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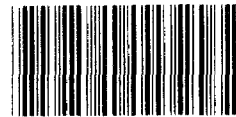
Testimony

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Comprehensive Review of Civil Penalties  
Needed

Statement of  
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Before the  
Subcommittee on Private Retirement Plans  
and Oversight of the Internal Revenue Service  
Senate Finance Committee



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## CIVIL PENALTIES

SUMMARY OF STATEMENT BY  
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The success of our tax system depends on voluntary taxpayer compliance. To encourage compliance and to punish noncompliance, Congress has enacted nearly 150 civil penalties in the past 70 years. In many instances, penalties were enacted or modified on an ad hoc basis without full consideration for the overall structure. In fiscal year 1987, IRS reportedly assessed almost 27 million penalties, totaling over \$14 billion. With greater use of penalties, more questions have been raised about the role civil penalties should play in our tax system and how IRS administers penalties.

Like other aspects of tax administration, taxpayers can encounter many different penalty situations, not only because of the large number of penalties but also because IRS' civil penalty management is so decentralized. Penalties are assessed and abated by thousands of IRS employees in 10 IRS service centers and 63 district offices all across the nation. Thus, IRS has a great challenge to ensure that penalties are consistently administered. The potential for inconsistency is exacerbated by the complexity of the penalty assessment and abatement process.

IRS' penalty administration is even more difficult because of the lack of good, readily available information. We continue to have concerns about the quality of data available to IRS managers to oversee the work and to evaluate performance. IRS data systems currently do not provide the information necessary to answer such basic questions as how many of each penalty are assessed and abated.

Past work by GAO and IRS Internal Audit have identified problems with IRS penalty administration. These 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.

The IRS Commissioner has initiated a study of civil penalties. This effort is timely and will be useful in reaching a consensus on the definition and role civil penalties should play. However, we do not believe that the study scope is comprehensive enough to identify the extent of problems, determine causes and impacts of identified problems, or develop specific recommendations to correct these problems. More complete information will be available when we complete our analyses of IRS' penalty data and IRS' administration of 11 key penalties.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist in your continuing review of the civil penalty provisions in the Internal Revenue Code (Code). At your request and that of the Subcommittee on Oversight, House Ways and Means Committee, we are reviewing IRS' administration of 11 key civil penalties and monitoring the Commissioner's Civil Penalty study. We have not completed our work; thus, the results we present today are preliminary.

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 such 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.

In fiscal year 1987, IRS reportedly assessed almost 27 million penalties, totaling over \$14 billion. This was more than a 100 percent increase over the total dollar amount of penalties reported in 1986.<sup>1</sup> With greater use of penalties, it is understandable that more questions have been raised about the role civil penalties should play in our tax system and about how IRS administers penalties.

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<sup>1</sup>The increase partially reflects penalty information added to the data base in 1987 rather than an actual increase in penalties.

My statement today is in three parts:

- First, we discuss IRS' administration of civil penalties and what we know from prior reviews about existing problems.
- Second, we address one aspect of penalty administration--the information available to managers.
- Third, we comment on the IRS Commissioner's Study of Civil Penalties, its usefulness and its limitations.

#### IRS PENALTY ADMINISTRATION

Like other aspects of tax administration, taxpayers can encounter many different penalty situations, not only because of the large number of penalties but also because IRS' civil penalty management is so decentralized. Penalties are assessed and abated by various functional areas within IRS such as Examination, Returns Processing, Collection, and Employee Plans/Exempt Organizations. The process involves thousands of IRS employees in 10 IRS service centers and 63 district offices all across the nation. Thus, IRS has a great challenge to ensure that the penalties are consistently administered.

The potential for inconsistency is exacerbated by the complexity of the penalty assessment and abatement process. IRS assesses penalties by computer and manually. Computer assessments typically involve the taxpayer failing to take a required action by a specific date such as failure to file a return or pay taxes on time. The computer is programmed to look for specific situations such as these and to assess the appropriate penalty when warranted.

Manual assessments are usually more complex and require more judgment. They involve such penalties as negligence, fraud, and understating tax liability. IRS employees may either "propose" or "assess" one of these penalties at the completion of an audit. If a penalty is proposed, the taxpayer receives advance notice and has an opportunity to prove that the penalty should not be assessed. On the other hand, when a penalty is not first proposed, but immediately assessed, the taxpayer does not get this opportunity. Under either procedure, IRS sends a notice to the taxpayer explaining the penalty and providing information on appeal procedures.

IRS has the authority to abate certain penalties for reasonable cause or the taxpayer's due diligence. Upon reviewing the taxpayer's written statement, which is to fully explain the basis for a reasonable cause or due diligence abatement, IRS notifies the taxpayer of its decision. The penalty may be abated

in whole or part or the abatement denied. If denied, or abated in part, the taxpayer is to receive information on further appeal rights. Depending on the Code section of a penalty, the taxpayer is given instructions on how to timely appeal within IRS or the Tax Court or how to petition the U.S. District Court.

Each IRS district office has a Penalty Review Committee to assure that penalty assessments and abatements are fair, fully documented and clearly applicable. The committees periodically review a limited number of assessments and abatements.

#### Problems Identified in IRS Administration of Penalties

Our current review is too preliminary to have conclusions on IRS' effectiveness in administering an increasingly complex system of civil penalties. However, our past work on several specific penalties and recent reports by the IRS Internal Audit staff identified problems which should be considered in a comprehensive review of the civil penalty structure. These 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

Both IRS Internal Audit and GAO studies have shown that IRS did not assess penalties in all cases where they were warranted.

Some examples:

- IRS Internal Audit concluded that, in 1986, IRS overlooked \$437 million of penalties that should have been assessed against employers who claimed fictitious tax deposits on their employment tax returns.
  
- Our study of IRS' administration of the penalty for promoting abusive tax shelters showed that IRS did not assess all applicable penalties in 39 percent of 28 cases three offices closed between September 1982 and July 1986. District officials did not know that multiple acts of organizing, promoting, and selling abusive tax shelters by the same person were each subject to penalty.
  
- This month, we reported that IRS has no way to determine whether payors of interest and dividends comply with the requirements of the Taxpayer Identification Number Penalty Program.

#### Penalties Not Computed Accurately

Computation and other types of errors have also been documented. In 1987, IRS' Internal Audit found computation errors 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 computation and oversight errors in the assessment of 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 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 1983 we reported that each IRS district determined its own level of activity for assessing the return preparer 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.

IRS' 1987 statistics indicate that wide variations still exist. The number of return preparer penalty assessments per district ranged from zero to 341. Even larger variations occurred in terms of the dollar value of assessments. Of the total \$4.3 million in such penalties assessed, \$2.2 million were assessed in a single district. Abatements also varied and were not in proportion to the number of assessments.

A second example is 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.

In 1985, IRS Internal Auditors found that IRS offices inconsistently administered the substantial understatement of tax liability penalty. Specifically, some but not all service centers used the penalty on correspondence examinations; some offices used the penalty when taxpayers did not appear for their appointments or provide records requested by the examiner but



others did not; and some offices used the penalty concurrently with other penalties but others did not.

CONCERNS WITH  
PENALTY INFORMATION

In addition to the problems discussed above, IRS' penalty administration is far more difficult because of the lack of good readily available information. We continue to have concerns about the quality of data available to IRS managers to oversee the work and to evaluate performance. Our concerns center on three issues:

- whether IRS captures all of the data needed to provide management oversight of the penalty program,
- why the information collected by IRS is not routinely made available to IRS management, and
- whether the data IRS collects is accurate.

IRS data systems currently do not provide the information necessary to answer such basic questions as how many of each penalty are assessed and abated. They also do not capture information on penalties proposed but dropped before assessment, identify the reasons a penalty was assessed or abated, identify whether the penalty assessment or abatement was the result of an IRS or taxpayer error, or identify the IRS function which made the assessment or abatement. These information needs have been identified not only by GAO but also by IRS as long ago as 1979.

While a lot of information is not captured, data which is collected is not routinely made available to IRS management. In addition, IRS does not aggregate the collected penalty data to make it useful in reviewing the various issues and concerns

associated with the imposition of civil penalties. This includes such issues as changes in the number and amount of penalties assessed, if penalties are being consistently assessed in the various district offices and service centers, and even if certain penalties are assessed at all. It is unclear how IRS is able to carry out its penalty management and oversight responsibilities without complete and accurate management information.

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

Our review of 1987 return preparer statistics indicated additional data accuracy problems. Preparer penalties under code section 6694 (a) and (b) are either \$100 or \$500 per assessment. However, IRS data shows that 16 districts have assessment totals that are not multiples of these amounts. For example, the total amount assessed in one district was reported as \$64,809.

At this time we do not know the extent or cause of the data problems. Our ongoing penalty work will continue to address the data accuracy issue.

USEFULNESS OF THE COMMISSIONER'S  
STUDY WILL BE LIMITED

In the fall of 1987, the IRS Commissioner initiated a study of civil penalties to examine the value of penalties, identify

administrative problems, and to recommend statutory and administrative improvements to the system. Given the ad hoc approach with which many of the present penalties were enacted, and the sweeping impact of the Tax Reform Act of 1986, the Commissioner's efforts are very timely. Based upon what we know about the study at this time, we believe it may be useful in reaching a consensus on the definition and role civil penalties should play in the federal tax system. However, we do not believe the study scope is comprehensive enough to

- identify problems and the extent of problems in the current system,
- determine the causes of problems and understand their impact, or
- develop recommendations to correct specific problems or make broad changes in the system.

Study Focus Shifted to  
Norms of Conduct

Initially, the study task force focused much of its efforts on examining penalties in specific groupings. The penalties were grouped into six families--(1) failure to file/failure to pay, (2) understatement, (3) employee plans, (4) exempt organizations, (5) information reporting and (6) preparer/promoter.

Task force subgroups were organized to research and report on the penalties in these families. Reports from the subgroups were to provide information that could be used to develop the final report. It is our understanding that draft reports were prepared by each subgroup and transmitted to the Chairman of the Penalty Task Force earlier this year. However, according to the Task Force Chairman, the draft reports were of limited use because of

the shift in focus and could not be used as planned. The Chairman is uncertain how the information in the reports will be used in the study's final report.

The Commissioner's Study will now address "norms of conduct." The norms of conduct are broken into four basic categories: (1) accuracy of returns, (2) timeliness of returns, (3) payment of liabilities, and (4) other specialized entities. We understand that the final report is expected to use these norms as a framework for categorizing the various civil penalties in the Code.

#### Limited Use of Empirical Information

The value of the study depends upon the quality and type of information or evidence it uses. In March 1988, we testified before the House Ways and Means Subcommittee on Oversight that the Commissioner's study would draw heavily on expert opinion and advice from IRS management and outside organizations. We also pointed out that the study's methodology did not provide for the scientific sampling of taxpayer returns and accounts needed to validate the nature and extent of perceived problems.

Our concern over the lack of empirical data and analysis has been increased by changes in the study methodology. The original methodology included the assembly of existing data on each of the penalties and the identification of any gaps in this data. As discussed above, we have concerns about the accuracy of IRS data. But at this time, we believe the data is sufficient to use as a starting point in identifying trends. We have requested such information, aggregated in various ways, which we plan to use in our review.

Discussions with the study's Executive Secretary and the Chairman of the Task Force indicate that even the limited data analysis

originally proposed is no longer included in IRS' methodology. Without this data and additional empirical information, it will be difficult not only to verify whether perceived problems exist but also to quantify the extent of existing problems.

#### SUMMARY

In summary, we support the need for a comprehensive review of the civil penalty structure. Several issues need to be addressed. These include the purpose, need for, and effectiveness of each penalty provision, problems with the current penalty system, and the equity and efficiency of IRS' civil penalty administration. Past work by us, 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 first step.

However, we believe the study will not develop the empirical analyses necessary to fully address the issues. Statistical analyses, and research of taxpayer returns and accounts are essential to determine what problems actually exist, their causes and solutions. As currently structured, the Commissioner's study will not allow IRS to answer many questions key to understanding changes needed to the existing system. These questions include how well penalties are being administered, what problems IRS employees and taxpayers are experiencing with penalties, and the effectiveness of penalties in encouraging compliance. More complete answers will be available when we complete our analyses of IRS' penalty data and IRS' administration of 11 key penalties.

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