C. § 6694.

⁵ Pub. L No 110-28 (2007).



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are compelling facts showing that the paid preparer substantially contributed to the understatement on the prepared tax return, then examiners and their managers should consider asserting an I.R.C. § 6694 penalty.

This review was performed at the SB/SE Division Headquarters Office in New Carrollton, Maryland, and the SB/SE Division Examination field and office functions in Oakland, California; Atlanta, Georgia; Greensboro, North Carolina; Philadelphia, Pennsylvania; and Memphis, Tennessee, during the period of September 2011 through January 2013. 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 and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Documentation Is Insufficient to Ensure That Required Managerial Approvals Have Been Obtained for Some Penalty Cases As Required

A review of a statistically valid random sample of 98 of 2,345 closed I.R.C. § 6694 preparer penalty case files showed that eight (8 percent) of the cases did not contain the proper documentation that the manager had appropriately approved the penalty. Additionally, more than half (53 cases) of the preparer penalty case files contained procedural errors.

The law requires managerial approval for the IRS to legally enforce preparer penalty assessments. The law states:

In general, no penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.⁶

If an I.R.C. § 6694 preparer penalty is asserted,⁷ the examiner is required to create a separate case file that includes Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*,⁸ and Form 3198, *Special Handling Notice for Examination Case Processing*. All documentation the examiner used to support the decision to assert the penalty is forwarded to the Examination manager for review, approval, and signature.

Instructions that are a part of Form 8278 state, in at least two different places, the requirement for managerial approval of the assessments/Form 8278:

IRC section 6751(b) requires that for Title 26 penalty assessments, the immediate supervisor of the individual making the determination (or a higher level official the Secretary may designate) must personally approve the assessment in writing. Personal approval of the immediate supervisor is met with an original signature or a digital (e.g., using the digital signature capability in Adobe Acrobat) signature. Exceptions that do not require managerial approval are penalties under IRC sections 6651, 6654, 6655, 6698, 6699, or any other penalty automatically calculated through electronic means.

*The Manager is **required** to sign (personally or using the digital signature capability in Adobe Acrobat) this form. Management approval for the assessment of the penalty is required under IRC section 6751. **Before Form 8278 is submitted for processing,***

⁶ I.R.C. § 6751(b).

⁷ The penalty is asserted after the manager agrees with the examiner's facts showing that the paid preparer substantially contributed to the understatement of tax on a prepared tax return.

⁸ See Appendix VI for an excerpt of Form 8278.



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verify that blocks 10(a–d) and 11a are complete. If blocks 10a and 11a do not contain an Originator **AND** a Manager's signature, Form 8278 and the associated case file will be returned to the manager.

Once approved, the case file is forwarded to the local return preparer coordinator for further review. The coordinator is required to verify that the case file contains all the required information, signatures, and forms and, if not, to return the case file.

Tests were conducted on a statistical sample of 98 penalty case files with assessed I.R.C. § 6694 penalties from a population of 2,345 cases with penalties totaling \$9.35 million that were closed during Fiscal Years 2009 through 2011.⁹ Results showed that of 98 penalty cases:

- Five (5 percent) were transferred to another IRS function and were not available for review.
- Eight (8 percent) did not contain any evidence in the case files to support that the \$19,000 in penalty assessments were *personally approved* in writing by the immediate manager.
 - Three cases had no manager's signature on the Form 8278 and no evidence (such as a handwritten or digital signature or a manager's notation on any other documents in the case file) that the manager was involved in the penalty determination process or that the penalty assessment complied with the intent of I.R.C. § 6751(b).
 - Five cases had the manager's name typed on the Form 8278. However, there was no evidence (such as a handwritten or digital signature or a manager's notation on any other documents in the case file) that the manager was involved in the penalty determination process or that the penalty assessment complied with the intent of I.R.C. § 6751(b).

Based on the eight cases with \$19,000 in penalties, we estimate that approximately 191 of the I.R.C. § 6694 preparer penalty cases that were closed for Fiscal Years 2009 through 2011 may have been improperly assessed \$454,643 in penalties.¹⁰ The lack of proper approval could hinder the IRS's ability to successfully litigate these penalty assessments in court if necessary.

- 38 (39 percent) had procedural errors in which the manager did not properly follow IRS guidelines when approving paid preparer penalties.
 - 31 cases only had the manager's name typed on the Form 8278. However, all cases had sufficient evidence that the manager was involved in the penalty determination

⁹ See Appendix I for details of our statistical sampling methodology.

¹⁰ We are 90 percent confident that the range of penalty cases without evidence that the manager personally approved the penalty assessments in the case file is between 86 and 296. As a result, we estimate that between \$116,730 and \$792,555 in penalties could be improperly assessed. See Appendix IV for details on how all projections were calculated.



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- process and appear to comply with the intent of I.R.C. § 6751(b).
- Seven cases had no manager's signature on the Form 8278. However, all seven cases had sufficient evidence that the manager was involved in the penalty determination process and appear to comply with the intent of I.R.C. § 6751(b).
 - 15 (15 percent) cases did not have a Form 8278 or any other documentation in the case files showing that managers were involved with the penalty determination process. As a result, we were not able to make a definitive determination of whether these penalty assessments complied with I.R.C. § 6751(b).
 - 32 (33 percent) had either a physical or digital signature on the Form 8278 documenting that the penalty assessments were *approved* by the immediate manager and that the penalty assessment complied with the intent of I.R.C. § 6751(b).

SB/SE Division officials stated that they consider typed names on the Form 8278 as a signature and they *accept any form of signature, including handwritten, typed, or digitally signed*. However, typed signatures do not meet the intent of the law, which requires an assessment to be personally approved in writing. Additionally, a typed signature could be challenged in U.S. District Court if a case is litigated.

SB/SE Division officials also stated that they expect managers to use Form 8278 to document their reviews and approvals of the penalty assessments. However, officials are aware that managers often document their approvals of the penalty assessment on the Form 3198 or other forms within the case file. Although not procedurally correct, the presence of their signatures in the penalty case file helps mitigate concerns about the legality of the penalty assessments.

After discussing the results of the case reviews with SB/SE Division officials, they took immediate corrective actions. Specifically, they:

- Included in their September 2012 Technical Digest an article reminding managers that they must sign and date Forms 8278 using ink or a digital signature.
- Reminded return preparer coordinators that they are the gatekeepers of the Form 8278 and should ensure that the managers properly sign and date it.
- Issued a memorandum to their field offices emphasizing the importance of managerial approval of penalties using a handwritten or a digital signature. This guidance also included directions to the return preparer coordinators and Centralized Case Processing function employees reminding them to ensure that the cases files contain a manager's signature on Form 8278. The Centralized Case Processing function assesses the penalty and closes the penalty cases.
- Held discussions with Examination Area Directors regarding the importance of managerial approval of penalties.



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Employees did not always appropriately document reviews and the processing of preparer penalty assessments

For 10 (10 percent) of the 98 cases sampled, the return preparer coordinators did not follow the procedures and instructions directing them to sign and date the Form 8278. The Internal Revenue Manual and processing guidelines require that employees who process Form 8278 are to sign and date it. The signatures are necessary to verify that the assessment was appropriately reviewed.

For ***** 1 *****
***** 1 *****. SB/SE Division officials stated that these employees do not have specific Internal Revenue Manual procedures to follow for processing preparer penalties. However, to document penalty case processing, they are instructed to either attach a Form 11036, *Case Record*, to Form 8278 or use their assigned Integrated Data Retrieval System input number on Form 8278 to identify who processed the assessment. ***** 1 *****
***** 1 *****

We project that approximately 287 of the penalty cases closed during Fiscal Years 2009 through 2011 had employee procedural errors in which the return preparer coordinators or Centralized Case Processing function employees did not follow proper procedures and guidelines when reviewing or processing the paid preparer penalties.¹¹ After discussing our audit results with SB/SE Division officials, they assisted the Centralized Case Processing function and the Office of Servicewide Penalty to clarify what identifying information Centralized Case Processing function employees should provide on Form 8278 during the current revision process for the form.

Recommendations

The Commissioner, SB/SE Division, should ensure that:

Recommendation 1: Periodic operational reviews are conducted and documented to verify that managers are adhering to the required procedures to properly sign and date Form 8278 for paid preparer penalty cases. This includes whether return preparer coordinators and Centralized Case Processing function employees properly documented their reviews.

Management’s Response: IRS management agreed with this recommendation. They agreed to conduct a return preparer penalty program review to ensure that managers, return preparer coordinators, and Centralized Case Processing terminal operators are properly reviewing, approving, and acknowledging assertion of return

¹¹ We are 90 percent confident that the range of preparer penalty cases that were closed during this period with employee procedural errors is between 161 and 413.



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preparer penalties. Examination Policy will coordinate with Campus Compliance Services to conduct the program reviews, which include proper completion of Form 8278.

Office of Audit Comment: Although IRS management agreed with our recommendation, they did not agree with the value of our outcome measure. IRS management stated that the finding and outcome measure projection was based on eight preparer penalty case files that lacked full documentation. We disagree with the IRS. All eight preparer penalty case files reviewed contained Form 8278, which the IRS uses to document management's approval of the paid preparer penalty assessment. However, there was no evidence in the case files to support that the immediate manager was involved with the penalty determination process or that the \$19,000 in penalty assessments were personally approved in writing as required by I.R.C. § 6751(b).

The IRS suggests that additional copies of Form 8278 for the tax years reviewed may be in some other tax year's archived penalty case files for these preparers. Five of the preparer penalty assessments were for only one year; therefore, there would be no additional penalty case files. The three remaining preparer cases had penalty assessments for more than one year, which means that there would be other archived penalty case files for these preparers. Nevertheless, in the case files we reviewed, ***1*****
*****1*****
*****1*****. It is likely that the other tax year's archived case would have copies of these same Forms 8278 and unlikely that the files would have different Forms 8278 with physical or digital signatures. As such, we believe that the lack of proper approvals would still hinder the IRS's ability to successfully litigate these preparer penalty assessments in court, if challenged.

Recommendation 2: Return preparer coordinators adhere to procedures and guidelines when processing Form 8278.

Management's Response: IRS management agreed with this recommendation. The SB/SE Examination Policy function will develop a training module for area return preparer coordinators to address adherence to procedures and guidelines related to the assertion of return preparer penalties and the processing of Form 8278.

Recommendation 3: The Internal Revenue Manual is updated to include preparer penalty processing procedures for Centralized Case Processing function employees.

Management's Response: IRS management agreed with this recommendation. They agreed to update Internal Revenue Manual 20.1.6 to include preparer penalty processing procedures for Centralized Case Processing employees. In addition, Form 8278 was updated in April 2013 to include instructions for the terminal operators.



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Documentation Is Insufficient to Determine if Tax Examiners Considered Preparer Penalties

The IRS's National Quality Review System (NQRS),¹² used to assess the quality of closed tax return examination cases, shows that the preparer penalty is not always considered and/or documentation is insufficient to support the nonassertion of the penalty. A review of Fiscal Years 2009 through 2011 NQRS reviewer narratives for all 231 closed taxpayer examination cases with I.R.C. § 6694 preparer penalty errors showed that in every case the NQRS reviewers stated that the preparer penalty was not considered or there was not proper documentation to support nonassertion of the penalty. Of the 231 errors:

The Internal Revenue Manual, management directives, training materials, and the quality measurement standards require examiners to properly document in their case files all aspects of their work during a taxpayer examination, which includes preparer penalty considerations and assertions.

Examination managers and field examiners should adequately document consideration of the preparer penalty so that NQRS reviewers can determine with certainty whether procedures were followed.

- 197 (85 percent) were charged because the examiner did not appear to have considered the preparer penalty but, based on documentation in the case file, the penalty should have been imposed.
- 32 (14 percent) were charged because the preparer penalty appears to have not been considered and there was no documentation to support nonassertion of the penalty.
- Two (1 percent) were charged because documentation did not support nonassertion of the penalty, although there was consideration given to the penalty.

The SB/SE Division uses NQRS reviewers to assess the quality of closed taxpayer examination cases. The reviewers use 18 quality attributes based on the SB/SE Division's expectations for quality examinations and guidelines that assist examiners in fulfilling their professional responsibilities. Of the 18 quality attributes, the NQRS reviewers use Attribute 408, Civil Penalty Determination, to evaluate whether preparer penalties were properly considered and correctly computed and whether the assertion or nonassertion of penalties was adequately documented in the taxpayer examination case files.

SB/SE Division officials stated that they do not believe that a quality reviewer can determine with certainty whether a paid preparer penalty was or was not considered by just reviewing the tax return examination case file and not the associated preparer penalty case file. When I.R.C. § 6694 penalties are assessed, the IRS creates separate case files for the preparers. Field

¹² The NQRS is a cornerstone of the Embedded Quality process, which is designed to place more emphasis on significant case actions and less on process steps.



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or office examiners could have asserted preparer penalties but simply failed to document their decisions in the taxpayers' examination case files.

In addition, officials stated that examiners must exercise caution when documenting preparer issues in the taxpayer's examination case file. They stated that the documentation needs to be limited to the information necessary to demonstrate that the examiner considered the paid preparer's actions. They can accomplish this by checking the appropriate box on the audit Penalty Lead Sheet. They may also include facts received from the taxpayer about the tax return preparation, including the taxpayer's statements about his or her interaction with the preparer. However, examiners cannot include any information about the return preparer's conduct gathered from other sources or conclusions about the assertion or nonassertion of the preparer penalty in the underlying case file.

However, the source of the errors the NQRS reviewers identified during their quality reviews of the case files may be attributed to Examination management's interpretation of the required procedures. These procedures specifically require that the examiner document the audit Penalty Lead Sheet when he or she determines whether or not to proceed with a preparer penalty investigation. In addition, the procedures require that when the examiner has made the decision that the tax return preparer may be responsible for the understatement of tax, he or she is to check the appropriate box on the audit Penalty Lead Sheet.

Adherence to these procedures would help NQRS reviewers determine whether the examiner considered the preparer penalty or documented his or her decision to not assert the penalty. SB/SE Division officials stated that they are currently reviewing the audit Penalty Lead Sheet to determine how much information should be included. Afterwards, officials will decide whether examiners and managers need additional training or a written reminder regarding the procedures. However, they will work with IRS's Office of Disclosure and Office of the Chief Counsel for clarification.

Recommendation

Recommendation 4: The Commissioner, SB/SE Division, should evaluate what information to include on the audit Penalty Lead Sheets related to preparer penalty determinations. Once the decision has been made, decide whether the Internal Revenue Manual needs to be updated and whether managers and examiners need refresher training.

Management's Response: IRS management agreed with this recommendation. The Director, Examination Policy, will evaluate the preparer penalty information included on the Lead Sheet 300, *Civil Penalty Approval Form*, and make necessary revisions to the lead sheet and Internal Revenue Manual to ensure that examiners have the tools and guidance needed to adequately document the income tax case file.



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Collection Actions Are Not Being Actively Pursued on Some Preparer Penalty Assessments

An analysis of the Master File accounts with an I.R.C. § 6694(a) and/or (b) paid preparer penalty assessment through January 14, 2013,¹³ identified 2,336 paid preparers and 7,365 penalty assessments. The penalty assessments totaled approximately \$35.1 million.¹⁴

- 2,866 of the assessments were I.R.C. § 6694(a) penalties totaling \$2.9 million.
- 4,499 of the assessments were I.R.C. § 6694(b) penalties totaling \$32.2 million.

See Figure 1 for the results of further analysis of the \$35.1 million in preparer penalties. Since the date of the original assessment, 66 percent have been paid, are in the process of being paid, or are being actively pursued by the IRS for payment. The other 34 percent are currently not collectible.

Figure 1: Status of the Preparer Penalty Assessments¹⁵

Dollar Amount	Percent	Status of Preparer Penalty Account
\$11.8 million	34%	Collection actions suspended (currently not collectible).
\$11.6 million	33%	Being actively pursued by either the IRS's Automated Collection System or Field Collection function.
\$3.1 million	9%	In notice status.
\$2.9 million	8%	Under a formal payment agreement for which payments are being made.
\$2.7 million	8%	Paid by levies or voluntary payments from the preparer. ¹⁶
\$1.9 million	5%	Written off because the 10-year collection statute period had expired.
\$1.2 million	3%	Paid by credit offsets from the preparers' related tax accounts.
\$35.1 million	100%	

Source: TIGTA analysis of the Master File accounts with an I.R.C. § 6694(a) and/or (b) paid preparer penalty assessment through January 14, 2013.

¹³ A penalty account may show multiple penalty assessments for the same paid preparer. January 14, 2013, was the latest date of any preparer penalty assessments in the database. If a preparer was assessed a penalty and fully paid, but the account is no longer active on the Master File, it was not included in our sample population.

¹⁴ The \$35.1 million is the amount of the original assessments and does not include any adjustments for subsequent payments, abatements, offsets, or write-offs.

¹⁵ Figures are rounded.

¹⁶ We were unable to differentiate the levies from the voluntary payments because the IRS uses the same transaction code to report both items.



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When I.R.C. § 6694 penalties are assessed, the IRS creates separate penalty accounts for the paid preparers on the Master File. These penalty accounts are subject to the traditional collection due process afforded to all taxpayers with outstanding tax obligations. Collection due process includes the IRS sending a series of notices to remind the paid preparer to either pay the penalty balance in full or to take steps to establish an installment agreement or an offer in compromise. However, if the paid preparer does not respond to the notices and does not make any effort to pay, the penalty account is considered delinquent and is subsequently referred to the IRS’s collection programs where employees can take enforcement actions.

Collection activities on some preparer penalty tax accounts were suspended

Further analysis of the 584 preparer penalty tax accounts related to the \$11.8 million for which collection activities were suspended showed that the largest number of accounts (243) was suspended because they were below the IRS’s thresholds or tolerances.¹⁷ The IRS will also suspend collection activities, for example, when a paid preparer is experiencing a financial hardship, when the IRS cannot locate the preparer, or when the IRS needs additional time to research and review the preparer’s account. Suspending collection activities is part of the normal collection due process for every taxpayer who meets certain criteria. The results of the analysis of suspended penalty accounts are captured in Figure 2.

**Figure 2: Collection Activity Suspended for
I.R.C. § 6694(a) and (b) Preparer Penalty Tax Accounts**

Number of Preparer Penalty Tax Accounts ¹⁸	Reasons the IRS Suspended Collection Activities
243	Suspended based on dollar thresholds and tolerances.
227	The preparer was unable to pay due to a financial hardship.
149	The IRS was unable to locate or contact the preparer.
45	The preparer was deceased.
7	The preparer was a defunct or bankrupt corporation.
1 **	***1*****

Source: TIGTA analysis of the Master File as of January 14, 2013.

SB/SE Division officials stated that although return preparers benefit from suspended collection actions, they are still expected to be current with filing their personal and/or business tax returns

¹⁷ The IRS has thresholds and tolerances for certain collection activities. If total amounts due are below certain thresholds or tolerances, the collection activities will be suspended. The thresholds and tolerances are different based on the collection activity.

¹⁸ The number of penalty tax accounts exceeds 584 because the IRS used more than one criterion for suspending collection activity.



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and paying any new taxes due. The IRS will reactivate the suspended preparer penalty account if the preparer incurs any further delinquencies or his/her income exceeds a certain dollar threshold. However, as long as the preparer does not meet these criteria, then the suspension of collection actions will continue.

Some unpaid preparer penalty assessments are never collected and the liabilities are subsequently written off

Of the 584 suspended preparer penalty tax accounts identified, 87 (15 percent) accounts with \$2.6 million in assessments are scheduled to expire before the end of Calendar Year 2014. The law provides that the IRS has 10 years from the date of an assessment to collect delinquent taxes. When the collection statute period expires before the penalty assessment is paid in full, the IRS writes off the outstanding assessment and the taxpayer or preparer is no longer obligated to pay the delinquent liability.

As shown in Figure 3, the \$2.6 million that could be written off represents 22 percent of the \$11.8 million in tax accounts with suspended collection actions.

Figure 3: Preparer Penalty Tax Accounts With Suspended Collection Actions to Potentially Be Written Off by Calendar Year

Calendar Year the 10-Year Collection Statute Period Expires	Number of Preparer Penalty Tax Accounts	Total Dollars Potentially Written Off
2013	60	\$2.2 million
2014	27	\$0.4 million
	87	\$2.6 million

Source: TIGTA analysis of the Master File as of January 14, 2013.

Thirty-nine (45 percent) accounts totaling approximately \$98,000 were suspended based on dollar thresholds or tolerances. The remaining 48 (55 percent) totaling approximately \$2.5 million were determined by the IRS to be uncollectible for various other reasons—hardship, unable to locate, *etc.*

The SB/SE Division’s analysis of preparer penalty cases in collection status had comparable results

The SB/SE Division conducted an analysis of the preparer penalty cases in collection status. Its October 2012 results showed that 68 percent of the preparer penalty tax accounts in collection status had suspended collection actions. By comparison, the overall rate for suspending all cases in collection status was 42 percent.



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SB/SE Division officials found that overall the collection cases were worked properly, but they did identify the following:

- Some revenue officers did not recognize what the preparer penalty represented.
- Revenue officers did not attempt to locate paid preparers who were no longer operating a tax return preparation business.
- A systemic weakness automatically caused tax accounts to suspend.
- There were some delays assigning preparer penalty cases to revenue officers. Most cases appeared to take five to seven years between the examination and assignment to a revenue officer.
- Some paid preparers were criminally convicted, released on probation, and unable to pay.
- Preparers took their assets and moved out of the country.

The results of the analyses led the SB/SE Division to develop the Return Preparer Penalty Collection Enterprise Improvement Project. The overall goal of the project is to investigate and identify improvement opportunities to reduce the suspense rate of preparer penalty assessments to below 68 percent. The project is currently in the information gathering/analysis stage and is scheduled to continue through Fiscal Year 2013 and beyond, dependent upon the SB/SE Division's long term needs.

Circular 230 provides disciplinary actions, but not all preparers come under the Circular 230 regulations

The IRS Office of Professional Responsibility has the authority to sanction practitioners who recklessly or through gross incompetence violate Circular 230 § 10.34. Circular 230 § 10.34 states, in part, that:

- (1) *A practitioner may not willfully, recklessly, or through gross incompetence —*
 - (i) *Sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that —*
 - (A) *Lacks a reasonable basis;*
 - (B) *Is an unreasonable position as described in § 6694(a)(2) of the Internal Revenue Code (Code) (including the related regulations and other published guidance); or*
 - (C) *Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in §6694(b)(2) of the Code (including the related regulations and other published guidance).*



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Since August 2, 2011, most paid tax return preparers have been subject to a new regulation in Circular 230 § 10.8(c), *Return preparation and application of rules to other individuals*. **1**
*****1*****
*****1*****. As Examination and Collection function personnel become more familiar with the new Circular 230 provision, more referrals should be received for disciplinary consideration by the Office of Professional Responsibility. Specifically, examiners are now mandated to refer I.R.C. § 6694(b) preparer penalty assessments to the Office of Professional Responsibility. However, in order to refer I.R.C. § 6694(a) preparer penalty assessments to the Office of Professional Responsibility, the examiner must show a pattern of willful intent to understate taxes on the part of the paid tax return preparer.

Tax return preparers are subject to tax compliance checks when they register for Preparer Tax Identification Numbers

When preparers register for a PTIN, they are subject to suitability tests that include a tax compliance check and a check for outstanding balances (which could consist of preparer penalties). However, the IRS does not have a systemic tax compliance check in place at the time of the PTIN application.

As of November 2012, 504 PTIN holders had been issued noncompliance notification letters. Only the most egregious received letters (those who owed \$100,000 or more, nonfilers who owed over \$50,000, or individuals with three or more nonfiled tax returns). In early Calendar Year 2013, the IRS sent additional letters to 175 credentialed preparers who received the initial noncompliance notification letters. As of April 5, 2013, the IRS has verified the personal tax compliance of more than 929,000 PTIN holders, and 97 percent are compliant. For the remaining 3 percent, the IRS is in the process of communicating with a sample of the credentialed preparers to address their outstanding tax obligations.

The purpose of proposing and assessing penalties on paid return preparers is to encourage accountability, change improper preparer behavior, and increase voluntary compliance. Therefore, when a tax account is a result of assessed penalties originating from tax return preparer violations, it is essential that all required actions are completed in collecting and resolving the outstanding balance due. Although most paid preparers are currently subject to Circular 230 regulations, the penalties are an important incentive for preparers to comply with the tax laws when preparing tax returns. The IRS can take steps to improve the collection of preparer penalties to ensure that the penalties are helping paid preparers prepare accurate tax returns.



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Recommendations

The Commissioner, SB/SE Division, should:

Recommendation 5: Develop procedures to minimize delays in assigning the I.R.C. § 6694 preparer penalty accounts to a revenue officer. This will help mitigate the risks to collectability, such as being unable to locate a paid preparer, because too much time has lapsed after the preparer penalty assessment.

Management's Response: IRS management agreed with this recommendation. On June 3, 2013, the Enterprise Collection Strategy function implemented changes to the risk coding of Return Preparer Penalty accounts to promote the timely assignment of these cases to the Field Collection function.

Recommendation 6: Address and act on the initial results from the Return Preparer Penalty Collection Enterprise Improvement Project that include processes to train revenue officers about the purpose and use of the I.R.C. § 6694 paid preparer penalties so that more careful consideration is given before suspending collection activities on these types of accounts. This should also include developing a process to monitor these penalties through the collection stream and analyzing the penalized preparers' subsequent filing actions to determine the return on investment of Collection resources and possible Collection improvement projects.

Management's Response: IRS management agreed with this recommendation. They provided a two-pronged corrective action: 1) The Enterprise Collection Strategy function will ensure that appropriate communication is issued within the Field Collection function to emphasize the importance of return preparer penalties. They will ensure that relevant Internal Revenue Manual sections contain appropriate guidance regarding the collection of these accounts. 2) Collection Policy will assess the effectiveness of the enhancements made as a result of the Return Preparer Penalty Collection Enterprise Improvement Project to determine if the changes resulted in increased collection of the penalties and subsequent deterrence and will consider future actions based on those results.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether controls are in place to ensure that the IRS effectively applies and enforces penalties against paid preparers¹ as required by I.R.C. § 6694.

To accomplish this objective, we:

- I. Determined whether the IRS developed effective procedures for asserting I.R.C. § 6694 penalties against paid preparers.
 - A. Reviewed I.R.C. § 6694(a) and (b); Internal Revenue Manual 20.1.6, *Penalty Handbook, Preparer, Promoter, Material Advisor Penalties* (rev. May 16, 2012), guidelines; and local desk procedures and determined the IRS's processes for considering, asserting, and assessing I.R.C. § 6694 paid preparer penalties.
 - B. Obtained from NQRS officials an NQRS data extract of the entire population of Fiscal Years 2009 through 2011 penalty case reviews with a failing rating for Attribute 408. There were 231 penalty cases with an error in Attribute 408.
 - C. Reviewed the narratives in the 231 NQRS preparer penalty error cases to determine whether the feedback the NQRS reviewer provided contained statements that identified the specific cause of the error.
 - D. Interviewed NQRS officials and analysts to determine whether they used the results of the NQRS evaluations to effectively target training needs and improve future performance.
 - E. Interviewed SB/SE Division Examination Policy officials to determine whether they used the results of the NQRS evaluations to improve the overall preparer penalty program.
- II. Determined whether the IRS timely processed paid preparer penalty cases.
 - A. Reviewed procedures in I.R.C. § 6751(b) and Form 8278 regarding the accountability of the immediate manager, return preparer coordinator, and Centralized Case Processing function employees in ensuring proper documentation of the assertion, review, and assessment of the preparer penalty. We also interviewed:

¹ See Appendix VII for a glossary of terms.



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1. SB/SE Division field and office examiners and immediate managers in Atlanta, Georgia, and Memphis, Tennessee, to assess proper adherence to procedures regarding considering and asserting the preparer penalty.
 2. SB/SE Division return preparer coordinators in various IRS locations to assess proper adherence to procedures regarding case reviews and documentation.
 3. SB/SE Division's Centralized Case Processing function employees in Memphis, Tennessee, to assess proper adherence to procedures regarding recording the penalty assessment.
- B. Extracted from the Treasury Inspector General for Tax Administration's Data Center Warehouse Individual Master File and Business Master File tables all penalties assessed from Fiscal Years 2009 through 2011 with a civil penalty Transaction Code 240 and Reason Codes 640 or 645.
- C. Selected a statistically valid random sample of 98 I.R.C. § 6694 preparer penalty cases from 2,345 cases closed during Fiscal Years 2009 through 2011 to determine whether the managers properly approved the penalty assertions. We used a 90 percent confidence level, a 10 percent expected error rate, and ± 5 percent precision level. We took a statistically valid random sample because we wanted to project the number and amount of deficiencies associated with not properly asserting the preparer penalty over the population of all 2,345 penalty cases closed during Fiscal Years 2009 through 2011.
- D. Assessed the validity of the Treasury Inspector General for Tax Administration's Data Center Warehouse records by selecting 10 of the 2,345 closed cases and comparing information from key fields (Employer Identification Numbers, preparer penalty reference numbers, and account balances) to information on the Integrated Data Retrieval System. We did not identify any discrepancies.
- E. Used the Treasury Inspector General for Tax Administration's contracted statistician to review and agree with the sampling plan and to develop projections.
- III. Determined whether the IRS effectively enforced paid preparer penalties.
- A. Used the Treasury Inspector General for Tax Administration's Data Center Warehouse to obtain a data extract of the entire population of I.R.C. § 6694 penalty assessments on the Master File as of January 14, 2013. The extract contained 7,365 paid preparer penalties totaling \$35.1 million.
- B. Analyzed the extract to assess the current collection status of the paid preparer penalties. The analysis included calculating the volume of accounts classified as fully paid or written off, under an installment agreement, in collection, or suspended.



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- C. Interviewed SB/SE Division Collection Policy officials to determine whether they have developed effective methods to enhance the current traditional enforcement tools.
- D. Assessed the impact of the program improvements on the 7,365 paid preparer penalty assessments in our data extract.

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 I.R.C.; IRS policies, procedures, and practices for asserting, assessing, and collecting I.R.C. § 6694 paid preparer penalties; and quality review procedures in place to evaluate the accuracy of penalty determinations. We evaluated these controls by reviewing source materials, interviewing management, and reviewing preparer penalty case files and quality review results.



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Appendix II

Major Contributors to This Report

Augusta Cook, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)

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Andrea Barnes, Lead Auditor

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Marge Filippelli, Auditor



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Appendix III

Report Distribution List

Principal Deputy Commissioner
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Operations Support OS
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Office of the Deputy Commissioner for Services and Enforcement SE
Chief Financial Officer OS:CFO
Director, Office of Professional Responsibility SE:OPR
Director, Return Preparer Office SE:RPO
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Enterprise Collection Strategy, Small Business/Self-Employed Division SE:S:CS
Director, Collection Policy, Small Business/Self-Employed Division SE:S:CS:CP
Director, Campus Compliance Operations, Memphis, Small Business/Self-Employed Division
SE:S:CCS:CCO:MEM
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

Revenue Protection – Potential; \$454,643 in preparer penalty assessments for 191 closed cases for which there is no evidence of written management approval of the preparer penalty (see page 4).

Methodology Used to Measure the Reported Benefit:

We selected and reviewed a statistically valid random sample of 98 I.R.C. § 6694 penalty cases. We selected the sample from the population of 2,345 penalty cases that were closed for Fiscal Years¹ 2009 through 2011. The sampled preparer penalty cases totaled \$9.35 million. We used a confidence level of 90 percent, a precision level of ± 5 percent, and an expected error rate of 10 percent to select the sample. Our results showed eight of 98 cases (8.16 percent) totaling \$19,000 in penalty assessments were improperly assessed because there was no evidence in the case files that the immediate managers *personally approved*, in writing, the assessments as required by I.R.C. § 6751(b). Three cases had no manager's signature and five had the manager's name typed on Form 8278. In addition, there was no evidence such as a handwritten or digital signature or a manager's notation on any other documents in the case files showing that the immediate manager personally approved the penalty assessments.

We project that approximately 191 preparer penalty cases closed during Fiscal Years 2009 through 2011 may have been improperly assessed \$454,643 in penalties because there was no evidence of any managerial approval in the case files.² We determined the 191 projected penalty cases by multiplying the 8.16 percent error rate against our population of 2,345 closed preparer penalty cases. We determined the projected penalty dollar amount by multiplying \$193.88, the average legal exception dollars for the penalty assessment from the eight exception cases, by our total population of closed cases. The totals may not agree due to rounding.

¹ See Appendix VII for a glossary of terms.

² We are 90 percent confident that the range of penalty cases without evidence that the manager personally approved the penalty assessments in the case file is between 86 and 296. As a result, we estimate that between \$116,730 and \$792,555 in penalties could be improperly assessed.



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Appendix V

Internal Revenue Code Section 6694

I.R.C. § 6694. Understatement of taxpayer's liability by tax return preparer

(a) Understatement due to unreasonable positions

(1) In general

If a tax return preparer—

(A) prepares any return or claim of refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2), and

(B) knew (or reasonably should have known) of the position, such tax return preparer shall pay a penalty with respect to such return or claim in an amount equal to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) Unreasonable position

(A) In general

Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.

(B) Disclosed positions

If the position was disclosed as provided in section 6662(d)(2)(B)(ii)(1) and is not a position to which subparagraph (C) applies, the position is described in this paragraph unless there is a reasonable basis for the position.

(C) Tax shelters and reportable transactions

If the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, the position is described in this paragraph unless it is reasonable to believe that the position would more likely than not be sustained on its merits.

(3) Reasonable cause exception

No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.



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(b) Understatement due to willful or reckless conduct

(1) In general

Any tax return preparer who prepares any return or claim for refund with respect to which any part of any understatement of liability is due to a conduct described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of—

(A) \$5,000, or

(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) Willful or reckless conduct

Conduct described in this paragraph is conduct by the tax return preparer which is—

(A) a willful attempt in any manner to understate the liability for tax on the return or claim, or

(B) a reckless or intentional disregard of rules or regulations.

(3) Reduction in penalty

The amount of any penalty payable by any person by reason of this subsection for any return or claim for refund shall be reduced by the amount of the penalty paid by such person by reason of subsection (a).

(c) Extension of period of collection where preparer pays 15 percent of penalty

(1) In general

If, within 30 days after the day on which notice and demand of any penalty under subsection (a) or (b) is made against any person who is an income tax return preparer, such person pays an amount which is not less than 15 percent of the amount of such penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2).

Notwithstanding the provisions of section _____, the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court. Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in paragraph (2).

(2) Preparer must bring suit in district court to determine his liability for penalty

If, within 30 days after the day on which his claim for refund of any partial payment of any penalty under subsection (a) or (b) is denied (or, if earlier, within 30 days after the



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expiration of six months after the day on which he filed the claim for refund), the income tax return preparer fails to begin a proceeding in the appropriate U.S. District Court for the determination of his liability for such penalty, paragraph (1) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.

(3) Suspension of running of period of limitations on collection

The running of the period of limitations provided in section _____ on the collection by levy or by a proceeding in court in respect of any penalty described in paragraph (1) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

(d) Abatement of penalty where taxpayer's liability not understated

If at any time there is a final administrative determination or a final judicial decision that there was no understatement of liability in the case of any return or claim for refund with respect to which a penalty under subsection (a) or (b) has been assessed, such assessment shall be abated, and if any portion of such penalty has been paid the amount so paid shall be refunded to the person who made such payment as an overpayment of tax without regard to any period of limitations which, but for this subsection, would apply to the making of such refund.

(e) Understatement of liability defined

For purposes of this section, the term "understatement of liability" means any understatement of the net amount payable with respect to any tax imposed by subtitle A or any overstatement of the net amount creditable or refundable with respect to any such tax. Except as otherwise provided in subsection (d), the determination of whether or not there is an understatement of liability shall be made without regard to any administrative or judicial action involving the taxpayer.

(f) Cross reference

For definition of income tax return preparer, see section 7701(a)(36).



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Appendix VI

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

Form 8278 (Rev. May 2013)		Assessment and Abatement of Miscellaneous Civil Penalties				
1. Name of Taxpayer		5. Year (mandatory) (yyyymm)		6. Statute date (mandatory) (mmddyyyy)		
2. Address		7. Identifying number (SSN (XXX-XX-XXXX) or EIN (XX-XXXXXXX))				
3. MFT (Check one) <input type="checkbox"/> IMF 55 <input type="checkbox"/> BMF 13		8. Function (Check one): <input type="checkbox"/> LB&I <input type="checkbox"/> SB/SE <input type="checkbox"/> W&I <input type="checkbox"/> TE/GE <input type="checkbox"/> Appeals				
4. Check if no ASED: <input type="checkbox"/>						
Reminders: <ul style="list-style-type: none"> ✓ Manager's signature is required in block 11a to meet the provisions of Internal Revenue Code (IRC) section 6751. ✓ Prepare a separate Form 8278 for each period penalties are warranted. ✓ If the Penalty Reference Number (PRN) is not listed, enter all information in the blank line provided at the bottom of each section. ✓ At the conclusion of the penalty investigation, provide the taxpayer a computation of the penalty with a copy of a detailed calculation worksheet. 						
9. A. Failure to File/Failure to Pay Penalties (IRM 20.1.2)						
(a) Penalty Code Section	Penalty Description	(b) Penalty Reference Number	(c) Number of Violations	(d) Amount Assessed	(e) Amount Abated	(f) Penalty Reason Code
6651(f)	Fraudulent failure to file (See IRM 20.1.2.2.7.5)	635				
9. B. Return Related Penalties (IRM 20.1.5)						
6676	Penalty for erroneous claim for refund or credit (exception: MFJ, MFT 30 must use Form 3870 with PRN 697. Don't use Form 8278)	565				
9. C. Excise (IRM 20.1.11)						
6675	Excessive claims with respect to the use of certain fuels	661				
6715	Dyed fuel sold for use or used in taxable use, etc.	656				
6715A	Tampering with or failing to maintain security requirements for mechanical dye injection systems	665				
6717	Refusal of entry or inspection - IRC sec. 4083(d)(1)	655				
6718	Failure to display tax registration on vessels - IRC sec. 4101(a)(3)	657				
6719	Failure to register/reregister - IRC sec. 4101(a)	670				
6720A	Penalty with respect to certain adulterated fuels	673				
6725	Failure to report a vessel/facility - IRC sec. 4101(d)	667				
9. D. Estate and Gift Tax (IRM 20.1.11)						
6716(a)	Failure of the executor to make a return required under IRC sec. 6018 relating to large transfers at death	559				
6716(a)	Failure to furnish information required by sec. 6018(b)(2) relating to certain transfers of gifts received by decedent within 3 years of death	560				
6716(b)	Failure to furnish information required by sec. 6018(e) or 6019(b) relating to certain transfers at death and gifts	561				
6716(d)	Failure to furnish information required by IRC sec. 6018(e) or 6019(b) relating to certain transfers at death and gifts—intentional disregard	562				
Remarks						
10a. Originator signature		10b. Date submitted		10c. Phone		10d. Organization code
11a. Manager signature		11b. Date signed		12a. Terminal operator		12b. Date input
Form 8278 (Rev. 5-2013) Catalog Number 62278G www.irs.gov Department of the Treasury—Internal Revenue Service						

Source: IRS.gov.



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Appendix VII

Glossary of Terms

Term	Definition
Audit	Field examinations of individuals, partnerships, and corporations that occur either at the taxpayer's place of business or through interviews at an IRS office.
Business Master File	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.
Calendar Year	A 12-consecutive-month period ending on December 31.
Centralized Case Processing	An IRS Campus function that provides support to the field operations of the Examination function.
Credentialed Preparers	Preparers who are certified public accountants, attorneys, or enrolled agents.
Currently Not Collectible	Tax accounts are reported as currently uncollectible when the taxpayer has no income or assets which are, by law, typically subject to levy.
Data Center Warehouse	A Treasury Inspector General for Tax Administration Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators.
Delinquent	A tax account for which part or the entire amount owed to the IRS is overdue. These amounts can represent quarterly taxes such as employment taxes or annual taxes for unemployment taxes that are due once per year.
Embedded Quality	A process tool to assist managers in identifying opportunities to build skills and enhance strengths in their employees' individual performance.
Examiners	IRS employees who examine tax returns to determine whether taxpayers accurately reported their tax liabilities.
Fiscal Year	A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.



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Term	Definition
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Installment Agreement	An agreement by which the IRS allows taxpayers to pay the tax they owe in monthly installments instead of immediately paying the full amount.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records. This system shows historical information (original account balances, adjustments, payments, abatements) and current account status (fully paid, collections, suspended, <i>etc.</i>).
Internal Revenue Manual	The official source of information on policies and procedures for use by all IRS offices.
Master File	The IRS database that maintains transactions or historical records of individual and business tax accounts.
Notice	Computer-generated messages resulting from an analysis of the taxpayer's account on the Master File. These include notices of assessments of tax, adjustments, balances due, or overpayments that are refunded to taxpayers.
Office of Appeals	An IRS office responsible for resolving tax controversies, without litigation, on a basis that is fair and impartial to both the Federal Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the IRS.
Oversight Board	An independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the Internal Revenue laws.
Paid Preparer	An individual who is compensated for preparing or assisting in the preparation of all or substantially all of a tax return or claim for refund of tax.
Penalty Lead Sheet	An audit tool examiners use to document whether a return preparer penalty was considered. Examiners use this tool because disclosure guidelines preclude reference to an examination of another taxpayer in the return preparer's client case file.
Preparer Tax Identification Number	An exclusive number used to identify any paid tax return preparer who is required to sign and submit tax returns to the IRS. The preparer must be at least 18 years of age.



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Term	Definition
Reason Code	A code the IRS uses when an adjustment is made to a taxpayer's tax account. Reason codes describe how the adjustment action affects the original return.
Return Preparer Coordinator	Conducts a cursory review of the return preparer penalty case file, which includes Form 8278, <i>Assessment and Abatement of Miscellaneous Civil Penalties</i> . If the Form 8278 is missing the signature of the originator or the originator's group manager, the return preparer coordinator signs and dates the form and returns it and the complete case file to the field group for correction.
Suitability Tests	Suitability tests include verifying information that the preparers provide on their PTIN applications, verifying that applicants meet minimum competency standards, and conducting tax compliance and background checks.
Summary Judgment	In law, a summary judgment is a judgment entered by a court for one party and against another party summarily, <i>i.e.</i> , without a full trial.
Tax Year	The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.
Transaction Code	A three-digit code used to identify actions being taken to a taxpayer's account.
Unenrolled Return Preparers	Tax return preparers who, except in a limited number of States, have no minimum education or training requirements. These preparers are generally not regulated by a State licensing authority or the Federal Government.



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Appendix VIII

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

JUL 24 2013

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 – Improvements Are Needed in Assessing
and Enforcing Internal Revenue Code Section 6694 Paid
Preparer Penalties (Audit # 201130038)

Thank you for the opportunity to review your draft report titled: "Improvements Are Needed in Assessing and Enforcing Internal Revenue Code Section 6694 Paid Preparer Penalties." As noted in the report, more than half of all taxpayers use a preparer to complete their Federal income tax return. Return preparers, therefore, serve a critical role in tax administration.

The IRS employs a multi-faceted approach to both support and monitor preparers to help ensure the accuracy of the tax returns they prepare. This approach includes, but is not limited to: communication and education; visitations and due diligence checks; and, when appropriate, the application of penalties under the Internal Revenue Code and referral to the Office of Professional Responsibility for possible sanctions under Circular 230, *Regulations Governing Practice before the Internal Revenue Service*.

In its review of 98 cases involving a preparer penalty, TIGTA found that eight case files were missing documentation items required by the Internal Revenue Code and Internal Revenue Manual. While documentation in the income tax case file may not always capture the consideration of return preparer penalties, this does not mean that they are not considered or asserted. We are taking actions to ensure examiners have the tools and guidance needed to adequately document the income tax case file to reflect the return preparer's involvement in, and responsibility for, the preparation of the return. In addition, TIGTA found that additional case files had other procedural issues. As TIGTA's report highlights, immediately upon learning of these issues, the IRS took corrective action to improve procedural consistency across the hundreds of offices and thousands of employees in the SB/SE Division who are responsible for helping



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taxpayers resolve complex tax situations and working with practitioners to ensure accurate tax return preparation.

With respect to the collection of assessed preparer penalties, the report highlights a 2012 SB/SE study which examined potential reasons some preparer penalty assessments were suspended or collection action was delayed. Corrective actions to help reduce delays were implemented in June 2013. Moreover, as shown in the draft report, the majority of the return preparer penalties TIGTA reviewed had been paid, are in the process of being paid, or are being actively pursued for payment. While Currently Not Collectible (CNC) determinations had been made in approximately one-third of the assessed penalties TIGTA reviewed, the IRS regularly reviews CNC determinations and may actively pursue these penalties if the preparer's financial condition changes.

While the IRS agrees with TIGTA's recommendations, we do not agree with the value for the Outcome Measure. Based on its finding that eight preparer penalty cases lacked full documentation, TIGTA projects that there are roughly another 183 cases with similar documentation deficiencies. TIGTA further assumes that none of the penalty assessments from these projected 191 cases are valid. The IRS does not agree that incomplete case file documentation automatically invalidates the assessments in the 191 projected cases.

During processing, case files are separated for legitimate reasons. As a result, documentation may be archived with a related tax year or case. The IRS conducted an additional review of the eight cases identified as having incomplete documentation and determined that in at least four of the eight cases documentation may have been archived in penalty files for related years that were not reviewed by TIGTA. While some assessments may not be sustainable, the report provides no evidence to support invalidating 100% of these assessments. The potential that documentation supporting these assessments may be archived in other case files was not addressed in TIGTA's review.

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:

Ensure periodic operational reviews are conducted and documented to verify that managers are adhering to the required procedures to properly sign and date the Form 8278 for paid preparer penalty cases. This includes whether return preparer coordinators and Centralized Case Processing function employees properly documented their reviews.

CORRECTIVE ACTION:

We agree to conduct a return preparer penalty program review to ensure managers, Return Preparer Coordinators (RPC), and Centralized Case Processing (CCP) terminal operators are properly reviewing, approving, and acknowledging assertion of return preparer penalties. Examination Policy will coordinate with Campus Compliance Services to conduct the program review of return preparer penalty cases, including proper completion and approval of Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*.

IMPLEMENTATION DATE:

November 15, 2014

RESPONSIBLE OFFICIAL(S):

Director, Campus Compliance Services, Small Business/Self-Employed Division (SB/SE)
Director, Examination Policy, SB/SE

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

Ensure return preparer coordinators adhere to procedures and guidelines when processing the Form 8278.

CORRECTIVE ACTION:

To address adherence to procedures and guidelines related to the assertion of return preparer penalties and processing of Form 8278, SB/SE Examination Policy will develop a training module for Area Return Preparer Coordinators. The training module will focus on return preparer penalty procedures and guidelines, proper case development, case file content, and Form 8278 requirements.

IMPLEMENTATION DATE:

November 15, 2014

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, SB/SE



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CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 3:

Ensure the Internal Revenue Manual is updated to include preparer penalty processing procedures for Centralized Case Processing function employees.

CORRECTIVE ACTION:

IRS will update IRM 20.1.6, *Preparer, Promoter, Material Advisor Penalties*, to include preparer penalty processing procedures for CCP employees. In addition, Form 8278 was updated in April 2013 to include instructions for the CCP terminal operators.

IMPLEMENTATION DATE:

March 15, 2015

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, SB/SE

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 4:

Evaluate what information to include on the audit Penalty Lead Sheets related to preparer penalty determinations. Once the decision has been made, decide whether the Internal Revenue Manual needs to be updated and whether managers and examiners need refresher training.

CORRECTIVE ACTION:

The Director, Examination Policy, will evaluate the preparer penalty information included on Lead Sheet 300, Civil Penalty Approval Form, and make necessary revisions to the lead sheet and Internal Revenue Manual to ensure examiners have the tools and guidance needed to adequately document the income tax case file to reflect the return preparer's involvement in and responsibility for the preparation of the return.

IMPLEMENTATION DATE:

June 15, 2015

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, SB/SE



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CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 5:

Develop procedures to minimize delays in assigning the I.R.C. § 6694 preparer penalty accounts to a revenue officer. This will help mitigate the risks to collectability, such as being unable to locate a paid preparer, because too much time has lapsed after the preparer penalty assessment.

CORRECTIVE ACTION:

On June 3, 2013, Enterprise Collection Strategy (ECS) implemented changes to the risk coding of Return Preparer Penalty accounts to promote the timely assignment of these cases to Field Collection.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 6:

Address and act on the initial results from the Return Preparer Penalty Collection Enterprise Improvement Project that include processes to train revenue officers about the purpose and use of the I.R.C. § 6694 paid preparer penalties so that more careful consideration is given before suspending collection activities on these types of accounts. This should also include developing a process to monitor these penalties through the collection stream and analyzing the penalized preparers' subsequent filing actions to determine the return on investment of Collection resources and possible Collection improvement projects.

CORRECTIVE ACTION:

1. Enterprise Collection Strategy will ensure that appropriate communication is issued within Field Collection to emphasize the importance of return preparer penalties. We will ensure that relevant IRM sections contain appropriate guidance regarding the collection of these accounts.
2. While we agree that the assertion of return preparer penalties is an effective deterrent, to implement a system that tracks penalties through the collection stream and then analyzes the penalized preparers subsequent filing actions



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would require extensive costs associated with programming that is not feasible at this time for this relatively small number of assessments; however, Collection Policy will assess the effectiveness of the enhancements made as a result of the Return Preparer Penalty Collection Enterprise Improvement Project to determine if the changes resulted in increased collection of the penalties and subsequent deterrence and will consider future actions based on those results.

IMPLEMENTATION DATES:

1. June 15, 2014
2. June 15, 2015

RESPONSIBLE OFFICIAL(S):

Director, Collection Policy, Enterprise Collection Strategy, SB/SE

CORRECTIVE ACTION MONITORING PLAN:

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