



*Systemic Penalties on Late-Filed Forms  
Related to Certain Foreign Corporations  
Were Properly Assessed, but the  
Abatement Process Needs Improvement*

**September 25, 2013**

**Reference Number: 2013-30-111**

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

### **SYSTEMIC PENALTIES ON LATE-FILED FORMS RELATED TO CERTAIN FOREIGN CORPORATIONS WERE PROPERLY ASSESSED, BUT THE ABATEMENT PROCESS NEEDS IMPROVEMENT**

## Highlights

**Final Report issued on  
September 25, 2013**

Highlights of Reference Number: 2013-30-111 to the Internal Revenue Service Commissioners for the Large Business and International Division and the Wage and Investment Division.

### **IMPACT ON TAXPAYERS**

The law requires a U.S. citizen or resident alien to furnish information with respect to certain foreign business entities. Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, is used to comply with the law and regulations. Further, the law provides a monetary penalty of \$10,000 for each Form 5471 that is filed after the due date of the associated income tax return, including any extensions. The IRS has developed a strategy to help meet the challenges of international tax administration. This has led to increased enforcement efforts on international information reporting requirements and increased assessments of related penalties.

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

One of the major trends challenging the IRS is accelerating globalization. The overall objective of the review was to determine whether the IRS has improved its penalty-setting process to promote filing compliance for entities with Form 5471 reporting requirements.

### **WHAT TIGTA FOUND**

Overall, controls ensured that systemic penalties for late-filed Forms 5471 were properly assessed and compliance was improved for many taxpayers. While a standardized framework was not used to develop a pilot program for systemically assessing late-filed

Form 5471 penalties, the IRS objectives to enhance revenue and improve taxpayer compliance were met.

However, controls are insufficient to ensure the proper abatement of systemically assessed penalties on late-filed Forms 5471. Specifically, in a statistically valid sample of 93 cases, the penalties were incorrectly abated in 40 cases. Total abatements for these 40 cases amounted to \$1.75 million, resulting in approximately \$31 million in incorrect abatements when projected to the population. In addition, the IRS did not properly process eight filing extensions. This led to \$6.4 million in unnecessary late-filed Form 5471 penalty assessments ultimately being abated, resulting in approximately \$11.6 million in incorrect assessments when projected to the population. Further, in 80 of the 93 sampled cases, IRS employees did not adequately document their decisions to abate these penalties.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the IRS: 1) conduct a study to determine if the automated late-filed Form 5471 penalty-setting process should be expanded, 2) provide refresher training to employees and their managers on the importance of documenting penalty abatement request decisions, 3) require managers to review all late-filed Form 5471 penalty abatements, and 4) ensure that filing extension requests received with a payment are properly coded and timely processed.

In their response, IRS officials agreed with all of our recommendations. The IRS has taken steps to implement two corrective actions and plans to take remaining corrective actions in the future.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 25, 2013

**MEMORANDUM FOR** COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL  
DIVISION  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

**SUBJECT:** Final Audit Report – Systemic Penalties on Late-Filed Forms Related  
to Certain Foreign Corporations Were Properly Assessed, but the  
Abatement Process Needs Improvement (Audit # 201130043)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) has improved its penalty-setting process to promote filing compliance for entities with Form 5471, *Information Return of United States Persons With Respect to Certain Foreign Corporations*, reporting requirements. This audit is included in our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Globalization.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Nancy Nakamura, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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*Abbreviations*

GAO	Government Accountability Office
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration



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## *Background*

One of the major trends challenging the Internal Revenue Service (IRS) is accelerating globalization. To help meet the challenges of international tax administration, the IRS's strategy is to:

- Expand employee knowledge and awareness of international tax issues.
- Develop deep expertise and capabilities in key international issue areas.
- Enhance coordination with treaty partners and international organizations.
- Aggressively target areas of significant risk.

This has led to increased enforcement efforts on international information reporting requirements and increased assessments of related penalties.

Internal Revenue Code (I.R.C.)<sup>1</sup> Section (§) 6038(a) and Treasury Regulation § 1.6038-2(a) require a U.S. citizen or resident alien<sup>2</sup> to furnish information with respect to certain foreign business entities. This information includes any foreign partnership/corporation entity data, stock ownership data, financial statements, and intercompany transactions with related persons. The Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, is used to comply with the law and regulations.

***Penalties for not timely filing the Form 5471 are severe—\$10,000 for each Form 5471 that is filed after the due date of the associated income tax return, including any extensions.***

Penalties for not timely filing the Form 5471 are severe. I.R.C. § 6038(b)(1) provides for a monetary penalty of \$10,000 for each Form 5471 that is filed after the due date of the associated income tax return, including any extensions.

### ***In January 2009, the IRS began to systemically assess penalties for late-filed Forms 5471 attached to some corporate tax returns***

In response to a recommendation in a prior Treasury Inspector General for Tax Administration (TIGTA) report,<sup>3</sup> the IRS convened a cross-functional group to decide whether or not to pursue automating the penalty-setting process for the Form 5471. The group analyzed the number of

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<sup>1</sup> See Appendix VI for a glossary of terms.

<sup>2</sup> Generally, the categories of persons potentially liable for filing the Form 5471 are U.S. citizens, resident aliens, U.S. domestic corporations, U.S. domestic partnerships, and U.S. domestic trusts.

<sup>3</sup> TIGTA, Ref. No. 2006-30-075, *Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed* (May 2006).



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various tax returns with an attached Form 5471, which includes Form 1040, *U.S. Individual Income Tax Return*, Form 1120, *U.S. Corporation Income Tax Return*, Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and Form 1065, *U.S. Return of Partnership Income*.

The IRS conducted a pilot study of Forms 5471 attached to a Form 1120, since this comprised the largest volume of Forms 5471. Based on Tax Year 2004 data, the IRS estimated that if a penalty was asserted on every late-filed Form 5471 attached to a Form 1120, and none of these penalties were abated, approximately \$88.6 million in additional revenue could be generated. If the anticipated results of this pilot study provided revenue enhancements and improved filing compliance, the IRS would consider investing additional resources to include Forms 1040 and 1065.

Figure 1 shows the penalties assessed and abated for Forms 5471 attached to late-filed Forms 1120 for Processing Years 2008 through 2012. Prior to Processing Year 2009, all I.R.C § 6038(b)(1) penalties on late-filed Forms 5471 attached to a Form 1120 were assessed manually by IRS tax examiners during taxpayer audits. Under the pilot for Processing Years 2009 through 2012, the penalties on late-filed Forms 5471 were systemically assessed, resulting in significantly more penalty assessments.

**Figure 1: Penalty Assessments and Abatements for the Form 5471  
Attached to a Late-Filed Form 1120 for Processing Years 2008 Through 2012**

	Processing Year					Total
	2008	2009	2010	2011	2012	
Late-Filed Form 5471 Penalty Assessments (Millions)	\$7.6	\$71.5	\$48.6	\$54.3	\$41.0	\$215.4
Less Late-Filed Form 5471 Penalty Abatements (Millions) <sup>4</sup>	(\$0.4)	(\$56.0)	(\$36.4)	(\$41.0)	(\$16.1)	(\$149.5)
<b>Total Late-Filed Form 5471 Net Penalty Assessments</b>	<b>\$7.2</b>	<b>\$15.5</b>	<b>\$12.2</b>	<b>\$13.3</b>	<b>\$24.9</b>	<b>\$65.9</b>
<b>Rate of Return</b>	<b>N/A*</b>	<b>22%</b>	<b>25%</b>	<b>24%</b>	<b>61%</b>	<b>31%</b>

Source: Our analysis of a Business Master File extract from the TIGTA Data Center Warehouse.

\*N/A = not applicable.

The IRS sends taxpayers a CP 215 notice (see Figure 2 for an example) when it systemically assesses a late-filed Form 5471 penalty. Taxpayers can request that the IRS remove the penalty by providing a reasonable cause for abatement.

<sup>4</sup> Abatements are usually processed the tax year following the penalty assessment. We matched the penalty abatements with the corresponding year of penalty assessments as of April 25, 2013, to analyze the program results.



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**Figure 2: Example of a CP 215 Notice**

AO 13	200612	670	0121		01154-298-00303-9	A0000002	215
201003	000002		04090	IRS USE ONLY	999999962	SB	J
Department of the Treasury Internal Revenue Service CINCINNATI OH 45999-0039				For assistance, call: 1-800-829-0115			
				<b>Notice Number:</b> CP215			
				<b>Date:</b> February 1, 2010			
				<b>Taxpayer Identification Number:</b> 99-9999962			
				<b>Tax Form:</b> CVL PHN			
				<b>Tax Period:</b> December 31, 2006			
aaaaaaaaa		aaaaaaaaa		aaa			
bbbbbbbbbb		bbbbbb		bbbbbbbbbb			
PO BOX xxx		WFJJS MF		04090-0112120			
We Charged You a Penalty				623			
We charged you a penalty under Section 6038 of the Internal Revenue Code for the following reason:							
Failure to File Form 5471 and/or Form 8865							

Source: IRS.

Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide taxpayers relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when taxpayers exercised ordinary business care and prudence in determining their tax obligations but nevertheless failed to comply with those obligations. The Philadelphia Accounts Management function primarily handles the reasonable cause abatement requests resulting from systemic penalties on late-filed Forms 5471 attached to a Form 1120.

This review was performed at the Large Business and International (LB&I) Division<sup>5</sup> Headquarters in Washington, D.C., and the Cincinnati, Ohio; Philadelphia, Pennsylvania; and Ogden, Utah, Campuses during the period August 2011 through April 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, 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.

<sup>5</sup> The LB&I Division, formerly the Large and Mid-Size Business Division, became the LB&I Division on October 1, 2010. LB&I Division is used throughout this report.



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## *Results of Review*

### ***Systemic Penalties for Late-Filed Forms 5471 Were Properly Assessed and Compliance Was Improved for Many Corporate Taxpayers***

Systemic controls over assessing penalties on late-filed Forms 5471 attached to a Form 1120 are working appropriately. A statistical sample of 94 penalty assessment cases from Processing Year 2010 showed that for all 94 cases sampled, the systemic Form 5471 penalties were properly assessed. These cases had penalty assessments totaling \$5.3 million. This sample was selected from a population of 1,507 business taxpayers<sup>6</sup> with systemically assessed Form 5471 penalties totaling approximately \$48.6 million.

The due date for filing Form 5471 is the same as the income tax return to which it is attached. The \$10,000 penalty for each Form 5471 filed after the due date of the associated income tax return applies whether or not any income tax is due.

#### ***The majority of taxpayers assessed the penalty complied with the law in the following year***

Additional testing of the 94 business taxpayers in our sample who were penalized for late filing of their Forms 5471 during Processing Year 2010 showed that the majority complied with the law in the following year. Of the 94 taxpayers:

- 60 (64 percent) subsequently filed their Tax Year 2010 Forms 1120 with an attached Form 5471 timely in Processing Year 2011.
- 14 (15 percent) subsequently filed their Tax Year 2010 Forms 1120 timely in Processing Year 2011, but did not attach a Form 5471. However, we could not determine whether or not these taxpayers were required to file a Form 5471 because the only way to make this determination would be through an audit of the tax return.
- 9 (10 percent) subsequently filed their Tax Year 2010 Forms 1120 with an attached Form 5471 late in Processing Year 2011 and were assessed \$920,000 in additional penalties.

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<sup>6</sup> The 1,507 records were identified on the Business Master File with a Transaction Code 240 (assessment code) and a Penalty Reference Number 599 (systemic assessment). See Appendix I for more details.



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- 11 (12 percent) did not file a Tax Year 2010 Form 1120 in Processing Year 2011. An examination would be required to determine if these taxpayers were required to file Forms 1120 and 5471 for Tax Year 2010.

**Consideration should be given to expanding systemic penalty assessments to other types of income tax and international information reporting returns**

In addition to Form 5471, the I.R.C. § 6038(b)(1) penalty also applies to Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*. Therefore, the IRS should consider expanding the program to pursue automating the penalty-setting process for any tax returns required to file that information return as well, such as Forms 1040 and Forms 1065. If this automated penalty-setting process is expanded, it could increase revenue and overall taxpayer compliance with the filing requirements for other income tax and international information reporting returns.

According to IRS data, there were 10,255 late-filed Forms 5472 attached to a Form 1120 in Processing Year 2011. Had the systemic penalty assessment process been expanded to the Forms 5472 prior to Processing Year 2011, taxpayers could have potentially been assessed approximately \$103 million in late-filed Form 5472 penalties for that year. The IRS stated that it implemented the systemic penalty for late-filed Forms 5472 attached to a Form 1120 in January 2013. In addition, the IRS plans to implement the systemic penalty for late-filed Forms 5471 attached to a Form 1065 in January 2014.

**While a standardized framework was not in place for the development of the pilot for the late-filed Form 5471 systemic penalty program, the program met its established goals**

An IRS cross-functional group conducted a study on automating the I.R.C. § 6038(b)(1) penalty-setting process and recommended that the IRS systemically assess penalties on late-filed Forms 5471 attached to a Form 1120. However, the IRS was unable to provide documentation to support the study group's decisions, the business case for development of a pilot program, or information on the pilot testing<sup>7</sup> of the program. When we discussed these issues with LB&I Division management, they pointed out that the program was transferred to them from the Small Business/Self-Employed (SB/SE) Division in December 2006.

Nevertheless, a standardized framework was not in place for the development of a business case or the implementation of the pilot Form 5471 penalty assessment program. A best practice for developing and implementing new business processes is to establish an overall approach that contains the detailed steps for carrying out the various phases of an initiative. The Government Accountability Office (GAO), together with experts from other Government entities and private

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<sup>7</sup> Pilot testing is designed to provide an opportunity to test how a change works in actual practice and address problem areas before full implementation.



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industry, developed a 20-step approach to evaluate such initiatives.<sup>8</sup> The 20 steps include an approach to help ensure that potential obstacles are considered in planning, problems are pinpointed and addressed through pilot testing, and results are evaluated accurately. The standardized framework or similar practices establishes procedures and ensures that the project contains the necessary documentation to support key decisions made during the planning, execution, and implementation phases.

In response to a 2004 GAO report,<sup>9</sup> the SB/SE Division Commissioner agreed with a recommendation to put in place a framework to guide planning of future SB/SE Division process improvement projects. Therefore, the SB/SE Division should have used a framework when it began to plan, develop, and implement this pilot systemic penalty-setting program. Similarly, the LB&I Division Commissioner issued a guidance memorandum in April 2009<sup>10</sup> that stressed the importance of using a standardized framework for planning and carrying out major process improvement initiatives.<sup>11</sup> The memorandum outlined that the LB&I Division should begin incorporating this practice into its procedures and stated that the use of a standardized framework will help define in detail the activities managers will need to complete when undertaking future initiatives.

Even though the IRS did not use a standardized framework to develop and evaluate a pilot prior to implementing this process or follow internally issued guidance, IRS management did establish two goals when they decided to pursue systemically assessing penalties on late-filed Forms 5471 attached to a Form 1120. These goals were to provide revenue enhancement and improve taxpayer filing compliance. Based on the results of our review, the IRS met both goals.

## ***Recommendation***

The Commissioner, LB&I Division, should:

***Recommendation 1:*** Conduct a study to determine if the automated penalty-setting process should be expanded to other types of income tax and international information reporting returns. The study should follow a standardized framework to ensure that any implemented changes are evaluated and that the key decisions made during the planning, execution, and implementation phases are adequately documented.

***Management's Response:*** The IRS agreed with this recommendation. The LB&I Division will conduct a study of appropriate scope to determine if the automated

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<sup>8</sup> GAO, GAO/AIMD-10.1.15 (version 3), *Business Process Reengineering Assessment Guide* p. 7 (May 1997).

<sup>9</sup> GAO, GAO-04-287, *Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* p. 6 (Jan. 20, 2004).

<sup>10</sup> LMSB 04-0209-007, *Guidance Memorandum: Use of Standardized Frameworks for the Design and Implementation of Major Process Improvement Initiatives* (April 9, 2009).

<sup>11</sup> LMSB-4-0209-007, LMSB Commissioner and Executive Memorandums.



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penalty-setting process should be expanded within the context of international information reporting forms.

### **Controls Over Abating Systemic Penalties on Late-Filed Forms 5471 Need Enhancement**

A statistical sample of 93 penalty abatement cases from a population of 1,617 business taxpayers with penalty abatements showed that controls are insufficient to ensure the proper abatement of systemically assessed penalties on late-filed Forms 5471. These penalties totaled approximately \$59.4 million and were abated during Processing Years 2008 through 2010.<sup>12</sup>

Once taxpayers are systemically assessed a late-filed Form 5471 penalty, they can request that the IRS remove the penalty by providing a reasonable cause for abatement. Generally, to show reasonable cause, taxpayers must demonstrate that they exercised ordinary care and prudence in meeting their tax obligations but did not comply within the prescribed amount of time.

Of the 93 cases reviewed, the IRS appropriately abated 53 (57 percent) penalties that had been assessed for late-filed Forms 5471 attached to a Form 1120. However, the penalties were inappropriately abated for 40 (43 percent) cases. Figure 3 shows the results of our review.

**Figure 3: Results of a TIGTA Review of Ninety-Three Sampled Cases With Penalty Abatements**

<b>Number of Cases</b>	<b>Percent<sup>13</sup></b>	<b>Abatement Action</b>
53	57%	The IRS appropriately abated the penalties.
18	19%	The taxpayers claimed that their Forms 1120 were timely filed, but they did not provide any proof to support their claims. Based on the case files, the taxpayers' Forms 1120 were filed late, and the penalties would still be applicable.
6	6%	The taxpayers either submitted a Form 5471 as a first-time filer or claimed relief as a first-time filer of the Form 5471. However, according to IRS policy, if a taxpayer is claiming relief as a first-time filer, the abatement request is to be denied.
5	5%	The taxpayers claimed ignorance of the law regarding the filing requirements for the Form 5471. The taxpayers' reasonable cause requests stated that they were either uninformed or relied on advice from tax professionals that were not knowledgeable of this filing requirement. However, according to IRS policy, the abatement request is to be denied if the taxpayer does not understand the law or relied on bad advice.

<sup>12</sup> Of the 93 cases selected for review, we determined that three cases were worked by other units outside of the Philadelphia Campus Accounts Management function.

<sup>13</sup> Percentage totals less than 100 percent due to rounding.



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Number of Cases	Percent	Abatement Action
4	4%	The taxpayers claimed relief for not timely filing an extension. The taxpayers' reasonable cause requests stated that this was caused by either an unintentional taxpayer or tax preparer oversight. However, according to IRS policy, the abatement request is to be denied if the taxpayer or their representative forgot to request an extension.
4	4%	The taxpayers claimed that they were unable to file a timely Form 1120 with an attached Form 5471 because their records were unobtainable or because of their financial situations. However, according to IRS policy, the abatement request is to be denied even if the taxpayer is having difficulty in obtaining his/her financial information or having financial problems. Further, IRS procedures state that when the taxpayer's unobtainable financial records become available, the taxpayer has 90 days to file a timely Form 1120 with an attached Form 5471.
**1**	**1**	*****1***** *****1***** *****1*****
**1**	**1**	*****1***** *****1***** *****1***** *****1*****
93	100%	

Source: The results of our analysis of 93 sampled cases.

IRS policy does not require managerial review and approval to abate systemically assessed late-filed Form 5471 penalties. Currently, managers only review a sample of these penalty abatements after the fact as part of their Embedded Quality reviews.

Incorrect abatements for these cases totaled approximately \$1.75 million. When we discussed these cases with IRS management, they agreed that the improper abatements occurred as a result of IRS employees accepting and not evaluating the taxpayers' reasonable cause requests in accordance with the Internal Revenue Manual criteria.<sup>14</sup> This resulted in an average incorrect penalty abatement of \$19,207 per case. Based on our stratified random sample, we project that improving controls over the abatement process could potentially prevent approximately

<sup>14</sup> Internal Revenue Manual 21.8.2.21.2(4) (Oct. 1, 2010).



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\$31 million in incorrect abatements<sup>15</sup> for 710 business taxpayers, or an estimated \$155 million for 3,550 business taxpayers over five years.<sup>16</sup>

**While a majority of taxpayer abatement requests were properly granted, some filing extension requests were not recognized, resulting in unnecessary late-filed Form 5471 penalty assessments**

While these 53 of the 93 cases reviewed were properly abated, we found late-filed Form 5471 penalties were unnecessarily assessed in eight (15 percent) of the 53 cases because the IRS did not properly process the taxpayers' Forms 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*.

For these eight cases, the taxpayers timely submitted a filing extension with their payments by the original due dates of the Forms 1120. While the IRS processed the taxpayers' payments correctly, it did not properly process the six-month filing extensions on the Forms 1120, which ultimately resulted in these taxpayers being unnecessarily assessed \$6.4 million in late-filed Form 5471 penalties that were ultimately abated.

When we discussed these cases with the IRS, officials explained that if taxpayers submit payments with their extension requests, the Master File codes the documents differently than if the taxpayers submit an extension without a payment. Because of the differences in coding, the Master File will not generate a systemic extension of the tax return due date when taxpayers submit payments along with their extension requests.

***The IRS did not properly process the six-month filing extensions for eight Forms 1120, which ultimately resulted in \$6.4 million of unnecessary late-filed Form 5471 penalties.***

Prior to implementing the systemic late-filed Form 5471 penalty assessments, there was no significant effect on taxpayers if the IRS did not process their extensions. However, since the implementation of the systemic penalty, if the IRS does not process the extension and the taxpayers file their tax returns after the original return due date, it will result in a systemic late-filed Form 5471 penalty.

Based on our stratified random sample, we project that improving the systemic processing of Form 7004 received with a payment will prevent approximately \$11.6 million in unnecessary Form 5471 penalty assessments<sup>17</sup> and reduce taxpayer burden on approximately 125 business taxpayers, or an estimated \$58 million for 625 business taxpayers over five years.

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<sup>15</sup> We are 95 percent confident that the range of potential incorrect abatements is between \$10.3 and \$51.8 million.

<sup>16</sup> See Appendix IV for details on the methodologies used to project the outcomes.

<sup>17</sup> We are 95 percent confident that the range of potential abatements of unnecessary Form 5471 penalty assessments is between \$6.4 and \$18.8 million.



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**Employees did not always properly document decisions related to abating penalties or denying taxpayers' reasonable cause requests**

For 80 (86 percent)<sup>18</sup> of the 93 cases in our sample, Accounts Management function employees did not appropriately document their decisions to abate the penalty or deny the taxpayers' reasonable cause requests in accordance with internal procedures. Specifically:

- 60 cases lacked any documentation as to why the employee granted the penalty abatement.
- 20 cases contained documentation concerning the section of the *Failure to File or Late Filed – Form 5471 Decision Tree*<sup>19</sup> (the decision tree) used but not the specific question which led to the employee's decision to abate the penalty.

When the IRS receives a taxpayer's reasonable cause request to have a systemically assessed late-filed Form 5471 penalty abated, an Accounts Management employee should evaluate the request using the decision tree. The decision tree was designed to assist employees in determining whether a request to abate the late-filed Form 5471 penalty for reasonable cause should be granted, denied, or referred to a specialist or the Examination function. The decision tree provides a list of questions that require a "Yes" or "No" response under an "If" and "Then" conditional statement to determine whether the penalty should be abated or the reasonable cause request denied.

The Internal Revenue Manual<sup>20</sup> also requires employees to notate the section and specific question in the decision tree that led to his/her determination to abate the penalty or to deny the reasonable cause request. Without proper use of the decision tree, employees have not adequately documented the decision to abate these penalties. In addition, the employee's manager would not be able to validate whether the case resolution was appropriate. Managers did not review during their quality review process the 80 potentially erroneous cases we identified.

In addition, IRS management stated that quality reviewers have not identified documentation of the use of the decision tree as a concern. However, if the decision tree is not used for the determination of a penalty, this would be considered a fatal error that directly affects the taxpayer.<sup>21</sup>

A review of first-line manager performance feedback recorded in the Embedded Quality Review System on 56 late-filed Form 5471 penalty abatement cases<sup>22</sup> showed that the managers provided written feedback on some of these cases. However, the feedback given about documenting the

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<sup>18</sup> Of the 80 case files that lacked adequate documentation to support the employee's decision to abate the late-filed Form 5471 penalty, \*\*\*\*\*1\*\*\*\*\*

<sup>19</sup> Internal Revenue Manual Exhibit 21.8.2-1 (Nov. 23, 2012). See Appendix V for more details.

<sup>20</sup> Internal Revenue Manual 21.8.2.21.2(4) (Oct. 1, 2010).

<sup>21</sup> Fatal errors are defined as customer accuracy defects that directly affect the taxpayer and their issue or case if not resolved or answered correctly.

<sup>22</sup> None of our sampled cases were quality reviewed as part of the Embedded Quality Review System.



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use of the decision tree was minimal. We do not know whether this was because managers had overlooked any insufficient documentation in the case files or whether there was sufficient documentation in almost all of the 56 case files that were quality reviewed. Of the 56 quality reviews performed by managers, only three provided written feedback on the employee's lack of documentation of the decision tree results. In total, this included:

- *You are required to use Decision Tree and notate in the remark section of your adjustment. IRM [Internal Revenue Manual] 21.8.2.21.2.*
- *IRM [Internal Revenue Manual] 21.8.2.21.2 was not followed – you did not notate in the remarks section of the ADJ54 which question, in which section of the Penalty Tree [Decision Tree], led to your decision to abate the reasonable cause request.*
- *Since you did not follow the IRM [Internal Revenue Manual] guidelines mentioned above, you failed to notate in the remarks section of the ADJ54 which question, in which section of the Penalty Tree [Decision Tree], led to your decision to abate.*

Based on our sample results, managerial controls are insufficient to ensure that employees adequately document their case files explaining why the taxpayers' reasonable cause requests are being granted or denied. Without adequate documentation controls in place, there is a risk that the IRS could continue to lose revenue as a result of incorrectly abating late-filed Form 5471 penalties.

Based on our statistical sample, we project that improving controls over accurately documenting the abatement decision process could provide reliable and supportive information to the accounts of approximately 1,420 business taxpayers. We are 95 percent confident that the range of potential business taxpayers is between 1,300 and 1,500. Projected over five years, this could affect approximately 7,100 business taxpayers.

### ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 2:** Provide refresher training to Accounts Management function employees and their managers on the importance of documenting late-filed Form 5471 penalty abatement request decisions.

**Management's Response:** The IRS agreed with this recommendation. As of March 31, 2013, the processing of the Form 5471 was moved from the Philadelphia Accounts Management Campus to the Ogden Accounts Management Campus. The staff was trained when the work was transitioned to the new campus. Employees will continue to receive necessary updates on processing the Form 5471 as part of their Continuing Professional Education sessions.

**Recommendation 3:** Require managers to review and approve all late-filed Form 5471 penalty abatements prior to case closure.



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**Management's Response:** The IRS agreed with this recommendation. On June 26, 2013, Accounts Management issued a procedural update for Internal Revenue Manual 21.8.2 to require managers to review and approve all late-filed Form 5471 penalty abatements.

**Recommendation 4:** Coordinate with the Information Technology organization to ensure that filing extension requests received with a payment are properly coded and timely processed.

**Management's Response:** The IRS agreed with this recommendation. Submission Processing's Paper Processing Branch will investigate the coding and processing of the extensions. If the Information Technology organization requires a work request for any proposed revision of the programming for the extension, the Paper Processing Branch will provide it. Implementation of any work request is contingent on the approval of the work request by the Information Technology organization and budgetary constraints.



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## Appendix I

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

Our overall objective was to determine whether the IRS has improved its penalty-setting process to promote filing compliance for entities with Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, reporting requirements. To achieve this objective, we:

- I. Determined whether controls are in place to properly assess late-filed Forms 5471 penalties.
  - A. Reviewed the I.R.C.,<sup>1</sup> Internal Revenue Manual, U.S. Department of the Treasury Regulations, and publications regarding assessing late-filed penalties for Forms 5471.
  - B. Interviewed IRS officials at the Cincinnati, Ohio; Philadelphia, Pennsylvania; and Ogden, Utah, Campuses to obtain an understanding of all the policies, procedures, and practices the IRS has established for detecting and addressing filing compliance with Forms 5471. This included gaining an understanding of the procedures for processing and assessing penalties for the late-filed Forms 5471.
  - C. Determined the population of penalties assessed for late-filed Forms 5471 during Processing Years 2008 through 2010 by obtaining an extract from the TIGTA Data Center Warehouse's Business Master File using Transaction Code 240 with Penalty Reference Numbers 599, 619, or 623. To verify the accuracy of the extract, we selected a random sample of 10 transactions from the Business Master File data and matched them to the Integrated Data Retrieval System.
  - D. Determined whether the automated assessment of penalties for late-filed Forms 1120, *U.S. Corporation Income Tax Return*, with a Form 5471 attached increased taxpayer compliance. We selected a stratified random sample of systemically assessed penalties on the Business Master File using a Transaction Code 240 with a Penalty Reference Number 599 from a universe of 1,507 records in Processing Year 2010. We used a confidence level of 95 percent, a precision of  $\pm 10$  percent, and an expected error rate of 50 percent. We conducted research using the Integrated Data Retrieval System to determine a taxpayer's history of compliance in prior and subsequent filing years. The accuracy of our sampling methodology was reviewed and confirmed by our contracted statistician.

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<sup>1</sup> See Appendix VI for a glossary of terms.



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- II. Determined whether controls are in place to properly abate penalties for late-filed Forms 5471.
- A. Interviewed IRS officials at the Philadelphia, Pennsylvania, and Ogden, Utah, Campuses to obtain an understanding of the policies, procedures, and practices the IRS has established for abating penalties for late-filed Forms 5471.
  - B. Obtained an extract from the TIGTA Data Center Warehouse's Business Master File for Processing Years 2008 through 2010 for Forms 5471 using Transaction Code 241 with a Penalty Reference Number 599, 619, or 623. We selected and reviewed a stratified random sample from 1,617 Business Master File records, using a confidence level of 95 percent, a precision of  $\pm 10$  percent, and an expected error rate of 50 percent. To verify the accuracy of the extract, we selected a random sample of 10 transactions from the Business Master File data and matched them to the Integrated Data Retrieval System. The accuracy of our sampling methodology was reviewed and confirmed by our contracted statistician.
  - C. Obtained the case files for the above samples and reviewed the documentation provided to determine whether the reasonable cause was sufficient to abate the penalty.
  - D. Identified the total number of records and penalties that were improperly abated and projected this amount over the universe of Business Master File records for Processing Years 2008 through 2010.
  - E. Evaluated the Philadelphia, Pennsylvania, Campus Accounts Management function performance management process for abating late-filed Form 5471 penalties to determine whether management is ensuring that Form 5471 penalty cases are being properly documented in accordance with Internal Revenue Manual 21.8.2.21.2(4).
    - 1. Obtained copies of the Examination Quality Review System reports for Fiscal Years 2010 and 2011 and identified the Data Collection Instrument numbers for the late-filed Form 5471 penalty cases and reviewed them on the Examination Quality Review System.
    - 2. Determined whether the Accounts Management performance management process ensured that the decision tree was documented in the case files in accordance with the Internal Revenue Manual procedures.
- III. Determined the status of corrective actions taken by the IRS on prior TIGTA recommendations related to Form 5471.
- A. Evaluated the methodology for initiating and monitoring the pilot program of the automated penalty-setting process for late-filed Forms 5471 attached to a Form 1120.



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- B. Assessed the pilot using the GAO's 20-step approach based on its *Business Process Reengineering Assessment Guide*<sup>2</sup> to determine if a framework was in place to accurately and reliably evaluate the results.
- C. Discussed our results with IRS officials and obtained their feedback.

**Data validation methodology**

During this review, we obtained Form 5471 penalty assessment and Form 5471 penalty abatement data from the TIGTA Data Center Warehouse's Business Master File. To evaluate the accuracy of this data, we selected certain data fields for review, such as the taxpayer's employer identification number, tax period, and dollar amount of assessment or abatement. We then verified the data to ensure that the data we obtained for the penalty assessments and abatements matched what is on the Integrated Data Retrieval System. These tests determined that the data were sufficiently reliable and could be used to meet the objective of this audit.

**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: the Wage and Investment Division's Accounts Management function processes and procedures for processing taxpayer abatement requests; Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Controls*; SB/SE Division guidance for process improvement projects (GAO-04-287); and LMSB 04-0209-007, *Guidance Memorandum on Use of Standardized Frameworks for the Design and Implementation of Major Process Improvement Initiatives*. We evaluated these controls by reviewing source materials, interviewing management, and analyzing a sample of late-filed Form 5471 penalty assessments from Processing Year 2010 and Form 5471 penalty abatements in Processing Years 2008 through 2010.

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<sup>2</sup> GAO, GAO-04-287, *Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* p. 21 (Jan. 20, 2004).



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## **Appendix II**

### *Major Contributors to This Report*

Carl Aley, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)

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

Frank Dunleavy, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)

Bryce Kisler, Director

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Margaret F. Filippelli, Senior Auditor



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**Appendix III**

*Report Distribution List*

Acting Commissioner  
Office of the Commissioner – Attn: Chief of Staff C  
Office of the Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner (International), Large Business and International Division SE:LB  
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W  
Director, Customer Account Services, Wage and Investment Division SE:W:CAS  
Director, International Business Compliance, Large Business and International Division  
SE:LB:IN  
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, Large Business and International Division SE:LB



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## Appendix IV

### *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:**

- Revenue Protection – Potential; \$31 million for 710 business taxpayers per year, or \$155 million for 3,550 business taxpayers over the next five years (see page 7).

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

We identified 1,617 Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, penalty abatement records from an extract of the Business Master File using Transaction Code 241 with Penalty Reference Number 599, 619, or 623 for Processing Years 2008 through 2010. For the first population, we selected a stratified random sample of **1** cases using a confidence level of 95 percent, a precision of  $\pm 10$  percent, and an expected error rate of 50 percent. Since all of these abatement cases were less than \$1 million, we also selected a second population of the **1** business taxpayer cases that were more than \$1 million. This resulted in a combined population of 93 abatement cases selected for review. From our sample of 93 abatement cases, we determined that three abatements were not worked in the Accounts Management function.

Based on our stratified random sample, we determined that 40 of the 93 cases were incorrectly abated because the taxpayers' reasonable cause requests did not justify abating the late-filed Form 5471 penalty. These 40 cases had a total of \$1.75 million in abatements. To project the results of our sample, we used a stratified random sample with a weighted average of \$19,207 per case. Projecting this weighted average over the stratified population of **1** cases, we estimate that improving controls over the abatement process could potentially protect revenue of approximately \$31 million per year for 710 business taxpayers, or \$155 million for 3,550 business taxpayers over the next five years. Figure 1 shows the projection to the population.



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**Figure 1: Weighted Average and Projection  
for Stratified Random Sample (Incorrect Abatements)**

	Abatements Less Than \$1 Million	Abatements More Than \$1 Million	Total
<b>Population Data:</b>			
Population	**1**	**1**	1,617
Population Percentage	**1**	**1**	100.00%
<b>Sample Data:</b>			
Sample Cases Reviewed	**1**	**1**	93
Number of Errors	**1**	**1**	40
Weighted Average Error Rate	**1**	**1**	43.91% <sup>1</sup>
Total Dollars on Error Cases (in millions)	**1**	**1**	\$1.75
Error Dollars Per Case: (Total Error Dollars [\$1,750,000] / Sample Cases Reviewed [91])			\$19,230.77
<b>Weighted Average Error Dollars Per Case:</b>			
(Error Dollars Per Case [\$19,230.77] x Population Percentage [99.88%])			\$19,207.00
<b>Weighted Average Error Dollars Per Year:</b>			
(Error Rate [\$19,207.00] x Population [1,617])			\$31 million
<b>Weighted Average Over 5 Years:</b>			
(\$31 Million x 5 Years)			\$155 million
<b>Number of Business Taxpayers Per Year:</b>			
(Weighted Average Error Rate [43.91%] x Population [1,617])			710
<b>Number of Business Taxpayers Over 5 Years:</b>			
(Projected Errors Over 5 Years: 710 x 5 Years)			3,550

Source: Data obtained from the Business Master File<sup>2</sup> and our analysis of the abatement cases reviewed.

<sup>1</sup> The combined weighted average error rate of 43.91 percent is computed by multiplying the abatement percentage of \*\*1\*\* for the less than \$1 million population by the weighted average error rate of \*\*1\*\*\*, which equals \*\*1\*\*\*. We then added the abatement percentage of \*\*1\*\* for the more than \$1 million population and multiplied by the weighted average error rate of zero, which equals zero, for a combined weighted average error rate of 43.91 percent.

<sup>2</sup> See Appendix VI for a glossary of terms.



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*Systemic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement*

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**Type and Value of Outcome Measure:**

- Taxpayer Burden – Potential; \$11.6 million for 125 business taxpayers per year, or \$58 million for 625 business taxpayers over the next five years (see page 7).

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

Based on our stratified random sample, we determined that eight of the 93 Form 5471 penalties were unnecessarily assessed because the IRS did not properly process the taxpayer's Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*. For these eight cases, the taxpayers timely submitted an extension with a payment by the due date of the Form 1120. While the IRS processed the taxpayers' payments correctly, it did not properly process the six-month filing extension on the Form 1120, *Corporate Tax Return*, which ultimately resulted in these taxpayers being unnecessarily assessed \$6.4 million in late-filed Form 5471 penalties. To project the results of our sample, we used a stratified random sample with a weighted average. Projecting this weighted average over the stratified population of 1,617 cases, we estimate that improving the systemic processing of corporate return filing extensions received with a payment will prevent unnecessary Form 5471 penalty assessments from taking place and reduce taxpayer burden on approximately \$11.6 million in unnecessary assessments for 125 business taxpayers, or an estimated \$58 million for 625 business taxpayers over five years. Figure 2 shows the projection to the population.



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**Figure 2: Weighted Average and Projection for  
Stratified Random Sample (Unnecessary Assessments)**

	Abatements Less Than \$1 Million	Abatements More Than \$1 Million	Total
<b>Population Data:</b>			
Population	**1**	**1**	1,617
Population Percentage	**1**	**1**	100.00%
<b>Sample Data:</b>			
Sampled Cases Reviewed	**1**	**1**	93
Number of Errors	**1**	**1**	8
Weighted Average Error Rate	**1**	**1**	7.74% <sup>3</sup>
Total Dollars on Error Cases	***1***	***1***	\$6.41 million
Average Error Dollars (Total Error Dollars / Sample Cases)	***1***	***1***	
<b>Weighted Average Error Dollars Per Case:</b>			
(Error Dollars Per Case [***1***] x Population Percentage [***1***])			\$3,402
<b>Weighted Average Error Dollars Per Year:</b>			
(Error Dollars [\$3,402] x Population [***1***] = ***1***) Plus (Error Dollars [***1***] x Population [**1**] = ***1***)			\$11.6 million
<b>Weighted Average Over 5 Years:</b>			
(\$11.6 Million x 5 Years)			\$58 million
<b>Number of Business Taxpayers Per Year:</b>			
(Population Weighted Average Error Rate [7.74%] x Population [1,617])			125
<b>Number of Business Taxpayers Over 5 Years:</b>			
(Projected Errors Over 5 Years 125 x 5 Years)			625

*Source: Data obtained from the Business Master File and our analysis of the abatement cases reviewed.*

<sup>3</sup> The combined weighted average error rate of 7.74 percent is computed by multiplying the percentage of \*\*\*1\*\*\* for the abatements of the less than \$1 million population by the weighted average error rate of \*\*\*1\*\*\*, which equals \*\*\*1\*\*\*. We then added the percentage of \*\*\*1\*\*\* for the abatements of the more than \$1 million population and multiplied by the weighted average error rate of \*\*\*1\*\*\*, which equals \*\*\*1\*\*\*, for a combined weighted average error rate of 7.74 percent.



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**Type and Value of Outcome Measure:**

- Reliability of Information – Potential; the accounts of 1,420 business taxpayers, or 7,100 business taxpayers over the next five years (see page 7).

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

Based on our stratified random sample, we identified that, for 80 of the 93 cases worked in the Accounts Management function, IRS employees did not adequately document the decision tree penalty abatement resolutions in accordance with Internal Revenue Manual procedures. More specifically, 60 cases lacked any documentation as to why IRS employees allowed the penalty to be abated. In the remaining 20 cases, IRS employees documented the section of the decision tree but did not document the question that led to their decision to abate the penalty.

We project that improving controls over documenting the decision tree could provide reliable and supportive information to the accounts of approximately 1,420 business taxpayers as to why the taxpayers’ requests to abate the late-filed Form 5471 penalties were granted or denied. In addition, this could affect the accounts of approximately 7,100 business taxpayers over five years. Figure 3 shows the weighted average calculations and the projection to the population.

**Figure 3: Weighted Average and Projection for Stratified Random Sample (Documenting the Decision Tree)**

	Abatements Less Than \$1 Million	Abatements More Than \$1 Million	Total
<b>Population Data:</b>			
Population	***1***	**1**	1,617
Population Percentage	***1***	***1***	100%
<b>Sample Data:</b>			
Sample Cases Reviewed	***1***	**1**	93
Number of Documentation Errors	***1***	**1**	80
Weighted Average Error Rate	***1***	***1***	87.80% <sup>4</sup>
<b>Number of Business Taxpayers Per Year:</b>			
(Error Rate 87.80% x Population 1,617)			1,420
(Projected Errors Over 5 Years 1,420 x 5 years)			7,100

Source: Data obtained from the Business Master File and our analysis of the abatement cases reviewed.

<sup>4</sup> The combined weighted average error rate of 7.74 percent is computed by multiplying the percentage of \*\*\*1\*\*\* for the abatements of the less than \$1 million population by the weighted average error rate of \*\*\*1\*\*\*, which equals \*\*\*1\*\*\*. We then added the percentage of \*\*\*1\*\*\* for the abatements of the more than \$1 million population and multiplied by the weighted average error rate of zero, which equals zero, for a combined weighted average error rate of 87.80 percent.



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**Appendix V**

*Example of the Failure to File or  
Late Filed Form 5471 – Decision Tree*

21.8.2-1 Failure to File or Late Filed Form 5471 - Decision Tree

Skip Navigational Links

21 -> 21.8 -> 21.8.2  
**Any line marked with a # is for Official Use Only**

**21.8.2-1 Failure to File or Late Filed Form 5471  
 (10/01/2012) - Decision Tree  
 (11/23/2012)**

Failure to File or Late Filed Form 5471 - Decision Tree

1) Did taxpayer receive reasonable cause for failure to timely file Form 1120?

IF	THEN
a) Yes	Abate Penalty
b) No	continue

2) Is the taxpayer's request based on a frivolous position?

IF	THEN
a) Yes	Deny
b) No	continue

3) Is the taxpayer claiming they are first time filer and were unaware of the filing requirements?

IF	THEN
a) Yes	Deny
b) No	continue

Ordinary business care and prudence requires the taxpayer to determine their tax obligations when establishing a business in a foreign country.

4) Is the taxpayer requesting that the penalty be waived because of financial problems?

IF	THEN
a) Yes	Deny
b) If taxpayer refers to IRC § 7811	Follow IRM procedures
c) No	continue

Source: Internal Revenue Manual Exhibit 21.8.2-1 (Nov. 23, 2012).



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**Appendix VI**

*Glossary of Terms*

<b>Term</b>	<b>Definition</b>
<b>Business Master File</b>	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.
<b>Data Center Warehouse</b>	A TIGTA Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators.
<b>Embedded Quality Review System</b>	A tool that is designed to assist managers in identifying areas of strengths and weaknesses in their employees' individual performance as it relates to case activities.
<b>Fiscal Year</b>	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.
<b>Integrated Data Retrieval System</b>	An IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
<b>Internal Revenue Code (I.R.C.)</b>	The codified collection of U.S. laws on income, estate and gift, employment, and excise taxes, plus administrative and procedural provisions.
<b>Internal Revenue Manual</b>	The official source of information on policies and procedures for use by all IRS offices.
<b>Master File</b>	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
<b>Offshore Voluntary Disclosure Program</b>	An IRS program designed to bring taxpayers who have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with U.S. tax laws.



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<b>Term</b>	<b>Definition</b>
<b>Penalty Reference Number</b>	Penalty Reference Numbers are used to document the assessment and abatement of miscellaneous civil penalties on the Master File.
<b>Processing Year</b>	The calendar year in which the tax return or related document is processed by the IRS.
<b>Reasonable Cause</b>	Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercised ordinary business care and prudence in determining their tax obligations but nevertheless failed to comply with those obligations.
<b>Tax Year</b>	The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.
<b>Transaction Code</b>	A three-digit code used to identify actions being taken on a taxpayer's account on the Master File.



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**Appendix VII**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

August 20, 2013

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Paul D. DeNard   
Acting Commissioner, Large Business and International Division

SUBJECT: Draft Report #201130043, *Systemic Penalties on Late Filed  
Forms Related to Certain Foreign Corporations Were Properly  
Assessed, but the Abatement Process Needs Improvement*

We reviewed your draft report entitled, *Systemic Penalties on Late Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement*, and are pleased with the positive audit findings indicating that:

1. Systemic penalties for late filed Forms 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, were properly assessed and compliance improved for many corporate taxpayers,
2. IRS objectives to enhance revenue and improve taxpayer compliance were met, and
3. The majority of taxpayers assessed the penalty complied with the law in the following year.

We generally agree with the four audit recommendations. We have already taken actions to expand systemic penalty assessments to other types of income tax forms and international information reporting returns, and we will continue to evaluate whether further expansion of our program of systemic penalty assessments is appropriate. We will enhance controls on abatement of systemic penalties on late filed Forms 5471 to ensure they are processed correctly and timely. We will also improve the abatement request process, including documentation of abatement-request decisions, and we will deliver refresher training to employees.

We agree that improving controls over the abatement process could potentially protect revenue as described in Appendix IV.

Attached is a detailed response outlining the corrective actions that the IRS will take to address your recommendations. If you have any questions, please contact Sergio Arellano, Director, International Business Compliance, at (630) 493-5413.

Attachment



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*Systemic Penalties on Late-Filed Forms Related to  
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2

Attachment

**RECOMMENDATION 1:**

TIGTA recommends that the Commissioner, LB&I Division conduct a study to determine if the automated penalty-setting process should be expanded to other types of income tax and international information reporting returns. The study should follow a standardized framework to ensure any implemented changes are evaluated and that the key decisions made during the planning, execution, and implementation phases are adequately documented.

**CORRECTIVE ACTIONS:**

LB&I will conduct a study of appropriate scope to determine if the automated penalty-setting process should be expanded within the context of international information reporting forms. In so doing, LB&I will give due regard to available resources and to the relative weight of its strategic compliance priorities.

In response to previous TIGTA recommendations, specifically those outlined in Audit Report 2006-30-075, LB&I has already begun to take actions to expand systemic penalty assessments to late filing of Form 5471 with respect to other types of income tax and international information reporting returns, including Form 1120-S (U.S. Income Tax Return of an S Corporation), Form 1065 (U.S. Return of Partnership Income), and Form 1040 (Individual Income Tax Return). In particular:

- With respect to Form 1120-S, the IRS has systematically assessed penalties to late filing of Forms 5471 since 2009.
- With respect to Form 1065, the IRS provided TIGTA with information on Form 1065 and on the Tax Product Priority List process that we followed in 2008 to request changes to Form 1065 that would require identification of the number of Forms 5471 attached to the return. These changes became effective beginning in Tax Year 2011, and systematic assessment of penalties to late filing of Forms 5471 is scheduled to begin in 2014.
- With respect to Form 1040, the IRS is pursuing changes to Form 1040, Schedule B, that would require identification of the number of Forms 5471 attached to the return.

In 2013, the IRS also implemented systematic penalty assessments to late filing of Forms 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) for certain forms in the 1120 series.

**IMPLEMENTATION DATE:**

Estimated Completion: February 28, 2015.

**RESPONSIBLE OFFICIAL(S):**



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3

Director, International Business Compliance (LB&I: International: IBC)

**CORRECTIVE ACTION(S) MONITORING PLAN:**

The Office of Internal Control will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.

**RECOMMENDATION 2:**

TIGTA recommends that the Commissioner, Wage and Investment Division provide refresher training to the Accounts Management function employees and their managers on the importance of documenting late filed Form 5471 penalty abatement-request decisions.

**CORRECTIVE ACTIONS:**

As of March 31, 2013, the processing of Form 5471 was moved from the Philadelphia Accounts Management Campus to the Ogden Accounts Management Campus. The staff was trained when the work was transitioned to Ogden. Employees will continue to receive necessary updates on Processing Form 5471 as part of their CPE sessions.

**IMPLEMENTATION DATE:**

Completed: March 31, 2013

**RESPONSIBLE OFFICIAL(S):**

Director, Accounts Management, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION(S) MONITORING PLAN:**

The Office of Internal Control will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.

**RECOMMENDATION 3:**

TIGTA recommends that the Commissioner, Wage and Investment Division require managers to review and approve all late filed Form 5471 penalty abatements prior to case closure.



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**CORRECTIVE ACTIONS:**

Accounts Management has issued an Internal Revenue Manual (IRM) Procedural Update (IPU) for IRM 21.8.2 (IPU # 13U1155) on June 26, 2013 to require managers to review and approve all late filed Form 5471's penalty abatements.

**IMPLEMENTATION DATE:**

Completed: June 26, 2013

**RESPONSIBLE OFFICIAL(S):**

Director, Accounts Management, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION(S) MONITORING PLAN:**

The Office of Internal Control will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.

**RECOMMENDATION 4:**

TIGTA recommends that the Commissioner, Wage and Investment Division coordinate with the Information Technology function to ensure filing extension requests received with a payment are properly coded and timely processed.

**CORRECTIVE ACTIONS:**

Submission Processing Paper Processing Branch (PPB) will investigate the coding and processing of the extensions. If Information Technology (IT) requires a work request for any proposed revision of the programming for the extension, PPB will provide it. Implementation of any work request is contingent on the approval of the work request by IT and budgetary constraints.

**IMPLEMENTATION DATE:**

Estimated completion: March 15, 2015

**RESPONSIBLE OFFICIAL(S):**

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



*Systemic Penalties on Late-Filed Forms Related to  
Certain Foreign Corporations Were Properly Assessed,  
but the Abatement Process Needs Improvement*

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**CORRECTIVE ACTION(S) MONITORING PLAN:**

The Office of Internal Control will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.