



*Few Accuracy-Related Penalties Are
Proposed in Large Business Examinations,
and They Are Generally Not Sustained
on Appeal*

May 31, 2019

Reference Number: 2019-30-036

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

FEW ACCURACY-RELATED PENALTIES ARE PROPOSED IN LARGE BUSINESS EXAMINATIONS, AND THEY ARE GENERALLY NOT SUSTAINED ON APPEAL

Highlights

Final Report issued on May 31, 2019

Highlights of Reference Number: 2019-30-036 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

Taxpayers who underreport their income tax may be subject to accuracy-related penalties (Internal Revenue Code Section 6662). The penalty is generally 20 percent of the underpayment of tax that is due, and in certain cases, the penalty may be 40 percent. If the IRS does not properly consider and propose the accuracy-related penalty, taxpayers may be treated inconsistently and unfairly, undermining tax system integrity and diminishing voluntary compliance.

WHY TIGTA DID THE AUDIT

The largest part of the Tax Gap results from taxpayers who underreport their income, accounting for \$387 billion, or about 84 percent of the IRS's 2008 through 2010 estimated gross Tax Gap. This audit was initiated to determine whether accuracy-related civil tax penalties in the Large Business and International (LB&I) Division are properly considered and proposed.

WHAT TIGTA FOUND

For Fiscal Years 2015 through 2017, TIGTA reviewed IRS databases for closed LB&I business return examinations and identified 519 examinations in which LB&I examiners proposed accuracy-related penalties totaling \$1.8 billion. The Office of Appeals worked and closed 195 appealed examinations totaling \$773 million in proposed penalties that ultimately resulted in the elimination or reduction of the proposed penalties for 183 returns totaling \$765 million.

IRS systems also identified 4,600 LB&I business return examinations that resulted in additional tax assessments greater than \$10,000, for a total of \$14 billion of additional tax due. Of these 4,600 returns, only 295 returns (6 percent) had accuracy-related penalties assessed.

IRS policy requires examiners to identify the appropriate penalties, determine whether to propose penalties, document the reasoning for proposal or nonproposal, involve supervisors in penalty development, and obtain supervisory approval for the proposal of all penalties and for the nonproposal of the substantial understatement penalty.

TIGTA's review of a stratified, statistical sample of 50 business tax returns examined by the LB&I Division with additional tax assessment greater than \$10,000 and no accuracy-related penalties assessed showed that: in 10 cases (20 percent), examiners did not consider the accuracy-related penalty; in 10 cases (20 percent), examiners did not justify their decisions not to propose the penalty; in 13 cases (26 percent), there was no indication that the supervisor approved the decision not to propose the penalty; and in 13 cases (26 percent) with substantial understatements of income tax, there was no indication of supervisory involvement in penalty development.

In addition, TIGTA's review of a stratified statistical sample of 50 business tax returns examined by LB&I examiners with accuracy-related penalties assessed showed that: in four cases (8 percent), there was no indication the supervisor approved the decision to propose the penalty, and in three cases (6 percent), there was no indication that supervisors were actively involved with the development of the penalty issues.

WHAT TIGTA RECOMMENDED

TIGTA made several recommendations to the Commissioner, LB&I Division, to help improve examiners' accuracy-related penalty decisions.

The IRS agreed with four of five of our recommendations. Management partially agreed one recommendation.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 31, 2019

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Few Accuracy-Related Penalties Are Proposed in Large Business Examinations, and They Are Generally Not Sustained on Appeal (Audit # 201730035)

This report presents the results of our review to determine whether civil tax penalties in the Large Business and International Division are properly considered and assessed. This audit is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Improving Reporting and Payment Compliance.

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

If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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Abbreviations

CIC	Coordinated Industry Cases
FY	Fiscal Year
IC	Industry Cases
IMS	Issue Management System
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International Division
LQMS	LB&I Quality Measurement System
OSP	Office of Servicewide Penalties
SB/SE	Small Business/Self-Employed Division
TIGTA	Treasury Inspector General for Tax Administration



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Background

The Internal Revenue Service (IRS) uses penalties to enhance voluntary compliance.¹ Penalties encourage voluntary compliance by demonstrating the fairness of the tax system to compliant taxpayers and increasing the cost of noncompliance.² The largest part of the Tax Gap results from taxpayers who underreport their income, accounting for \$387 billion, or about 84 percent of the IRS's Tax Year 2008 through 2010 estimated gross Tax Gap.³

The IRS's Examination program is its largest compliance program spanning three of its operating divisions: ***Large Business and International (LB&I) Division*** (which is responsible for the tax compliance of partnerships, S and C corporations with assets of \$10 million or more, and individuals with high wealth or with international tax implications); ***Small Business/Self-Employed (SB/SE) Division*** (which examines other businesses with assets of less than \$10 million); and ***Wage and Investment Division*** (which examines taxpayers who have claimed certain refundable credits).

Accuracy-related penalties typically range from 20 to 40 percent of the tax amount owed but not properly reported.

IRS examiners are primarily responsible for determining the correct liabilities for taxpayers by conducting examinations. Examiners are responsible for considering the applicable penalties when recommending adjustments to tax liabilities and are required to fully explain and document the penalty issue, including accuracy-related penalties, when there is an indication the penalty should apply.⁴ The IRS directs managers to perform a meaningful review of the examiner's penalty determination prior to assessment, and approval must be in writing.⁵

The purpose of penalties generally is to encourage tax compliance.⁶ The accuracy-related penalty is one of the various civil penalties in the Internal Revenue Code (I.R.C.).⁷ The penalty amount is generally 20 percent of the underpayment of tax attributable to:⁸

- Negligence or disregard of rules or regulations – I.R.C. Section (§) 6662(c).

¹ Internal Revenue Manual (IRM) 1.2.20.1.1(1) (June 29, 2004). See Appendix IV for a glossary of terms.

² IRM 1.2.20.1.1(3) (June 29, 2004).

³ The gross Tax Gap is the amount of true tax liability that is not paid voluntarily and timely without taking into consideration the impact of late payments and revenue collected via enforcement actions. *IRS Tax Gap Estimates for Tax Years 2008 through 2010* (April 2016).

⁴ IRM 4.46.4.11.6 (Dec. 13, 2018); IRM 4.46.4.11.1 (1&3) (Dec. 13, 2018); IRM 4.46.4.2(4) (Dec. 13, 2018).

⁵ IRM 20.1.1.2.3.1 (Nov. 25, 2011). The words "manager" and "supervisor" have the same meaning in this report.

⁶ IRM 20.1.1.2 (Nov. 21, 2017).

⁷ I.R.C. § 6662.

⁸ IRM 20.1.5.1.1(2) (Dec. 13, 2016).



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- Substantial understatement of income tax – I.R.C. § 6662(d).
- Substantial valuation misstatement – I.R.C. § 6662(e).
- Substantial overstatement of pension liabilities – I.R.C. § 6662(f).
- Substantial estate or gift tax valuation understatement – I.R.C. § 6662(g).
- Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of I.R.C. § 7701(o)) – I.R.C. § 6662(b)(6).
- Any nondisclosed noneconomic substance transactions – I.R.C. § 6662(i).
- Any undisclosed foreign financial asset understatement – I.R.C. § 6662(b)(7) and (j).
- Any inconsistent estate basis – I.R.C. § 6662(b)(8).
- Understatements related to the listed or reportable transactions – I.R.C. § 6662A.

In certain cases with gross valuation misstatements, the penalty may be 40 percent.⁹ Understatements attributable to transactions lacking economic substance are penalized at 20 percent, which may be increased to 40 percent if the information is not adequately disclosed on the return.¹⁰ In addition, for listed or reportable transactions, the penalty is 30 percent of the reportable transaction understatement if not properly disclosed.¹¹

An understatement of income tax for individual returns is considered substantial if it exceeds the greater of: 1) 10 percent of the tax required to be shown on the return for a taxable year or 2) \$5,000.¹² Corporations (other than S corporations or personal holding companies) have a substantial understatement of income tax if the amount of the understatement exceeds the lesser of: 1) 10 percent of the tax required to be shown on the return for a taxable year (or, if greater, \$10,000) or 2) \$10,000,000.¹³

For the substantial understatement of income tax penalty, the amount of the understatement is reduced by the portion of the understatement that is attributable to: (1) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment or (2) any item if the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of such item by the taxpayer.¹⁴ In no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment

⁹ I.R.C. § 6662(h).

¹⁰ I.R.C. § 6662(b)(6) and § 6662(i).

¹¹ I.R.C. § 6662A.

¹² I.R.C. § 6662(d)(1)(A).

¹³ I.R.C. § 6662(d)(1)(B).

¹⁴ I.R.C. § 6662(d)(2)(B).



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does not clearly reflect the income of the corporation.¹⁵ Also, these reductions do not apply to items attributable to a tax shelter.¹⁶

The IRS reported that the gross underreported income tax of large corporations alone averaged an estimated \$28 billion annually from Tax Years 2008 through 2010.¹⁷ This creates a significant compliance challenge for the Examination function within the LB&I Division, requiring examiners to carefully consider the accuracy-related penalty during their examinations resulting in an underpayment of tax attributable to understated income and overstated expenses.

The Office of Servicewide Penalties (OSP), which is in the Operation Support function of the SB/SE Division, has overall responsibility for the IRS's penalty program, including the *Penalty Handbook* (which is the primary source of authority for the administration of penalties by the IRS). More specifically, the OSP is supposed to coordinate policies and procedures concerning the administration of penalty programs, ensure consistency with the penalty policy statement, review and analyze penalty information, research penalty effectiveness on compliance trends, and determine appropriate actions necessary to promote voluntary compliance. LB&I Division employees are required to follow these same procedures and guidelines administered by the OSP.

This review was performed at the LB&I Division and SB/SE Division Examination field offices in Plantation, Florida; New York, New York; and Houston, Texas; during the period of August 2017 through December 2018. 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹⁵ I.R.C. § 6662(d)(2)(B).

¹⁶ I.R.C. § 6662(d)(2)(C).

¹⁷ *IRS Tax Gap Estimates for Tax Years 2008 through 2010* (April 2016).



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Results of Review

Accuracy-Related Penalties Are Infrequently Proposed by the Large Business and International Division

For Fiscal Years (FY) 2015 through 2017, the Treasury Inspector General for Tax Administration (TIGTA) reviewed the IRS Issue Management System (IMS) and identified 6,709 business tax returns worked and closed by LB&I examiners. Accuracy-related penalties were proposed¹⁸ for 519 (8 percent) of those returns in the amount of \$1.8 billion. Taxpayers appealed 308 (59 percent) of the 519 returns with proposed penalties in the amount of \$1.5 billion. As of December 2018, the Office of Appeals had completed their work on 195 of the 308 appealed returns, resulting in the elimination or reduction of the proposed penalties for 183 returns totaling \$765 million.

For the same time period, TIGTA reviewed the IRS Audit Issue Management System for closed LB&I examinations that resulted in additional tax assessments greater than \$10,000 and identified 4,600 business tax returns with assessments of \$14.4 billion of additional tax. TIGTA limited the population to examined business returns with additional tax assessments greater than \$10,000 due to a higher likelihood that accuracy-related penalties, such as the substantial understatement penalty, would apply. Accuracy-related penalties on these returns were ultimately assessed on 295 (6 percent) returns totaling \$343 million, representing 12 percent of the total understatements. Additional assessments of income tax ranged as high as over \$750 million, with an overall average of \$3.1 million per return examined. Even though additional assessments of tax on these examined returns are significant, few accuracy-related penalties were ultimately assessed.

Examiners' proposed accuracy-related civil penalties may be eliminated by the Office of Appeals

The IMS is a computer-based system used by LB&I examiners to manage their business examination workload. The IMS is designed to obtain and retain some examination workpapers and other examination case data. When the examiner determines to propose a civil penalty in an examination, the amount of the proposed penalty is shown on the examiner's final examination report and is entered into the IMS closing screen penalty field. Although the IMS penalty field is supposed to represent the examiner's final proposed penalty for the examined return, the proposed penalty may be decreased or eliminated if the case is appealed. IRS management

¹⁸ The accuracy-related penalty is "proposed" when the penalty amount is shown on the examiner's final examination report.



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stated that it is possible the proposed penalty amount entered into the IMS case closing screen may be incorrect and that the system is not relied upon by IRS management for tracking the proposed penalty; however, it is the only system the LB&I Division has to track proposed penalties.

Before the examination is closed, taxpayers can request penalty relief by presenting reasonable cause arguments to examiners on some proposed civil penalties. Examiners determine whether the taxpayer acted with reasonable cause and in good faith on a case-by-case basis, taking into account all the relevant facts and circumstances of the case. For example, reasonable reliance on tax advice and an honest and reasonable misunderstanding of fact or law are common reasonable cause arguments used by taxpayers. In these cases, examiners consider a variety of factors such as the taxpayer's education, sophistication, and business experience level. Advice from a tax advisor must be based on reasonable factual or legal assumptions or representations. Taxpayers can also reduce an understatement subject to the substantial understatement of income tax penalty by demonstrating that there was substantial authority for the item or that all relevant facts related to the item were disclosed on the tax return and that there was a reasonable basis for the tax treatment of the item.

Taxpayers may also appeal a proposed tax assessment or penalty to the Office of Appeals (Appeals). Appeals may reduce or eliminate a penalty when the underpayment of tax from the issue adjustment for which the penalty relates is reduced or eliminated. Appeals can also reduce or eliminate a penalty when accepting a penalty defense, such as reasonable cause raised by the taxpayer, that the examiner did not. Appeals can make this decision for several reasons, such as hazards of litigation (when analysis shows there is a high risk the penalty will not be upheld in tax court), insufficient development of the issue, or new information provided by the taxpayer not previously considered by the examiner. When information is received during the Appeals process that was not previously considered by the examiner, Appeals can either send the case back to the examiner to consider it or have the examiner review the information while Appeals maintains control over the case.

IMS data shows that there were 211 closed LB&I business return examinations with proposed accuracy-related penalties in the amount of \$357.1 million, from FYs 2015 through 2017, that were not appealed by the taxpayers.¹⁹ Proposed penalties may change if the taxpayer appeals the examiner's proposed tax adjustment or penalty to Appeals. Over the same three-year period, taxpayers appealed 308 cases, compared to 211 cases that were not appealed. Figure 1 compares the IMS proposed accuracy-related penalty amounts for closed LB&I business return examinations from FYs 2015 through 2017 with the actual penalty assessments for cases that were appealed by the taxpayers.²⁰

¹⁹ These cases are the LB&I business return examinations with a proposed accuracy-related penalty in the IMS database that were not closed to Appeals from FYs 2015 through 2017.

²⁰ These cases are the LB&I business return examinations with a proposed accuracy-related penalty in the IMS database that were closed to Appeals from FYs 2015 through 2017.



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Figure 1: Examiner-Proposed Accuracy-Related Penalties Compared to Final Assessments – Appealed Business Return Cases

Proposed Accuracy-Related (I.R.C. § 6662) Penalty Outcome	Number of Closed Cases to Appeals (FYs 2015–2017)	Examiners' Proposed Penalty Amount	Final Assessed Penalty Amount
No Change	12	\$5,728,985	\$5,728,985
Eliminated	153	\$740,483,414	\$0
Decreased	30	\$26,665,808	\$2,540,633
Open in Appeals	113	\$689,601,716	N/A
Total	308	\$1,462,479,923	\$8,269,618

Source: TIGTA analysis of IMS and Business Master File data.

Over the three year period, 308 (59 percent) of 519 total closed cases with proposed accuracy-related penalties were appealed. As of December 2018, 195 of the 308 cases were worked and closed by Appeals. Results show that only 12 (6 percent) of 195 closed appealed cases resulted in penalty assessments that did not change from the examiner proposed penalties, totaling \$5.7 million. The entire penalty amount was eliminated for 153 (78 percent) of the closed appealed cases, totaling approximately \$740 million. For 92 (60 percent) of the 153 cases, there was no penalty assessed because there was no resulting additional tax adjustment on the account.

Penalties were also reduced by Appeals for 30 (15 percent) of the 195 closed cases, decreasing from \$26.7 million to \$2.5 million. Collectively for the 195 cases that were appealed and are now closed, Appeals did not sustain 98.9 percent of the proposed accuracy-related penalty amounts (\$764.6 million of \$772.9 million) for these LB&I Division cases. There are 113 cases still open and being worked in Appeals, with proposed penalty amounts of \$689.6 million.

LB&I Division examiners assess proportionally fewer accuracy-related penalties than SB/SE Division examiners

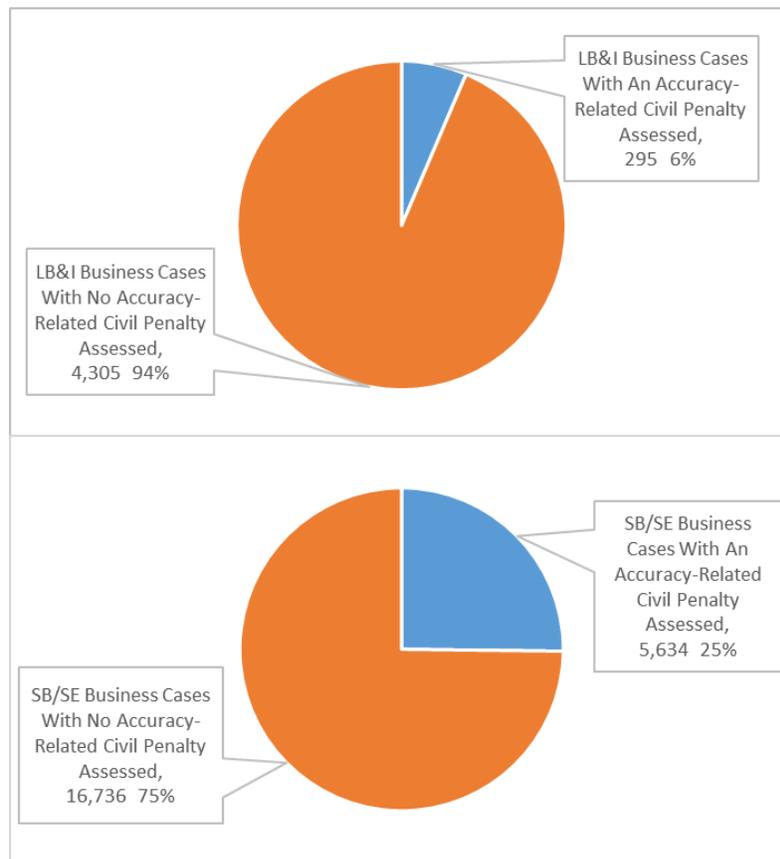
It is important that the IRS's consideration and proposal of accuracy-related penalties during examinations is fair and consistent across the business units. Requirements to consider and propose accuracy-related civil penalties are the same across the entire IRS Examination program. In addition, all IRS functions must use the IRS's civil penalty guidelines.

Our analysis of closed business examination cases with additional tax assessments greater than \$10,000 showed that LB&I Division examination assessed a significantly smaller percentage of accuracy-related penalties than those assessed by SB/SE Division examinations. Figure 2 compares the number and percentages of LB&I and SB/SE business return examinations for which accuracy-related penalties were assessed during FYs 2015 through 2017.



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Figure 2: Business Return Examination Cases With Additional Tax Assessments Over \$10,000 and Assessed Accuracy-Related Penalties for the LB&I and SB/SE Divisions – FYs 2015 through 2017



Source: TIGTA analysis of Audit Issue Management System data.

Over the three fiscal years, the number of closed LB&I business examination cases with assessed accuracy-related penalties averaged six percent, compared to 25 percent of closed cases worked by SB/SE examiners. The disparity may be attributable to the differences in LB&I and SB/SE business taxpayers. For example, the LB&I Division examines businesses with assets of more than \$10 million, while the SB/SE Division examines businesses with assets of \$10 million or less. Therefore, LB&I business cases are larger and more complex than SB/SE cases. In addition, IRS management stated that LB&I taxpayers are sophisticated business owners or publicly traded companies, with the majority having their own internal tax department, a tax director or controller, *etc.*, and that SB/SE taxpayers may be less likely to employ full-time tax expertise. Another factor, according to IRS management, is that substantial understatement accuracy-related penalties in large business returns may be less likely to apply when tax understatements are less than 10 percent of the corrected tax liability, even though the additional tax exceeds \$10,000.



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Another reason for the disparity between LB&I Division and SB/SE Division assessment of accuracy-related penalties may also be attributable, at least in part, to other conditions we identified during this audit. Specifically, LB&I examiners did not always consider or justify the penalty decision, and supervisors were not always involved in the decision to propose, or not propose, the penalty. In addition, the IRS's quality review systems do not address all required actions that examiners must take for proper consideration of civil penalties.

Recommendation

Recommendation 1: The Commissioner, LB&I Division, should conduct a study to: 1) understand the reason why examiners' proposed tax assessments and accuracy-related penalties are not being sustained by Appeals and 2) evaluate whether examiners are taking into account all the relevant facts and circumstances before proposing the tax adjustments and accuracy-related penalties.

Management's Response: The IRS partially agreed with the recommendation. The IRS will discuss with Appeals whether there is information available to help the LB&I Division better understand why Appeals did or did not sustain accuracy-related penalties.

The IRS also stated that it is important to recognize two fundamental points in considering this issue, both of which somewhat constrain the efficacy of this recommendation. First, the LB&I Division's mission is different from that of Appeals, which is tasked with resolving tax controversies, without litigation, on a basis that is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service. As such, Appeals can resolve issues/cases based on Appeal's assessment of the hazards of litigation, whereas examination employees cannot resolve cases on that basis.

Second, the IRS notes that penalty resolution varies from case to case and issue to issue. The LB&I Division already analyzes Appeals Case Memorandums (ACMs) on individual issues to better understand Appeals' views; however, that is not as effective for penalty issues because so many may be conceded if the underlying issue is conceded in whole or in part. The reasons for Appeals to concede penalties are case-specific and frequently relate to its settlement authority for the case as a whole, which does not provide insight to examiners.

Office of Audit Comment: We believe that the IRS should have a single approach to penalty issuance and that large corporations should be subject to the accuracy-related penalty to the same extent as small businesses. The LB&I Division should understand whether there is a reluctance among its revenue agents to impose the accuracy-related penalties on large corporations and, in the instances in which the penalty is proposed, to understand the specific factors Appeals will rely upon to sustain the penalty.



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Examiners Did Not Always Consider or Justify Accuracy-Related Penalties, and Supervisors Were Not Always Involved in Penalty Development and Approval

Examiners are responsible for identifying the appropriate penalties, determining whether to propose penalties, and accurately calculating the penalty amount. In addition, the case file should fully document the consideration, reasoning for proposal or nonproposal, and computation of all applicable penalties. Examiners must also document the supervisor's involvement on Form 9984, *Examining Officer's Activity Record*, and in the workpapers related to the penalty under consideration.

For LB&I cases, all adjustments, including penalties, are proposed and incorporated in writing on Form 5701, *Notice of Proposed Adjustments*, and Form 886-A, *Explanation of Items*.²¹ Form 5701 provides a summary of the proposed adjustment and Form 886-A provides a detailed explanation of the adjustment. The IMS is used to prepare the Form 5701 and Form 886-A, and before these forms are issued to the taxpayer, they need to be reviewed and approved by the supervisor. In addition, the IMS offers an option to use pro forma lead sheets for many issues, including penalties. The penalty lead sheet documents whether the appropriate penalties were considered and is referenced to the supporting workpapers showing the reason for proposal or nonproposal. The lead sheet must be approved by the supervisor for nonproposal of the penalty when there is a substantial understatement of income tax under I.R.C. § 6662(d). For most LB&I cases, a final examination report is prepared on Form 4549, *Income Tax Examination Changes*, for which supervisory approval should be secured and documented before the report is presented to a taxpayer for signature.²²

Our review of a stratified, statistical sample of 50 closed LB&I business return examinations (cases) with accuracy-related penalties assessed²³ and a stratified, statistical sample of 50 LB&I business return examinations for which there were additional tax assessments greater than \$10,000 and no accuracy-related penalties assessed²⁴ showed that examiners are not always considering penalties, not always supporting their decisions for nonproposal of accuracy-related

²¹ IRM 4.46.4.11 (Mar. 9, 2016).

²² IRM 4.46.6.7 (Apr. 16, 2014).

²³ Using the Audit Issue Management System and the IMS databases, TIGTA identified a population of 280 Business Master File tax returns examined by LB&I Division revenue agents and closed from FYs 2015 through 2017 in which the accuracy-related penalties were assessed. A taxpayer could have more than one tax return examined in this population. In addition, a case could have more than one exception issue.

²⁴ Using the Audit Issue Management System and the IMS databases, TIGTA identified a population of 4,519 Business Master File tax returns examined by LB&I Division revenue agents and closed from FYs 2015 through 2017 in which there was an additional tax assessment greater than \$10,000 and the accuracy-related penalty was not assessed. A taxpayer could have more than one tax return examined in this population. In addition, a case could have more than one exception issue.



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Lack of clarity in IRS procedures may also be contributing to employee confusion. Specifically, LB&I examination procedures do not specify if the team coordinator or the field specialist is responsible for development of the civil penalty, stating only that team coordinators are responsible for the accuracy of the Revenue Agent Report prior to issuing it to the taxpayer. In addition, the IRS *Penalty Handbook*, which contains the IRS Service-wide penalty procedures, does not give specific procedures for a team coordinator or field specialist. The only specific instruction for LB&I examiners is that LB&I team members should document managerial supervisory involvement on the *Standard Audit Index Number Lead Sheet 011*. Therefore, procedures used for penalty development are not specific or clear on which LB&I team members should develop the penalty issues and who is ultimately responsible for it.

If examiners do not consistently consider accuracy-related penalties in required cases, it undermines the fairness and integrity of the tax system and diminishes voluntary compliance. Based on our case review results, we projected the errors to the population of 4,519 examined business returns with additional tax assessments greater than \$10,000 for which no accuracy-related penalties were assessed using a 17.79 percent overall estimated error rate, a ± 12.0 percent precision factor, and a 95 percent confidence level. We estimate that examiners did not properly consider the accuracy-related penalty in 804 cases as required. We are 95 percent confident that the actual value is between 261 and 1,347 cases.

Without an explanation of the basis for the decision not to propose the accuracy-related penalty, there is a higher risk that LB&I Division examiners' decisions not to propose the penalties are incorrect. Based on review results, we projected the errors to the same population using a 20.56 percent overall estimated error rate, a ± 15.3 percent precision factor, and a 95 percent confidence level. We estimate that examiners did not properly support their decisions not to propose the accuracy-related penalty as required in 929 cases. We are 95 percent confident that the actual total value is between 281 and 1,577 cases.

Supervisors were not always involved in the development and approval of accuracy-related penalty decisions

IRS procedures require the approval of supervisors in any case for which there is a substantial understatement of tax and no penalty is proposed. Supervisory approval of all accuracy-related penalties must be documented on the examiner's penalty lead sheet.²⁷ In addition, I.R.C. § 6751(b)(1) states that, in general, no penalty under Title 26 (the I.R.C.) shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate. IRS procedures also require LB&I Examination group managers to be actively involved with the development of all penalty issues, and examiners must document the

²⁷ IRM 4.46.4.11.2 (Dec. 31, 2018); 20.1.5.1.4.1 (Dec. 13, 2016).



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supervisor's involvement on Form 9984, *Examining Officer's Activity Record*, and in the workpapers related to the penalty under consideration.²⁸

When penalties were assessed, our review of the 50 cases showed that in:

- ****1**** (8 percent) cases, there was no indication the supervisor approved the decision to propose the penalty as required by law or the approval was not timely. *****1*****
*****1*****
*****1*****
*****1*****
*****1*****²⁹
- Three (6 percent) cases, there was no indication that supervisors were actively involved with the development of the penalty issues. IRS management disagreed with these three cases based on missing or incomplete paper case files.

When penalties were not assessed, our review of the 50 cases showed that in:

- 13 (26 percent) cases, there was no indication that the supervisor approved the decision not to propose the penalty. IRS management agreed that, in four cases, the supervisor did not approve the examiner's decision not to propose the penalty. In the other nine cases, the IRS disagreed based on missing or incomplete paper case files.
- ***1*** (26 percent) cases with substantial understatements of income tax, there was no indication of supervisory involvement in penalty development. In *****1***** IRS management disagreed and stated that supervisory involvement for the development of the penalty did not apply because examiners did not propose the penalty. However, supervisors are required to be involved in development of accuracy-related penalty issues due to the substantial understatement of income tax whether the penalties are proposed or not proposed. *****1*****
*****1*****

The wording used in the Internal Revenue Manual (IRM) examination procedures for LB&I examiners may lead to misinterpretation of the requirement for supervisory involvement in cases without proposal of the penalty. IRM procedures for LB&I examiners state that group managers (supervisors) must:

- 1) Be actively involved with the development of all penalty issues.
- 2) Approve any penalty proposed and any case for which there is a substantial understatement of tax and no penalty proposed.

While instruction number two for the penalty approval specifies when the requirement applies to penalties that will be proposed (any penalty) and not proposed (substantial understatement of tax

²⁸ IRM 4.46.4.11.1 (Dec. 31, 2018); IRM 4.46.11.2 (Dec. 31, 2018).

²⁹ The missing case documentation problems are discussed later in this report.



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accuracy-related penalty), supervisory involvement instruction number one is not specific. In fact, this confusion appears to extend to higher levels of IRS management, who argued that supervisory approval was not required for our sampled cases because the penalty was not proposed. However, without supervisory involvement in penalty development of the decision to propose or not propose the accuracy-related penalty, there is a higher risk of inconsistent or incorrect penalty decisions.

In addition, when the proposal of an accuracy-related penalty does not receive supervisory approval or is untimely approved, there is a risk of loss of penalty revenue in tax court legal challenges. A recent case disputing a large accuracy-related penalty was ultimately ruled in favor of the taxpayer by the Second Circuit Court of Appeals because the IRS had not met its burden in providing written supervisory approval for the penalty.³⁰

Based on review results of the stratified, statistical sample of 50 cases, we projected the errors to the population of 280 examined business returns for which accuracy-related penalties were assessed using a 9.43 percent overall estimated error rate, a ± 8.6 percent precision factor, and a 95 percent confidence level. We estimate that supervisors were not actively involved in the development of penalty issues or did not approve the decision to propose the penalty as required in 26 cases.³¹ We are 95 percent confidence that the actual total value is between two and 50 cases.

In addition, based on the review results of the stratified, statistical sample of 50 cases, we projected the errors to the population of 4,519 examined business returns with additional tax assessments greater than \$10,000 in which accuracy-related penalties were not assessed, using a 23.34 percent overall estimated error rate, a ± 14.5 percent precision factor, and a 95 percent confidence level. We estimate that group supervisors were not actively involved in the development of penalty issues or did not approve the decision not to propose the penalty when required in 1,055 cases.³² We are 95 percent confident that the actual value is between 399 and 1,711 cases.

The quality review system within the LB&I Division may not address all required actions associated with the proposal or nonproposal of civil penalties

IRS procedures require managers to institute, on an ongoing basis, a quality review system that evaluates the timely and correct disposition of penalty cases and encourages consistent administration of penalties.³³ The LB&I Division has an independent quality review system, known as the LB&I Quality Measurement System (LQMS), that uses standard measures (attributes) to determine examiner work quality on closed examination cases.

³⁰ Chai v. Commissioner, 851 F.3d 190 (2nd Cir. 2017).

³¹ See Appendix I for more details on how the projection was calculated.

³² See Appendix I for more details on how the projection was calculated.

³³ IRM 20.1.1.1.3 (Dec. 11, 2009).



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LQMS error rates for the penalty supervisory approval attribute averaged 1.3 percent over the four quarters in FY 2016 and increased to an average of 4 percent in FY 2017. These results are significantly lower than our sampled case review findings, in which error rates were in the 8 percent range for proposed cases and 26 percent range nonproposed cases.³⁴

LQMS error rates for the examiner's consideration and supporting statements for the penalty decision were higher, averaging 15 percent in FY 2016 and increasing slightly to an average of 16 percent in FY 2017. These results were also significantly lower than our findings of 40 percent for nonassessed cases. Specifically, in 20 percent of cases, examiners did not consider the accuracy-related penalty as required, and in 20 percent of cases (those in which examiners did consider the penalty), examiners did not make supporting statements explaining the examiner's decision not to propose the penalty.³⁵

The disparity between our results and the LQMS results may be attributable to the depth of the review. We completed a detailed case review of all required actions associated with civil penalties. LQMS measures quality performance by assessing compliance with two attributes to determine if examiners are properly working civil penalty issues. However, one of the attributes assesses managerial involvement in penalty issues based on whether the examiner obtained written supervisory approval for proposal (or nonproposal of the substantial understatement penalty) of the penalty rather than requiring evidence of managerial involvement to be documented in the case history as instructed in IRM guidelines.

In addition, the OSP, which has overall responsibility for the IRS's penalty policies, developed the Civil Penalty Accuracy Review Process to enhance controls of the accuracy of penalty assessments and abatements. This biannual review measures the accuracy of the calculation of civil penalties assessed or abated. However, these reviews do not determine whether examiners adequately supported their decisions to propose or not propose the civil penalties. OSP employees advised us that the OSP has not conducted physical case reviews of closed penalty cases in many years due to budget limitations.

Recommendations

The Commissioner, LB&I Division, should:

Recommendation 2: Ensure that examiners and supervisors are trained to: 1) consider the accuracy-related penalty for all applicable examination cases; 2) follow the proper procedures to document all actions taken during penalty consideration and development, whether proposing or

³⁴ LQMS error rates for FYs 2016 and 2017 are based on nine reviewed cases. The accuracy-related penalty is mentioned in eight of the nine cases.

³⁵ LQMS error rates for FYs 2016 and 2017 are based on 58 reviewed cases. The accuracy-related penalty is mentioned in 10 of the 58 cases.



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not proposing the penalty; and 3) follow the requirements for supervisory involvement and timely, written approval of all penalty decisions.

Management's Response: The IRS agreed with the recommendation. The IRS stated that the Penalty Practice Network will provide materials for all LB&I employees on procedures to document penalty considerations and development and the requirements for supervisory involvement and timely written approval of penalty decisions. The Penalty Practice Network will also consider revising the penalty lead sheet to address this recommendation.

Recommendation 3: Revise IRM 4.46 guidelines to: 1) clearly indicate which LB&I examiners are ultimately responsible for penalty development and documentation and 2) provide more specificity on the requirements of supervisory involvement in penalty development when proposing and not proposing penalties.

Management's Response: The IRS agreed with the recommendation. The IRS stated that IRM 4.46 has recently been updated for some penalty-related matters. IRM 20.1.1, *Penalty Handbook, Introduction and Penalty Relief*, is in the process of being updated. The Penalty Practice Network will review and provide recommendations, if any, for potential additional updates.

Recommendation 4: Ensure that quality review systems are adequate and can accurately determine whether examiners are properly considering civil penalties, adequately supporting penalty decisions, consistently involving management, and obtaining required approvals.

Management's Response: The IRS agreed with the recommendation. The Quality Review and Analysis function will review the IRM, including any updates or revisions, to determine if and how the quality review process should be modified to consider examiner and management responsibilities related to accuracy-related penalties.

Many Closed Examination Paper Case Files Were Missing or Incomplete

The LB&I Division has traditionally divided its business taxpayers into two broad categories: Coordinated Industry Cases (CIC) and Industry Cases (IC). Any case assigned to the LB&I Division for which the taxpayer and its effectively controlled entities warrant the application of team examination procedures is identified as a CIC case. Generally, a team of examiners is assigned to a CIC case. In contrast, IC case are those cases that have not been defined as CIC cases or generally have one or two examiners assigned to the case.

The LB&I closing procedures require all IC examination workpapers to be forwarded with the closed paper case file to the IRS's Centralized Case Processing function. Staff in Centralized Case Processing perform some of the closing actions on the cases before forwarding the closed examination files to the Federal Records Center. However, CIC examination workpapers are



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kept in the LB&I Examination group. LB&I closing procedures state that CIC workpapers should be forwarded to the Federal Records Center no earlier than four years after the date of closing. In addition, examiners are required to upload completed examination workpapers into the IMS for cases with at least one unagreed issue but are not required to upload completed workpapers for cases with all agreed issues.

During our review in April 2018, we ordered the closed examination paper case files via normal ordering procedures through the Integrated Data Retrieval System.³⁶ Normal processing time for receipt of the files is approximately 12 business days. However, as of May 2018, we had only received eight complete paper case files for the 90 sampled cases ordered. We then followed procedures to order the files via a special search request directly through Centralized Case Processing staff. Centralized Case Processing staff work directly with the Federal Records Center to locate the examination files. At that point, we also engaged LB&I leadership and experts for their assistance in locating the files over a period of several months throughout this audit.

Although we reviewed the documentation that was available in the IMS for all sampled cases and any partial or complete paper files received, as of September 2018, the IRS had not located the complete examination paper case files for 29 (32 percent) of 90 requested files.

Figure 3: Status of Requested Sample Cases as of September 2018

Status of Case Files	IC	CIC
Case Files Received	47	14
Partial Case File Received	19	5
No Case File Received	5	0
Total	71	19

Source: TIGTA analysis of sample cases ordered as of September 2018.

We received the complete paper case file documentation from the Federal Records Center for 47 (66 percent) of the 71 IC cases ordered. However, for 24 IC cases (34 percent), we only received a partial paper case file or no case file. We received the complete paper case files or copies of paper case file documentation for 14 cases (74 percent) of the 19 CIC cases ordered, but we only received partial paper case files for five CIC cases ordered.

IRS management explained that CIC cases are kept in the field groups because they have ongoing examinations. The IRS provided the supervisor or examiner names for us to contact in some of these cases. However, for five cases, only a partial paper case file was provided. IRS management could not explain why we did not receive the 24 complete IC workpaper case files

³⁶ TIGTA used required examination file ordering procedures based on IRM 3.5.61.



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from the Federal Records Center, stating that they believe the problem is that employees are not ordering the case files properly.

If the completed, closed examination files cannot be found, the IRS may not be able to defend itself in tax court situations when documentation is needed to support examination decisions. In addition, there is a risk that missing taxpayers' files could be exposing taxpayers to fraud or identity theft. For example, uncontrolled or lost taxpayer examination files include personally identifiable and proprietary information that could be vulnerable to unlawful disclosure to third parties.

After reading a draft version of this report, IRS management provided us with most of the remaining paper case files that were missing or incomplete during the months of November and December 2018. TIGTA ultimately received and subsequently reviewed the complete paper case files for 72 of the 90 requested files. IRS management explained that, while procedures to request case files exist, management is not sure that IRS employees ordering the cases were aware of them. However, this reason does not explain why TIGTA auditors did not receive the complete case files when following the proper IRM procedures or why it ultimately took over seven months for the IRS to obtain those files.

Recommendation

The Commissioners, LB&I Division and Wage and Investment Division, should:

Recommendation 5: Using the IRS's Lean Six Sigma team or other process improvement resources, evaluate the procedure for closing, shipping, and storing paper examination case files and take corrective action to improve the process.

Management's Response: The IRS agreed with the recommendation. The IRS will review case closing and shipping procedures and the procedures to request closed case files from the Federal Records Center to determine whether additional clarity is needed and to ensure that employees are aware of the procedures.

The IRS further stated that it believes employees follow the rules relating to record retention policies. While TIGTA experienced problems in securing closed case files, the IRS believes that was due to many factors, including how the files were requested, the Document Locator Number used, the fact that the entire CIC case could not be provided due to its size, and that not all case information is initially closed to the Federal Records Center. Nonetheless, the IRS agreed that TIGTA's report highlights the need for the IRS to evaluate improvements or adjustments to its current file retrieval process.

Office of Audit Comment: As discussed on page 15 of this report, IRM procedures require all IC examination workpapers with the closed paper case file to go to the IRS's Centralized Case Processing function for closing actions and then to be sent to the Federal Records Center. TIGTA followed the IRM procedures to order the cases and provided the IRS with all the information used in the ordering process, including the



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Document Locator Numbers, to assist with locating the files. As of December 2018, we had only received partial closed files for 12 IC cases and received no files for four IC cases. Even if not all workpapers are initially sent to the Federal Records Center, as management states in their response, the fact remains the IRS was not able to provide the remaining workpapers.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether accuracy-related civil tax penalties in the LB&I Division are properly considered and assessed. To accomplish our objective, we:

- I. Evaluated the adequacy of controls, requirements, and processes for considering and assessing the accuracy-related penalties.
 - A. Reviewed the applicable I.R.C. sections, IRM¹ (policy and procedural) sections, management directives, and examiner training materials to obtain an understanding of the audit areas.
 - B. Interviewed territory/group managers and revenue agents in Plantation, Florida; New York, New York; and Houston, Texas, to discuss the policies, procedures, and training used in the three field offices to properly consider and assess accuracy-related penalties. Locations were determined by identifying locations that had various levels of staff from the different LB&I practice areas.
 - C. Interviewed Appeals management to obtain an understanding of the procedures and guidelines for working appealed LB&I examination cases and to identify the criteria and reasoning used by Appeals officers when reviewing and settling cases with proposed assessments of accuracy-related penalties.
- II. Evaluated the methods and business results that LB&I Division management and the OSP use to measure the proper use and assessment of civil tax penalties.
 - A. Obtained and analyzed (using the TIGTA Data Center Warehouse) the Automated Information Management System business examination cases closed in FYs 2015 through 2017 for both the LB&I and SB/SE Divisions to identify and compare trends related to assessment and nonassessment of civil penalties.² We used the Primary Business Codes between 300 and 317 for LB&I cases and between 201 and 218 for SB/SE cases. The resulting data were then matched to the Business Master File and Individual Master File data in the Data Center Warehouse to obtain the additional tax assessment (Transaction Code 300) and penalty assessment (Transaction Code 240 – with accuracy-related penalty codes) data.

¹ See Appendix IV for a glossary of terms.

² We compared closed examinations to civil penalties assessed and dollars assessed between the LB&I Division and the SB/SE Division to identify any trends and to gain an understanding of any differences in how the two divisions assess accuracy-related penalties. Examiners may audit more than one tax return module for a taxpayer, but examination cases are closed by tax return module.



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- B. Obtained and analyzed statistical data from the IMS on closed LB&I examination cases for FYs 2015 through 2017 for which there were proposed penalty assessments, including numbers of cases, penalty dollars proposed, and penalty dollars assessed.
 - C. Interviewed LQMS personnel to gain an understanding of how the quality review process is used to determine the proper use and assessment of civil tax penalties.
 - 1. Obtained and analyzed the LQMS quality review quarterly reports with penalty quality standards for FYs 2016 and 2017.
 - 2. Identified penalty standards and areas LQMS reviews identified needing improvement and any actions taken by management to address weaknesses in the areas identified.
 - D. Interviewed OSP personnel to identify their roles and responsibilities and how the OSP measures the proper use and assessment of civil tax penalties.
 - 1. Obtained and analyzed the results from the OSP penalty reviews for FYs 2016 and FY 2017.
 - 2. Reviewed the methodology used by the OSP to select sample cases for review.
- III. Conducted case reviews of LB&I business returns closed in FYs 2015 through 2017, for cases in which penalties were assessed and cases in which penalties were not assessed, to determine if examiners are properly considering and assessing accuracy-related penalties.
- A. Joined the Audit Information Management System records identified in Step II.A and the IMS records identified in Step II.B.
 - B. Identified the two populations by:
 - 1. Identifying the examination cases that were assessed a civil penalty with an accuracy-related penalty (Transaction Code 240). We identified 280 cases.
 - 2. Identifying the examination cases that were not assessed a civil penalty (no Transaction Code 240) but had additional tax assessment (Transaction Code 300) amount greater than \$10,000. We identified 4,519 cases.
 - C. Discussed the population characteristics with the TIGTA contract statistician to determine a stratified, statistically valid sampling plan and for the two populations.³
 - D. Ordered examination paper case files and tax returns for the two selected samples.

³ Requested the sampling plan be based on a stratified, statistical sample of 50 cases from each population. One population was stratified by additional tax dollars assessed and the other population was stratified by penalty dollars assessed; however, we did not project dollars to population strata, just the number of error cases to the entire population for each sample.



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- E. Selected and reviewed a stratified, statistically valid sample of 50 business returns to determine whether accuracy-related penalties were properly assessed for the population identified in Step III.B.1.
 - 1. Reviewed the examiner's workpapers kept in the IMS for all 50 sample cases and all partial and complete paper case files received from the Federal Records Center.
 - 2. Determined if proposal of the accuracy-related penalty was fully documented by the examiner and if the penalty was properly assessed.
 - 3. Determined if managers were actively involved with the development of the penalties and if the proposal of penalty was reviewed and approved by the manager.
- F. Selected and reviewed a stratified, statistically valid sample of 50 business returns to determine whether accuracy-related penalties were properly considered, but not assessed, for the population identified in Step III.B.2.
 - 1. Reviewed the examiner's workpapers kept in the IMS for all 50 sample cases and some partial or complete paper case files received from the Federal Record Center.
 - 2. Determined if the accuracy-related penalty was considered and fully documented by the examiner.
 - 3. Determined if managers were actively involved with the development of the penalty and if the nonproposal of the penalty was approved by the manager.
- G. Discussed case review results with IRS management.
- H. Contract statistician projected the number of cases with errors to the two populations to determine the potential number of cases in which LB&I examiners did not:
 - 1. Consider the accuracy-related penalty. Based on our review results, we projected the errors to the population of 4,519 examined business returns (no penalty proposed) using a 17.79 percent overall estimated error rate, a ± 12.0 percent precision factor, and a 95 percent confidence level.
 - 2. Explain the reasoning for decisions not to propose the penalty. Based on our review results, projected the errors to the population of 4,519 examined business returns (no penalty proposed) using a 20.56 percent overall estimated error rate, a ± 15.3 percent precision, and a 95 percent confidence level.
 - 3. Involve managers in penalty development or obtain manager approved when not proposing the penalty. Based on our review results, projected the errors to the population of 4,519 examined business returns (no penalty proposed) using a



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23.34 percent overall estimated error rate, a \pm 14.5 percent precision, and a 95 percent confidence level.

4. Involve management in penalty development or obtain manager approval when proposing the penalty. Based on our review results, projected the error to the population of 280 examined business returns (accuracy-related penalty proposed) using a 9.43 percent overall estimated error rate, a \pm 8.6 percent precision, and a 95 percent confidence level.
- IV. Validated the data obtained for the populations identified in Steps II.A and II.B. Compared population counts to data reported in the FYs 2015 and 2016 IRS Data Book for reasonableness and reviewed a random sample of records for each population to verify that certain data fields and transaction codes which appear in the extracted data match what is found in the Integrated Data Retrieval System. Based on our validation results, we are satisfied that the data are sufficient, complete, and relevant to the review.

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 LB&I Division's and SB/SE Division OSP's policies, procedures, and practices for considering, proposing, and assessing the accuracy-related civil penalties. We evaluated these controls by performing case reviews of LB&I examination cases closed in FYs 2015 through 2017 for cases both with and without assessed accuracy-related penalties.



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Appendix II

Major Contributors to This Report

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Carl Aley, Director

Phyllis Heald London, Director

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Doris Cervantes, Lead Auditor

Myriam Dolsaint, Auditor

Marcus Sloan, Auditor



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Appendix III

Report Distribution List

Commissioner, Small Business/Self-Employed Division
Commissioner, Wage and Investment Division
Deputy Commissioner, Large Business & International Division
Director, Enterprise Activities Practice Area, Large Business and International Division
Director, Operations Support, Small Business/Self-Employed Division
Director, Office of Audit Coordination



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Appendix IV

Glossary of Terms

Term	Definition
Audit Issue Management System	The database used by IRS examination functions to control returns examined, input assessments/adjustments to the Master File, provide management reports, and to trace examination results through final determination of tax liability, including results from Appeals and tax court cases.
Business Master File	The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
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.
Integrated Date Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Internal Revenue Code	The I.R.C., found at Title 26 of the United States Code, is the primary source of Federal tax law. It imposes income, estate, gift, employment, and miscellaneous excise taxes and provisions controlling the administration of Federal taxation.
Internal Revenue Manual	Provides an official central repository of uniform guidelines on operating policies and procedures for use by all IRS offices. It contains guidance on IRS policies and directions our employees need to carry out their responsibilities in administering the tax laws or other agency obligations. The IRM is also widely used by practitioners, taxpayers, State agencies, and even foreign governments to understand how the IRS carries out its tax administration responsibilities.



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Term	Definition
Issue Management System	The IMS database is used by LB&I examiners to manage their examination case workload.
Tax Gap	The estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.
Tax Module	Part of a taxpayer's account that reflects tax data for one tax class and one tax period.
Tax Year	The 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
Transaction Code	A three-digit code used to identify actions being taken on a taxpayer's account on the Master File.



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Appendix V

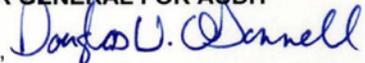
Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

May 1, 2019

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

FROM: Douglas W. O'Donnell, 
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report # 2017-30-035, Few Accuracy-Related
Penalties Are Proposed in Large Business Examinations and
They Are Generally Not Sustained on Appeal

Thank you for the opportunity to respond to your report entitled "*Few Accuracy-Related Penalties Are Proposed in Large Business Examinations and They Are Generally Not Sustained on Appeal (TIGTA Audit 2017-30-035).*"

We recognize the importance of accuracy related penalties and their impact on voluntary compliance. We also recognize the importance of the Taxpayer Bill of Rights which includes ensuring taxpayers pay only the amount of tax legally due, including penalties, have the right to challenge the IRS's position and be heard, and have the right to appeal an IRS decision in an independent forum. Examiners through their issue development consider information provided by the taxpayer, including substantial authority and reasonable cause arguments. The LB&I Division respects the Appeals Division mission to resolve tax controversies fairly and impartially, without litigation, and their authority to settle cases based on hazards of litigation which the LB&I examination function does not possess.

While we agree there are improvements to be made in this area, we disagree with some of the overall conclusions of the audit. Due to the methodology and approach of this audit, we do not believe that some of the overall conclusions are supported. Each examination and the facts and circumstances of an individual case stand on their own.

As discussed with the audit team, we have various concerns regarding the data gathered during the audit and the methodology used in the report. TIGTA did not consider cases where penalties were considered, but not proposed, and cases where penalties were initially proposed, but ultimately not included in the Revenue Agent Report because the taxpayer documented penalty exceptions, or other factors. Also, in its analysis to test LB&I's administration of the Substantial Understatement of Income Tax penalty, TIGTA used the single criteria of "deficiencies of \$10,000 or more" when a more complex set of conditions exists to determine if the penalty applies. One such



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condition/example is that for corporations, this penalty applies only if the amount of the understatement for the taxable year exceeds the lesser of:

- 10% of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or
- \$10,000,000

For an LB&I examination, it is unlikely that most audit adjustments would result in \$10,000 being the greater number because of the amount of tax reported on returns LB&I examines. For example, an additional assessment exceeding \$10,000 is not substantial when the correct tax deficiency is in the millions. Finally, in identifying the sample of cases to review, the valuation method was questionable, and the sample size was too small to enable a reliable projection to the entire population.

The Office of Servicewide Penalties and LB&I offer training on various penalty related topics, including accuracy related penalties. For example, the LB&I Penalty Practice Network conducted a community meeting on the *Chai* court case decision cited in this report and its impact on examinations and examiner and manager actions. However, we acknowledge there is a need to do more; especially in the area of documentation requirements and the managers' role in review and approval of accuracy related penalties.

Attached is a detailed response outlining our corrective actions that address your recommendations.

If you have any questions, please contact me, or a member of your staff may contact Scott Ballint, Director, Enterprise Activities Practice Area at (304) 238-8235.

Attachment



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Attachment I

RECOMMENDATION 1:

The Commissioner, LB&I Division, should:

Conduct a case study to: 1) understand the reason why examiners' proposed tax assessments and accuracy-related penalties are not being sustained by the Office of Appeals and 2) evaluate whether examiners are taking into account all the relevant facts and circumstances, before proposing the tax adjustments and accuracy-related penalties.

CORRECTIVE ACTION(S):

We partially agree with this recommendation, in that we will discuss with Appeals whether there is information available to help LB&I better understand why Appeals did or did not sustain accuracy related penalties. However, it is important to recognize two fundamental points in considering this issue, both of which somewhat constrain the efficacy of this recommendation. First, LB&I's mission is different from that of Appeals, which is tasked with resolving tax controversies, without litigation, on a basis that is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service. As such, Appeals can resolve issues/cases based on Appeal's assessment of the hazards of litigation whereas, examination employees cannot resolve cases on that basis.

Second, we note that penalty resolution varies from case to case, and issue to issue. LB&I already analyzes Appeals Case Memorandums (ACMs) on individual issues to better understand Appeals views, however, that is not as effective for penalty issues, since so many may be conceded if the underlying issue is conceded in whole or in part. The reasons for Appeals to concede penalties are case specific and frequently relate to their settlement authority for the case as a whole which does not provide insight to examiners.

IMPLEMENTATION DATE:

April 15, 2020

RESPONSIBLE OFFICIAL:

Director, Enterprise Activities Practice Area, LB&I

CORRECTIVE ACTION(S) MONITORING PLAN:

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



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RECOMMENDATION 2:

The Commissioner, LB&I Division, should:

Ensure that examiners and supervisors are trained to: 1) consider the accuracy-related penalty in all applicable examination cases, 2) follow the proper procedures to document all actions taken during penalty consideration and development, whether assessing or not assessing the penalty, and 3) follow the requirements for supervisory involvement and timely, written approval of all penalty decisions.

CORRECTIVE ACTION(S):

We agree with this recommendation. The Penalty Practice Network will provide materials for all LB&I employees on procedures to document penalty considerations and development, and the requirements for supervisory involvement and timely written approval of penalty decisions. The Practice Network will also consider revising the penalty lead sheet to address this recommendation.

IMPLEMENTATION DATE:

April 15, 2020

RESPONSIBLE OFFICIAL:

Director, Enterprise Activities Practice Area, LB&I

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 3:

The Commissioner, LB&I Division, should:

Revise the IRM 4.46 guidelines to: 1) clearly indicate which LB&I examiners are ultimately responsible for penalty development and documentation and 2) provide more specificity on the requirements of supervisory involvement in penalty development when asserting and not proposing penalties.

CORRECTIVE ACTION(S):

We agree with this recommendation. Internal Revenue Manual (IRM) 4.46 has recently been updated for some penalty related matters. IRM 20.1.1, Penalty Handbook, Introduction and Penalty Relief, is in the process of being updated. The Penalty Practice



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Network will review and provide recommendations, if any, for potential additional updates.

IMPLEMENTATION DATE:

April 15, 2020

RESPONSIBLE OFFICIAL:

Director, Enterprise Activities Practice Area, LB&I

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 4:

The Commissioner, LB&I Division, should:

Ensure that quality review systems are adequate and can accurately determine whether examiners are properly considering civil penalties, adequately supporting penalty decisions, consistently involving management, and obtaining required approvals.

CORRECTIVE ACTION(S):

We agree with this recommendation. Quality Review and Analysis will review the IRM, including any updates or revisions, to determine if and how the quality review process should be modified to consider examiner and management responsibilities related to accuracy related penalties.

IMPLEMENTATION DATE:

April 15, 2020

RESPONSIBLE OFFICIAL:

Director, Program & Business Solutions, LB&I

CORRECTIVE ACTION(S) MONITORING PLAN:

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



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RECOMMENDATION 5:

LB&I Division and Wage & Investment Division Commissioner's should:

Using the IRS's Lean Six Sigma team or other process improvement resources, evaluate the procedure for closing, shipping and storing paper examination case files, and take corrective action to improve the process.

CORRECTIVE ACTION(S):

We agree to review case closing and shipping procedures, and the procedures to request closed case files from the Federal Records Center to determine whether additional clarity is needed, and to ensure employees are aware of the procedures. We believe employees follow the rules relating to record retention policies. While TIGTA experienced problems in securing closed case files, we believe that was due to many factors including how the files were requested, the Document Locator Number used, the fact that the entire CIC case could not be provided due to its size, and that not all case information is initially closed to the Federal Records Center. Nonetheless, your report highlights the need for us to evaluate improvements or adjustments to our current file retrieval process, and we appreciate your recommendations on this issue.

IMPLEMENTATION DATE:

June 15, 2020

RESPONSIBLE OFFICIAL:

Director, Enterprise Activities Practice Area, LB&I

CORRECTIVE ACTION(S) MONITORING PLAN:

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