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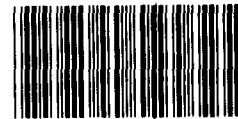
Testimony

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Comprehensive Review of Civil Penalties
Needed

Statement of
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Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives



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CIVIL PENALTIES

SUMMARY OF STATEMENT JOHNNY C. FINCH DEPUTY DIRECTOR GENERAL ACCOUNTING OFFICE

Congress has enacted nearly 150 civil penalties in the Internal Revenue Code (Code) to encourage compliance with the tax laws. In many instances, penalties were enacted or modified on an ad hoc basis without full consideration being given to the overall civil penalty structure. Given this and the sweeping impact of the Tax Reform Act of 1986, this Subcommittee, other Congressional committees, and the Commissioner have expressed concerns over the civil penalty provisions of our tax laws. We share these concerns and support the notion that a comprehensive review of those provisions is in order.

The IRS Commissioner has initiated a comprehensive study of civil penalties. We think the study timetable is ambitious. The methodology of the study is evolving, but at present it does not appear to encompass the empirical analysis we believe necessary to fully address the issues. Our work will help fill part of the gap by providing the empirical evidence necessary to evaluate the effectiveness of IRS' administration of a limited number of specific penalties.

We were asked to determine if by using computers, IRS assesses a significant number of inaccurate penalties which are ultimately abated or erroneously paid by the taxpayer. We found that IRS does not have readily available data to identify the number of computer-generated penalty assessments or the percentage of those assessments abated or erroneously paid. Theoretically, computer-generated penalties should be assessed in a more consistent fashion than manually-generated penalties. This is because penalties assessed by the computer involve conditions which are specific, well defined, and do not require the exercise of subjective judgment.

We have not yet done sufficient work to be in a position to comment conclusively on IRS' overall effectiveness in administering civil penalties. However, our work related to several specific penalties and recent reports by the IRS Internal Audit staff identify potential problems that should be considered in any comprehensive review. These problems include instances where IRS did not assess certain penalties when they were warranted, abated penalties when they were not required to do so, made computational errors, and were not consistent in assessment policies among IRS offices.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its review of the civil penalty provisions in the Internal Revenue Code (Code). My statement today covers four points:

- first, we endorse the need for a comprehensive review of civil penalties and discuss some of the objectives for such a review,
- second, we comment on the evolving methodology of the IRS Commissioner's Study of Civil Penalties,
- third, we describe the circumstances in which computers generate penalties, and
- fourth, we summarize what we know about problems in IRS' administration of civil penalties.

COMPREHENSIVE REVIEW OF CIVIL PENALTIES NEEDED

The success of our tax system depends on voluntary taxpayer compliance. To encourage compliance and to punish noncompliance, Congress has enacted numerous civil penalties. In the past 70 years, nearly 150 civil penalties have been placed in the Code. In many instances, penalties were enacted or modified on an ad hoc basis without full consideration being given to the overall structure of civil penalties.

With greater use of penalties, more questions have been raised as to the role civil penalties should play in our tax system. In fiscal year 1987, IRS assessed almost 27 million penalties, totaling over \$14 billion. This was more than a 100 percent increase over the total dollar amount of penalties assessed in 1986. IRS' administration of civil penalties frequently results in criticism. The criticisms have focused primarily on IRS' (1) failure to fully utilize all penalty provisions, (2) assessment of many penalties which are subsequently abated, and (3) inconsistent assessment of penalties by different IRS offices and functions.

Our tax system and our society are different than they were in the past. We now face a tax gap of over \$80 billion, large federal budget deficits, and what IRS describes as growing animosity between the taxpayer and the tax administrator. Given this, the ad hoc approach with which many of the present penalties were enacted, and the sweeping impact of the Tax Reform Act of 1986, this Subcommittee, other congressional committees, and the Commissioner have expressed concerns over the current structure of the civil penalty provisions of our tax laws. We share these concerns and support the notion that a comprehensive review of those provisions is in order.

Objectives of Planned Studies

If civil penalties are to be a major enforcement tool in our tax system, we need to assure ourselves that they are well thought-out, credible, understood by the nation's taxpayers and tax practitioners, can be administered consistently and effectively by IRS, and do in fact achieve their purposes. Whether the present system of penalties accomplishes these goals is not known.

The first step in examining civil penalties should be to identify and understand the problems with the existing system. To this end, the Commissioner has launched a study of the civil sanctions available to IRS. The study proposes to review the value of these sanctions to the tax system, identify problems arising from their administration, and make recommendations for improvement.

Similarly, at the request of this Subcommittee and the Senate Finance Committee's Subcommittee on Private Retirement Plans and Oversight of IRS, we are beginning work which will focus on IRS efforts to fairly and consistently administer civil penalties. We will analyze the quality of the information used by IRS in assessing and abating certain penalties, determine if IRS is assessing and abating the penalties in a fair and consistent fashion, and if appropriate, comment on how the administration of the penalties could be improved.

Chairman Pryor has requested that we examine civil penalties for substantial understatement of tax liabilities [section 6661], civil negligence and fraud [section 6653 (a) and (b)], and understatement by a return preparer [section 6694 (a) and (b)]. We are presently discussing with Subcommittee staff the penalties and scope of work that will be involved in responding to your request.

Our work and that of the Commissioner's study group will provide much of the information needed to consider the adequacy of the civil penalty structure and will establish a better foundation for congressional deliberation and debate.

COMMISSIONER'S STUDY OF CIVIL
PENALTIES STILL EVOLVING

At the request of this Subcommittee and the Senate Subcommittee on Private Retirement Plans and Oversight of IRS, we have begun to review the methodology being used in IRS' study. Our analysis to date has been limited to the study prospectus. Our preliminary observations are that the methodology (1) is still evolving, (2) currently draws heavily on expert opinion and advice from IRS management and outside organizations, and (3) will attempt to aggregate existing IRS statistics in a fashion that will enhance their usefulness in analyzing civil penalties.

While expert opinions and advice are valuable in identifying problems and developing recommendations for improvement, the IRS study does not presently provide for any scientific sampling of taxpayer returns and accounts to validate the experts' concerns and opinions, or to empirically determine how well IRS is administering the various penalties. Without this information it will be difficult to quantify the nature and extent of the problems or to identify and correct their cause.

The IRS study calls for the assembly of existing data on each penalty and for the identification of gaps in this information. It is our experience that IRS has not historically aggregated the penalty data it collects in such a fashion to make it useful in reviewing all of the various issues and concerns associated with the imposition of civil penalties against taxpayers. For example, IRS does not routinely aggregate penalties by Code section.

Further, it is unclear whether IRS statistics capture all of the penalties assessed and abated. For example, the most dramatic increase from fiscal year 1986 to 1987 in penalty assessments was in the non-return category. The non-return category includes penalties assessed in situations where the noncompliance is not associated with the filing of a return by the taxpayer, such as tax shelter promoter penalties and preparer penalties.

Assessments in this category rose from \$268 million in 1986 to about \$6.0 billion in 1987. In terms of the number of penalties assessed, the non-return category increased from about 106,000 in 1986 to about 478,000 in 1987. IRS attributes most of this increase to penalties which had previously not been captured in IRS statistics.

The quality of IRS' statistical data also needs to be considered. An October 1987 IRS Internal Audit report concluded that penalty management information reports may contain misleading and inflated figures on assessments, abatements, and abatement rates. Internal Audit found that in 1986 about \$340 million in Failure To Deposit employment tax penalties had been erroneously assessed and subsequently abated. Since IRS detected and abated over 90 percent of these erroneous penalties before notifying taxpayers, including such figures in IRS statistics produced misleading results.

The Commissioner's study prospectus calls for the identification of data needed to complete the study by April 1988. The points we have made should be included in this needs assessment.

COMPUTERS USED TO GENERATE
NONSUBJECTIVE PENALTIES

You asked us to determine the extent to which IRS uses computers to assess penalties and, if by using computers, IRS assesses a

significant number of inaccurate penalties which are ultimately abated or erroneously paid by taxpayers. We found that IRS does not have data readily available to identify the number of penalty assessments which are computer generated. Neither is information available on abatements or erroneous payments.

IRS began using computers for tax administration purposes in the early 1960s. Since that time, IRS has included penalty assessments in its use of computers. Presently, the majority of penalties assessed by the 10 IRS service centers are computer generated. These penalties typically result when the taxpayer fails to take a required action by a specific date, such as failure to file a return on time.

While returns and related documents are being processed, the computer will identify situations in which the required conditions for a specific penalty are present. For example, when a service center receives a tax return with an outstanding tax liability after the due date, the computer will automatically assess the failure to file penalty, unless the taxpayer's account indicates that an extension was previously granted. The computer would also assess a failure to pay penalty if there is any outstanding tax liability.

After a penalty is assessed, the computer prepares a notice that is mailed to the taxpayer stating a reason for the penalty. If

the taxpayer disagrees with the assessment, the taxpayer can present evidence requesting an abatement.

Theoretically, computer generated penalties should be more consistently assessed than manually-generated penalties. Penalties assessed by the computer involve conditions which are specific, well-defined, and do not require the exercise of subjective judgement. The computer uses the information provided or lack thereof to determine that a penalty is or is not appropriate.

In contrast, penalties are assessed manually when the complexity of the issue requires the use of subjective judgement. These penalties include negligence, fraud, or promoting abusive tax shelters. The accuracy of manually generated penalties can be affected by many factors, including IRS employee judgement, training, clarity of guidance, and district policy.

Conversely, computer-generated penalty inaccuracies generally stem from instances where the data provided the computer is inaccurate or incomplete, or where there is an error in the computer program. In such instances, computer-generated penalties have the potential to affect many more taxpayers than those that are manually generated. For example, in February 1988 the IRS, using inaccurate information provided by the Social Security Administration, generated thousands of erroneous penalty

notices assessing penalties against employers for failing to file W-2 information on magnetic media. While one service center discovered the inaccuracy before notifying the employers, other service centers did not and mailed out inaccurate notices.

IRS reviews a selected sample of both computer-generated and manually generated penalty notices before they are sent to taxpayers. The review is performed to ensure that the notices are technically as well as mathematically correct.

PROBLEMS IDENTIFIED IN IRS
ADMINISTRATION OF PENALTIES

We have not done sufficient work at this time to be in a position to comment on IRS' effectiveness or on the difficulties it encounters in administering an increasingly complex system of civil penalties. However, we believe our work related to several specific penalties and recent reports by the IRS Internal Audit staff identify some types of problems which should be considered in a comprehensive review of the civil penalty structure. These problems include instances where penalties were not assessed when warranted, where penalties were not computed accurately, and where IRS District Office policies varied on the assessment of certain penalties.

Penalties not assessed when warranted

Three IRS Internal Audit and two GAO studies have shown that IRS did not assess penalties in all cases where they were warranted. For example, a 1987 IRS Internal Audit report concluded that in 1986 IRS overlooked millions of dollars in penalties that should have been assessed against employers who claimed fictitious tax deposits on their employment tax returns. Internal Audit's sample of 426 taxpayer accounts contained 217 accounts with fictitious tax deposits. Of the accounts with fictitious deposits none were assessed the penalty. Internal Audit staff projected that, on a nationwide basis, IRS did not assess \$437 million in such penalties in 1986.

As a second example, our study of IRS' administration of the penalty for promoting abusive tax shelters at three selected district offices shows that IRS should have but did not assess all applicable penalties in 39 percent of the 28 total cases the three offices closed between September 1982 and July 1986. Penalties were not assessed because district officials did not know that multiple acts of organizing, promoting, and selling abusive tax shelters by the same person are each subject to penalty. National Office guidance did not illustrate how to treat multiple acts.

Penalties Not Computed Accurately

Computation and other types of errors have also been documented by GAO and IRS internal auditors. IRS' Internal Audit reported in 1987 that computation errors were found in 27 percent of 75 selected examination cases. These cases covered examinations of 1983 and 1984 individual income tax returns in 5 districts and one service center. The calculation errors ranged from an overassessment of \$1,386 to an underassessment of \$259.

In our tax shelter promoter study, we found that IRS made several computation and oversight errors when assessing abusive tax shelter promoter penalties. IRS made 20 such errors resulting in about \$4.0 million in penalty underassessments in 31 percent of the 29 total cases at 3 selected district offices.

Inconsistent District Office enforcement policies

Inconsistent enforcement of penalties by IRS District Offices has also been identified as a problem. For example, in a 1983 GAO report on return preparer penalties, we found that each IRS district determined its own level of activity for assessing the penalty against preparers who endorsed or negotiated taxpayers' refund checks. One district office, which took a more vigorous approach to identifying such situations and assessing the penalty

accounted for 75 percent of these penalties assessed nationwide during 1981.

As a second example, in our study of IRS' administration in three districts of the tax shelter registration late or non-filing penalty, we found that one district decided not to administer the penalty because of a belief that it was too new. The other districts were assessing late filing penalties but were using a late filing grace period greater than that established by the National Office.

Abatement of civil penalties

Taxpayers assessed a penalty have the right to request that IRS abate the assessment. However, the taxpayer must provide IRS with information which demonstrates reasonable cause for the noncompliance, evidence that the noncompliance did not occur, or other acceptable reasons for abatement. Upon receipt, tax examiners are to determine the merits of the evidence.

IRS has developed guidelines for its employees to use in abating penalties. The guidelines require that each request for abatement be judged on all the facts in hand. If the tax examiner denies the request for abatement, a notice is to be sent to the taxpayer explaining the reason for the denial and informing the taxpayer of the right to appeal the decision. If

the information provided by the taxpayer satisfies the examiner, the penalty is to be abated and a notice is to be sent advising the taxpayer of such action. These abatement procedures apply to both computer-generated and manually generated penalties.

In 1984, we reported that while most IRS penalty abatements were appropriate, IRS inappropriately abated penalties in 8 percent of the abatements made in fiscal year 1981 by six selected districts and three selected service centers. On a projected basis for those 9 offices, we estimated that IRS granted 32,600 inappropriate abatements out of 407,700 total abatements made. This amounted to \$21.7 million in inappropriate abatements. Abatements for reasonable cause (48,800 of the total abatements) were most in need of improvement. Twenty-six percent of the reasonable cause abatements (12,700 out of 48,800) were inappropriate.

We attributed the causes of inappropriate abatements to (1) incomplete IRS guidance defining reasonable cause, (2) minimal penalty abatement training, and (3) inadequacies in IRS review and quality assurance processes. IRS took action on our 1984 recommendations. However, much has changed since then and we do not know what IRS' current performance may be in abating penalties.

SUMMARY

In summary, we support the need for a comprehensive review of the civil penalty structure. We also believe that now is a good time to begin that review. As the tax system has become more complex so have the accompanying penalties. This has occurred with limited attention being paid to the overall structure of the civil penalty provisions, their effectiveness, or to the role they should play. The passage of the Tax Reform Act of 1986, with its extensive changes to the tax laws, provides a timely opportunity for this review.

Several issues need to be addressed. These include the purpose, need for, and effectiveness of each penalty provision, and the equity and efficiency of IRS' civil penalty administration. Past work by GAO, IRS, and others provides a starting point. But all the information necessary to respond to these issues is not presently available.

The Commissioner's civil penalties study is an important step in developing the information needed. Undertaking a review of almost 150 penalty provisions and their interrelationships is a massive task which will require time and the commitment of resources. The schedule established by the study group calls for the presentation of conclusions and recommendations to the Commissioner in July 1988. In our review, the study is an

ambitious undertaking for the targeted timeframes.

The methodology of the study is evolving, but at present it does not appear to encompass the empirical analysis we believe necessary to fully address the issues. Our work will help fill part of the gap by providing the empirical evidence necessary to evaluate the effectiveness of IRS' administration of a limited number of specific penalties.

The IRS study includes a milestone for identifying additional data needed. We will continue to monitor the evolution of the study and keep IRS advised of our thoughts as that milestone nears. The Subcommittee may also wish to follow up with IRS in this regard.

Mr. Chairman, that concludes my statement. I would be happy to respond to any questions the Subcommittee may have.