



*The Examination and Automated
Underreporter Functions Did Not Always
Ensure That Accuracy-Related Penalty
Abatements Were Appropriate*

August 3, 2015

Reference Number: 2015-30-066

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

2 = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

THE EXAMINATION AND AUTOMATED UNDERREPORTER FUNCTIONS DID NOT ALWAYS ENSURE THAT ACCURACY-RELATED PENALTY ABATEMENTS WERE APPROPRIATE

Highlights

Final Report issued on August 3, 2015

Highlights of Reference Number: 2015-30-066 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The IRS assesses penalties to encourage voluntary taxpayer compliance with standards required by the Internal Revenue Code, such as timely filing of tax returns and full payment of taxes owed. Procedures are available to reverse incorrect assessments of penalties that were due to errors by the IRS or taxpayers. Also, taxpayers can have the penalties abated if they can demonstrate that there was reasonable cause for the noncompliance with the tax laws.

WHY TIGTA DID THE AUDIT

This audit was initiated because the IRS abates millions of dollars in penalties assessed on taxpayer accounts each year. The overall objective of this audit was to determine whether the IRS's controls are sufficient to ensure appropriate accuracy-related penalty abatements. This review is part of our Fiscal Year 2015 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

The IRS did not always ensure that penalty abatements were appropriate. TIGTA reviewed a sample of 100 accuracy-related penalties abated by the Examination function in Fiscal Year 2012. However, 29 of the Examination function abatements in our sample were part of two large-scale projects to abate penalties that had been incorrectly assessed on certain refundable credits on approximately 168,635 returns. TIGTA's review found that the

IRS elected to remove all accuracy-related penalties from impacted taxpayer accounts, thereby abating hundreds of thousands of dollars in legitimate penalties. TIGTA found that 20 of the 29 abatements sampled from these large-scale projects were not appropriate. In addition, TIGTA found 386 of the 168,635 returns had been assessed additional taxes by IRS examiners and should not have had \$985,325 in accuracy-related penalties abated. Of the remaining 71 Examination function penalty abatements reviewed, TIGTA found five incorrect abatements, totaling \$122,722, that were primarily due to examiners not following the criteria for reasonable cause abatements and, in some cases, not documenting case files to substantiate the reason for the abatements.

TIGTA also reviewed a sample of 100 accuracy-related penalties abated by the Automated Underreporter function in Fiscal Year 2012 and found 16 incorrect abatements totaling \$157,203. Most of the incorrect abatements involved taxpayers who filed amended returns, removing audit adjustments and penalties that should have been considered for examination, but were not referred as required by IRS policy.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS should:

- 1) ensure that available data analysis capabilities are used to preserve legitimately assessed penalties when using large-scale abatement projects to correct erroneously assessed accounts;
- 2) reemphasize to examiners the rules for considering reasonable cause and properly documenting case files when abating accuracy-related penalties; and
- 3) include procedures in the Automated Underreporter function manual for referring amended returns for further review.

In response to the report, IRS management agreed with our recommendations and plans to take corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 3, 2015

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Examination and Automated Underreporter
Functions Did Not Always Ensure That Accuracy-Related Penalty
Abatements Were Appropriate (Audit # 201430026)

This report presents the results of our review to determine whether the Internal Revenue Service's (IRS) controls are sufficient to ensure appropriate accuracy-related penalty abatements. This audit is included in the Treasury Inspector General for Tax Administration's Fiscal Year 2015 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 VI.

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 Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Table of Contents

BackgroundPage 1

Results of ReviewPage 4

 The Examination and Automated Underreporter
 Functions Did Not Always Ensure That Accuracy-Related
 Penalty Abatements Were AppropriatePage 4

Recommendations 1 and 2:Page 10

Recommendation 3:.....Page 11

Appendices

 Appendix I – Detailed Objective, Scope, and MethodologyPage 12

 Appendix II – Major Contributors to This ReportPage 14

 Appendix III – Report Distribution ListPage 15

 Appendix IV – Outcome Measures.....Page 16

 Appendix V – Glossary of TermsPage 20

 Appendix VI – Management’s Response to the Draft ReportPage 21



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Abbreviations

AUR	Automated Underreporter
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



*The Examination and Automated Underreporter Functions
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Background

The Internal Revenue Service (IRS) assesses certain penalties to encourage compliance with the requirements of the Internal Revenue Code (I.R.C.),¹ such as timely filing of tax returns and full payment of taxes owed. The accuracy-related penalty is assessed for the underpayment of tax required to be shown on a tax return due to negligence and in the case of a substantial understatement of income tax.² However, the law also provides for abatement of the penalty if the penalty was assessed erroneously or if the taxpayer can demonstrate reasonable cause.³ Abatements are important because they can reverse incorrect assessments of penalties that were due to errors by the IRS or taxpayers, and they allow the IRS to recognize where taxpayers acted reasonably in light of all the facts and circumstances and acted in good faith. On the other hand, an erroneous abatement is problematic because it removes the deterrent to noncompliant behavior, which can adversely affect future compliance.

Each year, the IRS abates millions of dollars in penalty assessments on taxpayer accounts. Figure 1 shows a comparison of accuracy-related penalty assessments and abatements⁴ for Fiscal Years (FY) 2012 and 2013. Although the number and amount of accuracy-related penalty assessments increased in FY 2013, the number of abatements increased at a much higher rate.

¹ See Appendix V for a glossary of terms.

² I.R.C. § 6662 (c) imposes an accuracy-related penalty on any portion of an underpayment attributable to negligence or disregard of the rules or regulations and I.R.C. § 6662 (d) imposes a penalty for a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000. The amount of the penalty is 20 percent of the underpayment.

³ I.R.C. § 6664(c).

⁴ For individual, estate, and gift tax returns. These figures represent penalties for negligence, substantial understatement of income tax, substantial valuation misstatement, substantial overstatement of pension liabilities, substantial estate or gift tax valuation understatement (under I.R.C. § 6662), understatement of reportable transactions (under I.R.C. § 6662A), and underpayment of stamp tax (under I.R.C. § 6653).



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

**Figure 1: Accuracy-Related Penalty
Assessments and Abatements
FYs 2012 and 2013**

	<i>Civil Penalties Assessed</i>		<i>Civil Penalties Abated</i>	
	<i>Returns</i>	<i>Dollars</i>	<i>Returns</i>	<i>Dollars</i>
FY 2012	610,573	\$1,385,527,000	58,661	\$295,178,000
FY 2013	731,696	\$1,541,341,000	178,066 ⁵	\$532,566,000
Increase				
Amount	121,123	\$155,814,000	119,405	\$237,388,000
Percentage	20%	11%	204%	80%

Source: IRS Data Book, Table 17, for FYs 2012 and 2013.

Section (§) 6404 of the I.R.C. authorizes the IRS to abate a penalty assessment under certain conditions. Generally, taxpayers are afforded an opportunity to provide information to explain why the penalty should not be asserted in order for the IRS to abate a penalty. There are four categories in which the IRS allows relief from civil penalties: 1) reasonable cause; 2) statutory exception; 3) administrative waiver; and 4) correction of an IRS error.

Reasonable cause is the category most commonly used to abate penalties. Taxpayers are generally entitled to penalty relief if they had reasonable cause for the position taken and they acted in good faith. Each case must be judged individually based on the facts and circumstances at hand. Internal Revenue Manual (IRM) 20.1.1.3.2 provides some questions examiners should consider when making a reasonable cause determination:

- During the period of time the taxpayer was noncompliant, what facts and circumstances prevented the taxpayer from filing a return, paying a tax, and/or otherwise complying with the law?
- How did the facts and circumstances result in the taxpayer not complying?
- How did the taxpayer handle the remainder of his or her affairs during this time?
- Once the facts and circumstances changed, what attempt did the taxpayer make to comply?

Taxpayers may try to establish reasonable cause for an abatement based on taxpayer forgetfulness or oversight or by claiming that a mistake was made by the taxpayer or another

⁵ Approximately 111,107 abatements in FY 2013 were made in two large-scale abatement projects discussed later in this report.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

party. Generally, these reasons do not provide a basis for reasonable cause abatement because they are not in keeping with the standard of ordinary business care and prudence expected of taxpayers. Ignorance of the tax law is also not a valid reason for penalty abatement.

According to IRM 20.1.5.6.2, in general the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to report the proper tax liability. For example, reliance on erroneous information reported on an information return indicates reasonable cause and good faith, provided that the taxpayer did not know or have reason to know that the information was incorrect. Similarly, an isolated computational or transcription error may indicate reasonable cause and good faith. Other factors to consider are the taxpayer's experience, knowledge, and level of education, as well as the taxpayer's reliance on the advice of a tax advisor. All relevant facts, including the nature and complexity of the tax issues, the competence of the tax advisor, and the quality of the opinion relied upon must be developed to determine whether the taxpayer has reasonable cause and acted in good faith.

The IRS Restructuring and Reform Act of 1998⁶ added I.R.C. § 6751(b), which requires managerial approval of all penalties assessed after June 30, 2001, that are not automatically calculated through electronic means. However, managerial approval is not required for penalty abatements.

This review was performed with information obtained from the Small Business/Self-Employed (SB/SE) Division Headquarters located in New Carrollton, Maryland; Wage and Investment Division Headquarters located in Atlanta, Georgia; and Campus Compliance Services, SB/SE Division, located in Philadelphia, Pennsylvania, during the period March 2014 through January 2015. 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.

⁶ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Results of Review

The Examination and Automated Underreporter Functions Did Not Always Ensure That Accuracy-Related Penalty Abatements Were Appropriate

We reviewed a total of 200 accuracy-related penalties that were abated by the Examination and Automated Underreporter (AUR) functions during FY 2012 and found that a total of 41 penalties (21 percent) totaling \$289,220 were not properly abated in accordance with IRS policies and procedures or were systemically abated to avoid expending resources to manually correct the cases. Specifically, our review found that:

- In 20 cases involving large-scale penalty abatement projects in the Examination function, the IRS systemically abated legitimate penalties totaling \$9,295 in order to avoid expending resources to manually correct the cases.
- In five cases in the Examination function and 16 cases in the AUR function, with penalties totaling \$279,925, the IRS did not follow its existing policies and procedures for abating penalties and, in some cases, did not properly document the case files to show reasons for the abatements.

Large-scale penalty abatement projects in the Campus Examination function resulted in unwarranted penalty abatements

We selected a statistically valid sample of 100 accuracy-related penalties assessed on individual taxpayer accounts as a result of examinations that were abated during FY 2012 from a universe of 18,014 abatements.⁷ We found that 29 of these 100 cases were related to two large-scale penalty abatement projects that were necessitated by an IRS Chief Counsel Memorandum dated May 30, 2012 (Chief Counsel Memorandum).⁸ The Chief Counsel Memorandum addressed the situation when taxpayers erroneously claim a refundable tax credit such as the Earned Income Tax Credit on their tax return. The IRS policy had previously been to assess the accuracy-related penalty on taxpayers in these circumstances; however, IRS Counsel advised that when the IRS identifies the erroneous refundable credit claim before paying the refund there is no

⁷ Abatements of \$500 or more.

⁸ IRS Chief Counsel Memorandum, PMTA-2012-16, *Accuracy-Related Penalty on Underpayments – Frozen Refundable Tax Credits* (May 30, 2012).



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

“underpayment” amount as defined by I.R.C. § 6664, absent additional circumstances.⁹ Without an underpayment, the accuracy-related penalty under I.R.C. § 6662 should not be assessed against these taxpayers. Because the IRS had incorrectly assessed hundreds of millions of dollars in penalties, it was required to correct taxpayers’ accounts that were improperly charged, and it also took steps to ensure that the accuracy-related penalty would not be assessed incorrectly in the future. For administrative efficiency, the IRS chose to abate the full amount of accuracy-related penalties on impacted taxpayers’ accounts rather than abating only the portion that was incorrectly assessed. IRS officials informed us that based on the significant volume of potentially impacted cases they concluded it was more efficient to systemically abate all accuracy-related penalties instead of expending substantial resources to manually recalculate the correct penalty assessments.

During FYs 2012 through 2014, the IRS systemically abated a total of \$215.6 million in accuracy-related penalties on 168,635 returns based on the Chief Counsel Memorandum. The amount of penalties abated on each return ranged from less than \$4 to more than \$99,000.

Further, due to the large volume of cases, on August 21, 2012, the IRS approved a deviation from IRM procedures that allowed examiners to suspend assessment of the accuracy-related penalty on the accounts of all taxpayers impacted by the Counsel Memorandum until systemic corrections could be made for Examination function cases with deficiencies more than \$5,000. The system corrections were completed in October 2012.

Of the 29 cases in our sample relating to the Chief Counsel Memorandum, 20 were for taxpayers who had received a partial refund to which they were not entitled, which resulted in an underpayment of tax within the meaning of I.R.C. § 6662. However, the deviation in policy previously described resulted in abatement of penalties totaling \$9,295. Accuracy-related penalties were assessed in the original IRS audits of the 20 returns for the following actions by the taxpayers:¹⁰

- Using an incorrect filing status and not being entitled to dependency exemptions and/or other credits (**1**).
- *****1*****.
- *****1*****.

⁹ Underpayment is defined in I.R.C. § 6664 and the implementing regulation using the following formula: Underpayment = W - (X + Y - Z), where W = the amount of income tax imposed, X = the amount shown as the tax by the taxpayer on his return; Y = the amounts assessed before the return is filed that were not shown on the return (or collected without assessment), and Z = the amount of rebates made.

¹⁰ In some cases, the amount of the erroneous credit could have been subject to a penalty under I.R.C. § 6676, which allows the IRS to assess a civil penalty on erroneous claims for refund. However, because the IRS originally included the erroneous credit amount in the underpayment subject to penalty under I.R.C. § 6662, a penalty under I.R.C. § 6676 could not also have been assessed on the amount.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Additionally, in an attempt to further quantify the amount of legitimate penalties that were abated, we analyzed IRS Individual Master File data for the universe of 168,635 penalty abatements related to the Chief Counsel Memorandum and found that penalties were abated on 386 returns that had been examined by the IRS and assessed additional taxes of \$5,000 or more,¹¹ for a total of approximately \$4.9 million.¹² Due to the IRM deviation previously described, \$985,325 in accuracy-related penalties were abated on these 386 returns, even though the penalties were legitimate and not related to the issues that were the subject of the Chief Counsel Memorandum. The IRS could have prevented these penalties from being abated by using the Individual Master File to determine the additional taxes assessed by examiners to ensure that taxpayers who had substantially understated their income were penalized. When the IRS abates penalties for taxpayers who make claims for refunds they are not entitled to, these taxpayers may make future claims knowing that if they are identified the only consequence is paying the amount of tax they originally owed.

Examination function employees did not properly apply reasonable cause criteria

For the remaining 71 abatements in our sample of 100 abated penalties originally assessed by the Examination function, we found five incorrect penalty abatements totaling \$122,722 in which examiners did not always follow reasonable cause criteria for abatements. In some cases, the examiners did not properly document the case files to show reasons for the abatements. Projected over the remaining universe of 11,288 abatements,¹³ we estimate the IRS may have incorrectly abated 354 accuracy-related penalties,¹⁴ totaling \$1.71 million.¹⁵ Specifically, we found ***1*** abatements in which examiners did not follow the criteria for reasonable cause for abatements or provide adequate documentation to support the abatements and **1****
*****1*****. The five incorrect penalty abatements involved various issues such as tax shelters, inadequate books and records, and large and/or questionable expenses.

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¹¹ We used the same approach used by the IRS in its abatement projects and did not determine whether each return met the criteria for the accuracy-related penalty for substantial understatement.
¹² The amount does not include refundable credits that were refunded to the taxpayer and later disallowed.
¹³ We found that our universe of 18,014 penalty abatements included 6,726 abatements that related to the 168,635 Chief Counsel Memorandum penalty abatement projects. We removed them from the remaining universe of FY 2012 Examination penalty abatements.
¹⁴ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 5 and 885.
¹⁵ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$122,722 and \$4,138,522.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

- ***1*** taxpayers requested abatement of their accuracy-related penalties due to reasonable cause. However, the reasons given did not meet reasonable cause criteria. These taxpayers owed additional taxes of \$194,225. These taxpayers claimed large and/or questionable expenses, underreported income, or had inadequate books and records. According to the IRM, negligence is strongly suggested if a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item “which would seem to a reasonable and prudent person to be ‘too good to be true’ under the circumstances.” In these cases, taxpayers knowingly underreported income, claimed unsubstantiated deductions and expenses to avoid paying taxes, claimed ineligible dependents, and participated in tax avoidance schemes. Based on the amount of additional taxes owed, \$38,844 in accuracy-related penalties should not have been abated.
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AUR function examiners accepted insufficient documentation and amended returns that needed additional review

We selected a statistically valid sample of 100 accuracy-related penalties assessed by the AUR function for individual taxpayer accounts from a universe of 34,453 abatements¹⁶ that were a result of reconsiderations during FY 2012. We found 16 penalty abatements totaling \$157,203 for returns that also had incorrect tax abatements totaling \$637,478. Projected to the universe of accuracy-related penalties abated in FY 2012, we estimate that approximately 5,500 accuracy-related penalties,¹⁷ totaling \$22.29 million¹⁸ may have been incorrectly abated.

When taxpayers receive a notice from the AUR function that additional taxes are being proposed on their return due to a potential discrepancy, one possible response can be to amend their original return by submitting Form 1040X, *Amended U.S. Individual Income Tax Return*, often providing substantially different amounts for income and deductions. According to the IRM, information received directly from a taxpayer will generally be taken at face value by the AUR function, including schedules of expenses submitted by the taxpayer to offset unreported income. However, the IRM also instructs AUR function examiners to consider the reasonableness of the taxpayer’s information and consult with the team leader if Examination issues are found, and consult with the Examination function if necessary.

Of the 16 cases with incorrect penalty abatements, 11 involved amended individual returns¹⁹ that included changes that were questionable and required further discussion with team leaders or the

¹⁶ Abatements of \$500 or more.

¹⁷ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 2,684 and 8,416.

¹⁸ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$3,071,221 and \$41,508,193.

¹⁹ Some of the 11 amended returns had multiple issues.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Examination function. However, these returns were accepted and both the tax assessments and penalties were abated. There was no evidence in these cases to show that the necessary discussions were held with team leaders or the Examination function. For example:

- Six amended returns had Schedules C, *Profit or Loss From Business*, with large, questionable expenses. These taxpayers were notified by the AUR function that they did not claim all their income. In response, they either submitted a new Schedule C or adjusted the expenses to their original Schedule C eliminating \$604,727 in taxes and \$120,978 in penalties. No supporting documentation, such as receipts for new or additional expenses, was submitted. In addition, **1** of the six taxpayers had similar issues in other tax years. These returns should have been sent to the Examination Classification function based on the large, questionable expenses and the taxpayer's prior history.
- Six amended returns involved changes to Schedule A, *Itemized Deductions*, Schedule D, *Capital Gains and Losses*, and unreported pension withdrawals. *****1*****
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- In four instances, we found examiners abated \$29,544 in penalties with no documentation to support reasonable cause abatements when the taxpayers agreed to the AUR function tax assessments. These taxpayers excluded up to 50 percent of their income from their returns, and acknowledged that they had made mistakes on the returns. Generally, forgetfulness or making a mistake is not in keeping with the ordinary business care and prudence standard and would not be considered reasonable cause for penalty abatement.
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The Examination and Automated Underreporter Functions Did Not Always Ensure That Accuracy-Related Penalty Abatements Were Appropriate

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Other IRS functions have more clear-cut procedures to instruct employees when issues on amended returns should be referred for further review. For example, Figure 2 shows IRM 21.5.3-2 “Category A” criteria*****2*****

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Figure 2: Category A Criteria *****2*****
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Category A Criteria
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Source: IRM 21.5.3-2.

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*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Also, IRM 21.3.1.4.56 provides guidance and examples to Accounts Management function employees for when an Individual Master File Underreporter amended return meets Category A criteria and should be referred to the Examination Classification function for review. These examples are:

- Form 1040X received with a Schedule C reducing underreported income through expense reporting and subsequently reducing self-employment tax.
- Form 1040X received with a Schedule D adjusting the basis on the underreported capital gain.
- Form 1040X filed only to change filing status and/or add a dependent.

Taxpayers who are audited by Examination function employees may have their amended returns questioned while those reviewed by AUR function employees may have their amended returns accepted as filed. The differing treatment of amended returns raises concerns about the equitable treatment of taxpayers. In addition, when examiners do not refer amended returns containing questionable issues to the Examination function, the IRS is missing an opportunity to properly assess the correct amount of taxes and penalties. Similarly, when the IRS accepts inadequate documentation, taxpayers are able to avoid paying the proper amount of taxes and avoid penalties. If examiners are not carefully considering documentation submitted by taxpayers, the IRS cannot ensure that penalties for individual taxpayers are fairly, accurately, and consistently assessed and/or abated.

Recommendations

Recommendation 1: The Commissioner, SB/SE Division, should ensure that available data analysis capabilities are used to preserve legitimately assessed penalties when using large-scale abatement projects to correct erroneously assessed accounts.

Management's Response: IRS management agreed with this recommendation and stated that they will apply lessons learned from the mass abatement process to improve their approach in the future. Because the mass abatement process is rarely used, IRS management does not anticipate the need for further corrective action.

Recommendation 2: The Director, Examination/AUR Policy, SB/SE Division, should reemphasize to examiners the rules for considering reasonable cause and properly documenting case files when abating accuracy-related penalties.

Management's Response: IRS management agreed with this recommendation and stated that they will publish an article in the Technical Digest to reemphasize the rules for consideration of reasonable cause and properly documenting case files when abating accuracy-related penalties. IRS management also stated that they will issue a memorandum to the field reemphasizing the rules and resources for applying reasonable cause and documenting case files.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

IRS management also stated that they did not agree that five examination cases were improperly abated based on the lack of documentation in the case files. In addition, management does not agree with the outcome measures as presented because of concerns with the sampling methodology.

Office of Audit Comment: As discussed in the report, in addition to a lack of proper documentation, the abatements in the five cases clearly did not meet reasonable cause criteria as outlined in the IRS's own guidance. The lack of documentation in these cases does not negate the fact that the abatements were erroneous.

Our sample and projections are statistically valid and were developed with assistance from our contract statistician. Our sample of abatements by the Examination function was selected separately from the sample of abatements by the AUR functions because of the differences in the abatement procedures between the two functions. However, the same reasonable cause criteria for abating penalties applies in both the field and automated Examination environments. Therefore, our sample of abatements by the Examination function did not distinguish between the two environments. Additionally, our sample design took into consideration the distinct characteristics of the examination and the AUR function by selecting separate samples for each, and our outcome measure was generated by forecasting the results of our audit separately as well.

We were not informed of the two large-scale abatement projects during our planning discussions with the IRS. The existence of the abatement projects was not disclosed until we had completed our sample review. Because we recognized the uniqueness of these projects, we excluded the abatement projects from our outcome measure calculation, as shown in Appendix IV.

Recommendation 3: The Director, Examination/AUR Policy, SB/SE Division, should include procedures in the AUR function manual for referring amended returns for further review.

Management's Response: IRS management agreed with this recommendation and stated that they will clarify the AUR function manual criteria for referring cases to the Examination function when there are other questionable issues raised on an amended return submitted in response to an AUR function notice.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS's controls are sufficient to ensure appropriate accuracy-related penalty abatements. To accomplish our objective, we:

- I. Identified the controls for ensuring accuracy-related penalties are properly abated when they meet the criteria for abatement.
 - A. Documented the applicable I.R.C.¹ sections, Treasury Regulations, IRM (policy and procedural) sections, management directives, examiner training materials, and IRS public announcements and notices that provide the authority and reasons for abating penalties. We also documented controls and procedures for ensuring that abatements are correctly input.
 - B. Conducted a walkthrough of the AUR program and interviewed IRS managers and operational personnel in both the AUR and Examination functions to identify ongoing changes, such as policy and procedural changes, examiner training, stakeholder outreach activities, and IRS public notices and announcements that are aimed at enhancing the administration of penalties. We determined that there were no changes to abatement procedures for abatements processed in FY 2013.
- II. Reviewed a statistically valid stratified random sample of records with accuracy-related penalty abatements to determine if the abatements were appropriate.
 - A. Obtained an extract from the Data Center Warehouse's Individual Master File to identify the population of FY 2012 accounts in which there is a Transaction Code 241² with Penalty Reference Number 680.³ To assess the reliability of our data, we matched these data to the IRS Statistics of Income Table 17 Civil Penalties Assessed and Abated for FY 2012. We determined that the data were sufficiently reliable for purposes of this report.
 - B. Selected two statistically valid stratified random samples: (1) 100 records from a universe of 18,014 Examination function records; and (2) 100 records from a universe of 34,453 AUR function records, both with a Transaction Code 241 of \$500 or greater with Master File Tax code 30,⁴ using a confidence level of 90 percent, error rate of 10 percent, and a precision rate of 5 percent. A contracted statistician assisted with

¹ See Appendix V for a glossary of terms.

² Abates a miscellaneous penalty generally associated with a penalty reference number.

³ The accuracy-related penalty is 20 percent of the applicable underpayment.

⁴ Form 1040 series.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

developing and reviewing the sampling plans and projections. We used a random sample to ensure that each taxpayer had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results.

1. Identified 6,726 records in our sample universe of 18,014 Examination abatements that were part of an IRS project related to an IRS Chief Counsel Memorandum regarding frozen refundable credits and accuracy-related penalties. During FYs 2012 through 2014, the IRS systemically abated accuracy-related penalties on 168,635 returns based on the Chief Counsel Memorandum.
 2. Matched the 168,635 returns to the IRS Individual Master File to determine the range of penalty dollars abated.
- C. Ordered Examination and AUR functions case files and related returns for the samples in Step II.B.
- D. Determined whether the examiner properly abated the penalties based on documentation in the case files.
- E. Secured agreement to the case review results from IRS management.
- F. Estimated the potential revenue that could be lost over a five-year period if examiners improperly abated penalties by applying the error rates and penalty amounts determined in the cases reviewed against examinations in our population.

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 and SB/SE Divisions' policies, procedures, and practices for abating accuracy-related penalties. We evaluated these controls by performing a review of accuracy-related penalty abatements processed by the Examination and AUR functions' examiners during FY 2012.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Appendix II

Major Contributors to This Report

Nancy Nakamura, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Bryce Kisler, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)
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Ken Henderson, Senior Auditor



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Campus Examination, Small Business/Self-Employed Division SE:S:E:CE
Director, Headquarters Examination, Small Business/Self-Employed Division SE:S:E:HQ
Director, Examination/AUR Policy, Small Business/Self-Employed Division SE:S:E:HQ:EP
Director, Examination Performance Planning and Analysis, Small Business/Self-Employed
Division SE:S:E:PP&AE
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Director, Office of Audit Coordination OS:PPAC:AC
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

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; \$1,708,726 from reducing incorrect abatements of accuracy-related penalties for negligence and substantial understatement for Examination function cases; \$8,543,630 forecasted over five years¹ (see page 4).

Methodology Used to Measure the Reported Benefit:

To estimate the potential revenue protection associated with the Examination function's incorrect abatement of accuracy-related penalties for negligence and substantial understatement of tax liabilities, we obtained an extract from the IRS Individual Master File² for all accuracy-related penalties abated in FY 2012.³ We then identified a universe of 18,014 abatements for accuracy-related penalties previously assessed by the Examination function. We stratified the records by penalty dollars abated and selected a statistically valid sample of 100 penalty abatements.

Our analysis shows 25 of 100 accuracy-related penalties were inappropriately abated. However, 20 penalties were abated based on an IRS Chief Counsel Memorandum dated May 30, 2012 (Chief Counsel Memorandum). The memorandum advised that when the IRS does not pay a refund or approve a refundable tax credit that the taxpayer claimed, but is not entitled to, the amount not paid will not be considered an "underpayment" as defined by I.R.C. § 6664, absent additional circumstances. However, the 20 taxpayers in our sample received refunds they were not entitled to; therefore, the IRS incorrectly abated the penalties.

During FYs 2012 through 2014, a total of \$215.6 million in accuracy-related penalties were abated on 168,635 returns based on the Chief Counsel Memorandum. Due to the large volume of cases, on August 21, 2012, the IRS approved a deviation from IRM procedures to allow the accuracy-related penalty not to be assessed on all pre-refund Discretionary and Earned Income Tax Credit cases until systemic corrections could be made for Examination cases with

¹ The five-year forecast for the potential for revenue protection is based on multiplying the base year result by five and assumes, among other considerations, that economic conditions and tax laws do not change.

² See Appendix V for a glossary of terms.

³ Abatements \$500 or more.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

deficiencies more than \$5,000. IRS officials informed us that based on the significant volume of potentially impacted cases they concluded it was more efficient to systemically abate all accuracy-related penalties instead of expending substantial resources to manually recalculate the correct penalty assessments.

We identified 6,726 records in our sample universe of 18,014 abatements that were part of the 168,635 penalties abated based on the Chief Counsel Memorandum. These records were removed from our sample universe. In addition, we removed 29 returns in our sample of 100 penalty abatements sampled that were part of the Chief Counsel Memorandum abatement projects. Figure 1 shows the results of our case reviews.

Figure 1: FY 2012 Examination Function Accuracy-Related Penalty Abatements

	STRATUM 1 \$0 to \$9,999	STRATUM 2 \$10,000 to \$99,999	STRATUM 3 \$100,000 to \$999,999	STRATUM 4 \$1 Million or More	TOTAL
Stratum Population	10,643	596	43	6	11,288
Percentage of Population	94.3%	5.3%	0.38%	0.05%	100%
Cases Reviewed	40	15	10	6	71
Population Dollars	\$22,990,606	\$14,933,641	\$9,047,998	\$71,330,007	\$118,302,252
Number of Exceptions	***1***	***1***	***1***	0	5
Exception Dollars	***1***	***1***	***1***	\$0	\$122,722

Source: Treasury Inspector General for Tax Administration analysis of the Individual Master File for FY 2012.

We found five of 71 accuracy-related penalties, totaling \$122,722, were inappropriately abated. Projected over the population of 11,288 abatements, we estimate 354⁴ accuracy-related penalties totaling \$1,708,726⁵ were inappropriately abated. Based on these parameters, a total of \$8,543,630 (\$1,708,726 x 5) in accuracy-related penalties could have been inappropriately abated when forecast over five years.

⁴ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 5 and 885.

⁵ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$122,722 and \$4,138,522.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$22,289,707 from reducing incorrect abatements of accuracy-related penalties for substantial understatement for AUR function cases; \$111,448,535 forecasted over five years⁶ (see page 4).

Methodology Used to Measure the Reported Benefit:

To estimate the potential revenue protection associated with the AUR function’s incorrect abatement of accuracy-related penalties for substantial understatement of tax liabilities, we obtained an extract from the IRS Individual Master File for all accuracy-related penalties abated in FY 2012. We then identified a universe of 34,453 abatements⁷ for accuracy-related penalties previously assessed by the AUR function. We stratified the records by penalty dollars abated and selected a statistically valid sample of 100 penalty abatements. Figure 2 shows the results of our case reviews.

Figure 2: FY 2012 AUR Function Accuracy-Related Penalty Abatements

	STRATUM 1 \$0 to \$9,999	STRATUM 2 \$10,000 to \$99,999	STRATUM 3 \$100,000 to \$999,999	STRATUM 4 \$1 Million or More	TOTAL
Stratum Population	32,316	2,088	***1***	***1***	34,453
Percentage of Population	93.8%	6.1%	***1***	***1***	100%
Cases Reviewed	68	20	***1***	***1***	100
Population Dollars	\$73,036,770	\$49,567,340	***1***	***1***	\$140,733,403
Number of Exceptions	11	***1***	***1***	***1***	16
Exception Dollars	\$16,375	***1***	***1***	***1***	\$157,203

Source: Treasury Inspector General for Tax Administration analysis of the Individual Master File for FY 2012.

⁶ The five-year forecast for the potential for revenue protection is based on multiplying the base year result by five and assumes, among other considerations, that economic conditions and tax laws do not change.

⁷ Abatements \$500 or more.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

We found 16 of 100 accuracy-related penalties totaling \$157,203 were inappropriately abated. Projected over the population of 34,453, we estimate 5,550⁸ accuracy-related penalties totaling \$22,289,707⁹ were inappropriately abated. Based on these parameters, \$111,448,535 (\$22,289,707 x 5) in accuracy-related penalties could be inappropriately abated when forecast over five years.

⁸ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 2,684 and 8,416.

⁹ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$3,071,221 and \$41,508,193.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Appendix V

Glossary of Terms

Automated Underreporter – The AUR Program matches items reported on an individual’s income tax return to information supplied to the IRS from outside sources (*e.g.*, employers, banks, credit unions) to determine if the taxpayer’s tax return reflected the correct amounts ensuring the tax amount is correct.

Examination Classification Function – The IRS Examination function that consists of experienced examiners who received appropriate tax law training. They determine whether a return should be selected for examination, what issues should be examined, and how the examination should be conducted.

Fiscal Year – Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government’s fiscal year begins on October 1 and ends on September 30.

Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.

Internal Revenue Code – Title 26 of the United States Code enacted by Congress containing all relevant rules pertaining to Federal tax law. This includes estate, excise, gift, income, payroll, and sales taxes.

Internal Revenue Manual – The single, official source of IRS instructions to staff. Instructions to staff are procedures, guidelines, policies, delegations of authority, and other such instructional materials relating to the administration and operation of the IRS.

Reconsideration – The process the IRS uses to reevaluate the results of a prior audit where additional tax was assessed and remains unpaid, or a tax credit was reversed.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

JUL 13 2015

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Examination and Automated
Underreporter Functions Did Not Always Ensure That Accuracy-
Related Penalty Abatements Were Appropriate (Audit #
201430026)

Thank you for the opportunity to review the subject report which examined the Internal Revenue Service's (IRS) controls on the abatement of accuracy-related penalties. The IRS's policy on penalty imposition and abatement aims to promote voluntary compliance. When determining whether a penalty is properly abated, the most important factor is the extent of the taxpayer's effort to report the proper tax liability. This determination is made on a case-by-case basis in light of the facts and circumstances of each taxpayer's case.

We appreciate your acknowledgment that there was only a small number of examination cases (5 of 71) lacking documentation that the accuracy-penalty was properly abated. Because penalty abatement is fact-specific, we agree proper documentation is essential so we can determine whether the abatement is appropriate. While the five cases may have lacked documentation, we do not agree those cases were improperly abated or contained evidence that taxpayers had knowingly attempted to understate their tax liabilities. We believe instead that the analysis should have distinguished between cases that lack documentation and cases in which the reasonable cause abatement criteria was not correctly applied to the specific facts.

As was noted in the report, a number of abatements in your sample relate to action taken as a result of a Chief Counsel memorandum dated May 30, 2012, that retroactively changed the legal interpretation of the application of Internal Revenue Code section 6662, Imposition of accuracy-related penalty on underpayments, to frozen refundable credits. Prior to that time, the IRS had assessed the accuracy-related penalties on frozen refundable credits in accordance with Chief Counsel guidance issued in 2009 and 2010. As a result of the revised guidance, the IRS was



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

2

required to adjust approximately 169,000 penalty assessments. In some cases, only a portion of the total penalty amount related to a frozen refundable credit. The IRS carefully evaluated the resources needed to ensure the penalties were corrected for all affected taxpayers. Due to resource constraints and the demands of higher priorities competing for these limited resources, we made the decision to systemically abate the entire accuracy-related penalty for the impacted cases with the understanding that, in some cases, a portion of the penalty remained proper and should not have been abated. The alternative would have required that we expend substantial resources to manually recalculate the correct penalty assessments. We agree a thorough analysis of available data is essential before making mass abatement decisions and will use lessons learned from this event to continue to improve our approach if such circumstances arise in the future. We do not agree, however, that the decision in this isolated instance may lead taxpayers to make future improper tax claims based on their belief that the penalty will again be abated.

In addition, because such a large-scale abatement project is a rare and unusual occurrence, we believe the inclusion of these mass abatements cases with the routine abatement cases in your sample overstates the reported condition. You state “[a]lthough the number and amount of accuracy-related penalty assessments increased in FY 2013, the number of abatements increased at a much higher rate.” The table provided shows that accuracy-related penalty assessments increased 20% between FY 2012 and FY 2013 and shows that abatements increased 204% during that time period. However, when the mass abatement figures are excluded from the analysis, the abatements increased only 14% from FY 2012 to FY 2013.

Finally, we disagree with the outcome measures as presented. As discussed above, TIGTA reviewed abatement cases with significant distinctions, such as whether the abatement occurred during a field examination or in an automated environment, or arose from special projects (i.e., the mass abatement); and also designated abatements with inadequate documentation as improper abatements. The distinctions between these abatements should have been considered in the sample design, and adjusted accordingly during the audit, rather than simply presenting the results, backing out the sampled mass abatements, and effectively reducing the sample size, basis and precision. Also, the calculated estimates in the Figures in Appendix IV have extremely wide ranges—e.g., between 5 and 885 for examination accuracy-related penalty abatements totaling between \$122,722 and \$4,138,522. This expansive range becomes even more pronounced if projected over five years, which is not done in the Appendix, and does not reflect the variance of abatements from year-to-year. Instead the point estimate, not the range, is multiplied by five. The forecasted five year Outcome Measure, therefore, does not afford the reader an understanding of how far such a forecasted Measure ranges based on the sample size and design. Finally, we note that penalties are not appropriately measured as “revenue” but should be measured by their influence on voluntary compliance using a multiplier effect.



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

3

Attached is a detailed response outlining planned corrective actions to address your recommendations. 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



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

Attachment

Recommendation 1: The Commissioner, SB/SE Division, should ensure that available data analysis capabilities are used to preserve legitimately assessed penalties when using large-scale abatement projects to correct erroneously assessed accounts.

Corrective Action: We will apply lessons learned from the “frozen refund” mass abatement process to continue to improve our approach if such circumstances arise in the future. Because the mass abatement process is rarely used, we do not anticipate the need for further corrective action.

Implementation Date: Implemented.

Responsible Official: N/A

Corrective Action Monitoring Plan: N/A

Recommendation 2: The Director, Examination/AUR Policy, SB/SE Division, should reemphasize to examiners the rules for considering reasonable cause and properly documenting case files when abating accuracy-related penalties.

Corrective Action: We will publish an article in the Technical Digest to reemphasize the rules for consideration of reasonable cause and properly documenting case files when abating accuracy-related penalties. We will also issue a memorandum to the field reemphasizing these rules and existing resources for applying reasonable cause and documenting case files.

Responsible Official:
Director, Examination/AUR Policy, SB/SE

Implementation Date: July 15, 2016

Corrective Action Monitoring Plan: IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 3: The Director, Examination/AUR Policy, SB/SE Division, should include procedures in the AUR function manual for referring amended returns for further review.

Corrective Action: We will clarify criteria for referring cases to Exam in the AUR function manual where there are other questionable issues raised on an amended return in response to an AUR notice.

Implementation Date: July 15, 2016



*The Examination and Automated Underreporter Functions
Did Not Always Ensure That Accuracy-Related
Penalty Abatements Were Appropriate*

2

Responsible Official: Director, Examination/AUR Policy, SB/SE

Corrective Action Monitoring Plan: IRS will monitor this corrective action as part of our internal management system of controls.