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Report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Committee on Finance, U.S. Senate

January 1991

TAX ADMINISTRATION

Effectiveness of IRS' Return Preparer Penalty Program Is Questionable

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The Honorable David Pryor
Chairman, Subcommittee on Private
Retirement Plans and Oversight
of the Internal Revenue Service
Committee on Finance
United States Senate

Dear Mr. Chairman:

This report responds to a request to review IRS' administration of the return preparer penalty program. The report discusses whether IRS opened preparer penalty cases when warranted, imposed return preparer penalties appropriately and consistently, and referred penalized preparers to the Director of Practice or the local district director as required. It includes recommendations on how the administration of these penalties can be improved.

We are sending copies of the report to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties upon request.

Major contributors to this report are listed in appendix VII. If you have any questions, please call me on (202) 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

Executive Summary

Purpose

In 1989, almost half of the individual income tax returns filed were prepared by paid return preparers. The Internal Revenue Service (IRS) has experienced problems with what it calls incompetent and unscrupulous tax return preparers who understate their clients' tax liabilities. Civil penalties are a principal tool IRS can use to punish and deter noncompliant behavior by preparers. The Senate Finance Subcommittee on Private Retirement Plans and Oversight of IRS asked GAO to review whether IRS administers preparer penalties appropriately and consistently.

Background

IRS assesses penalties on return preparers when its examination of tax returns reveals that the preparer understated the taxpayer's taxes due to (1) negligent or intentional disregard of rules and regulations, which results in a $100 penalty per return, or (2) willful understatement, which calls for a $500 penalty per return. The Omnibus Budget Reconciliation Act of 1989 raised these penalties to $250 and $1,000 respectively and revised the definitions. If IRS determines there are indications of a pattern of misconduct by a preparer, penalties may also be assessed on multiple returns in what IRS calls a program action case. A return preparers coordinator in each IRS district serves as the focal point to ensure that preparer penalty cases receive appropriate attention. In addition to assessing penalties, IRS can also refer preparers to Treasury's Director of Practice or the local district director for further disciplinary action, including reprimands or prohibiting preparers from representing taxpayers before IRS.

Results in Brief

IRS needs to better ensure that preparers engaged in negligent or abusive tax practices are penalized. Although IRS generally assessed the right penalty when it decided to penalize a preparer, GAO found that penalty cases were often not opened when potential preparer misconduct was evident on returns with at least $5,000 in taxes owed. This limits IRS' ability to penalize preparers who are guilty of misconduct and may weaken the agency's ability to deter preparer misconduct for the large number of returns not reviewed in IRS' examination program.

IRS' examiners and their supervisors indicated they were reluctant to pursue return preparer penalties because of the low dollar amounts of the penalties. Even though preparer penalties may not yield significant revenues, GAO believes their potential long-term effect in encouraging voluntary compliance by preparers and their client taxpayers should also be considered in determining the value of penalty actions.

GAO also found that IRS district offices may assess different penalties and penalty amounts for similar misconduct. This is partly due to difficulties in clearly distinguishing between the two penalties (for "intentional disregard" and for "willful understatement") and ambiguities the 1989 legislation will only partly resolve.

IRS referral of preparers for disciplinary action can also provide incentives for compliance. However, the effectiveness of this process is limited because referrals are often not made when required. This is due to examiners' lack of familiarity with the referral process, unclear guidance explaining referral procedures, and the lack of internal controls to ensure that required referrals are made.

Principal Findings

Penalty Determinations Correct but Penalty Cases Not Always Opened When Warranted

GAO reviewed fiscal year 1987 preparer penalty cases using the same criteria IRS used to make its original penalty determinations. In the 200 cases where IRS assessed a preparer penalty, the penalty determination was appropriate 84 percent of the time. IRS failed to assess all warranted penalties in 15 percent of these cases, but in only 1 percent did the agency assess penalties that were not warranted. (See pp. 15-17.)

GAO also reviewed a random sample of tax returns for which IRS had determined that there was a tax understatement of at least $5,000 but no preparer penalty case was opened. GAO estimated that in 52 percent of 455 cases for which there was enough documentation to identify the preparer's role in understating the taxpayer's liability, IRS should have opened a preparer penalty case. (See pp. 18-20.)

IRS staff indicated that the amounts of the penalties were too low to justify the time and effort required to assess them. IRS data showed that an examiner can realize several thousand dollars more from pursuing regular taxpayer audits rather than preparer penalty cases. Recognizing that IRS must make trade-offs in allocating its limited resources, GAO believes that the potential long-term effect of preparer penalties in encouraging voluntary compliance should also be considered in determining the value of preparer penalty actions. (See pp. 21-22.)

Penalties Assessed Inconsistently

Separate penalties exist for understatement of a taxpayer's liability due to "intentional disregard" of the rules and for "willful understatement." Because these two criteria are difficult to distinguish in practice, examiners must subjectively determine which penalty is appropriate; therefore, different penalties may be assessed for similar misconduct. Although recent legislation revised the penalty definitions, it is not clear that the revisions will solve the problem.

Inconsistent handling of preparer penalty cases was also prompted by differing IRS district policies. Of the district offices GAO visited, one required a higher standard of evidence than the other three to assess the penalty for willful understatement, resulting in far fewer of these penalties assessed in this district. (See pp. 22-26.)

Required Referrals Not Made

IRS policy requires that penalized certified public accountants, lawyers, and enrolled agents be referred to Treasury's Director of Practice for consideration of further disciplinary action. All other paid preparers are to be referred to the local IRS district director. However, GAO found that in 18 (about 38 percent) of the 47 cases requiring referral to the Director of Practice, no referral was made. In 70 (about 78 percent) of the 90 cases requiring referral to the district director, there was no evidence that the referral was made. GAO determined that a lack of familiarity with the referral process, unclear guidance, and poor internal controls resulted in IRS examiners failing to make required referrals. (See pp. 32-34.)

Recommendations to the Commissioner of Internal Revenue

GAO recommends specific actions the Commissioner of Internal Revenue should take to emphasize the importance of return preparer penalties, help ensure that IRS opens warranted preparer penalty cases, ensure more consistent application of the penalties, and ensure that referrals are properly made. (See pp. 27-28 and 35.)

Agency Comments and GAO's Evaluation

In written comments on a draft of this report, IRS agreed to most of the recommendations GAO made, stating that actions would be taken to improve examiner awareness, guidance, and training on the return preparer penalties and related referrals. However, the agency disagreed with GAO that a referral should be made whenever a penalty is assessed.

Apparently, the concern was that any referral would automatically result in disciplinary action. That is not the case. All it does is to trigger a further review of the preparer's conduct.

GAO believes that the failure to refer these cases would prevent referral authorities from having sufficient information to draw conclusions about compliance patterns for individual preparers that may only be apparent when reviewing a preparer's record in the aggregate. (See pp. 28-30 and 35.)

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Abbreviations

AMT	alternative minimum tax
CPA	certified public accountant
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service

ɔduction

In 1989, approximately 46 percent of the individual income tax returns filed were prepared by paid return preparers. Taxpayers pay a fee for tax return preparers' knowledge of tax law and their ability to prepare a correct return. However, for many years the Internal Revenue Service (IRS) has experienced problems with what it calls incompetent and unscrupulous tax return preparers who understate their clients' tax liabilities. When IRS identifies such preparers, they can be assessed civil penalties. According to IRS' most recent data available, 2,179 civil penalties were assessed against 1,150 preparers during fiscal year 1988.

Background

In the early 1970s, IRS statistics showed a substantial increase in the number of tax return preparers. IRS also found that a significant number of preparers had engaged in abusive tax practices. However, at that time IRS' only recourse against negligent and/or fraudulent tax return preparers was criminal prosecution. Since criminal penalties were often inappropriate, cumbersome, and ineffective deterrents because of the cost and length of time involved in trying the cases in court, IRS would generally proceed against only the most flagrant cases of return preparer fraud. Accordingly, IRS determined that criminal prosecution alone was not an effective deterrent and sought legislative authority for civil penalties. In a 1975 report, we also concluded that civil penalties would help IRS identify and take corrective action against preparers who engage in misconduct.[1] In the Tax Reform Act of 1976, Congress created civil penalties designed to enable IRS to effectively deal with the problem of incompetent and/or unscrupulous preparers.

IRS' Process for Penalizing and Referring Preparers

IRS' administration of return preparer penalties is a multistage process that includes the

- identification of potential preparer misconduct,
- opening and development of a preparer penalty case,
- proposal and assessment of appropriate penalties, and
- referral of penalized preparers for consideration of further disciplinary action.

The first step in IRS' administration of preparer penalties is the identification of potential preparer misconduct. Generally, this is done either by examiners during the audit of taxpayer returns or by district office

[1] No Apparent Need to Regulate Commercial Preparers of Income Tax Returns (GAO/GGD-76-8, Dec. 8, 1975).

return preparers coordinators, who monitor (1) ongoing examinations—audits—of tax returns completed by preparers and (2) preparer penalty assessments.

When auditing a taxpayer's return, examiners are required to determine if any tax understatement is potentially the result of preparer misconduct. To determine this, examiners are to consider various items, including whether the preparer exercised due diligence whether preparing the return.

While examiners focus on individual returns being audited, the return preparers coordinators are charged with monitoring all ongoing preparer penalty cases, as well as assessed preparer penalties, to determine if the information indicates a pattern of misconduct by a particular preparer on the returns of various taxpayers. When a pattern of misconduct exists, the coordinator is to request information on other returns completed by the preparer to determine if they appear to warrant examination.

If a review of this information indicates that the preparer has repeatedly demonstrated intentional misconduct or clear incompetence in preparing returns, a program action case should be opened.[2] In a program action case, a number of tax returns completed by the same preparer are selected for audit. During the audits, examiners again are to determine if the preparer exercised due diligence in preparing the returns and if any tax understatements were potentially the responsibility of the preparer.

When an examiner determines either through the audit of individual returns or a program action case that there are indications of preparer misconduct, the examiner is to open a preparer penalty case to determine if preparer penalties are warranted. In a preparer penalty case, the examiner is to develop and document the facts and circumstances concerning the preparer's conduct, including what actions the preparer took in completing the return and ensuring its accuracy. If after considering all the evidence the examiner determines that a preparer penalty is not warranted, the examiner is to document the basis for this determination and close the case without any further action taken (a no-change case).

If the examiner believes, on the basis of the information developed, the understatement did result from preparer misconduct, a penalty is to be proposed, and the penalty case is to be processed through a quality

[2]Program action cases must be approved by the district director or the assistant director.

review function. At this time, the quality review staff should notify the preparer of the impending penalty imposition and explain the right to appeal. If the preparer does not protest the penalty, the proposed penalty should be assessed. If the preparer protests, the penalty case is to be sent to Appeals. If Appeals determines that the penalty is not warranted, the case should be closed as a no-change case. If Appeals determines the penalty is warranted, the penalty should be assessed and recorded on the preparer's master file record.

After the appeals rights are exhausted, the preparer may request, through the filing of a claim for refund, that IRS reconsider the applicability of the penalty. If at this time IRS determines that the penalty was not warranted, it may partially or fully abate (forgive) the penalty. If IRS denies the claim, the preparer may appeal the case to a U.S. District Court.

When a penalty is assessed, IRS procedures require that certified public accountants (CPA), lawyers, and enrolled agents[3] be referred to Treasury's Director of Practice. All other paid preparers are defined as unenrolled preparers and, according to the Internal Revenue Manual (IRM), should be referred to the local IRS district director when their conduct may render them ineligible to represent taxpayers before IRS. These officials may initiate disciplinary action other than penalties. For example, the district director's disciplinary authority includes suspending preparers from representing taxpayers before IRS. The Director of Practice may institute a proceeding for suspension or disbarment of attorneys, CPAS, and enrolled agents.

Return Preparer Penalties

The Tax Reform Act of 1976 authorized two tiers of preparer penalties in section 6694 of the Internal Revenue Code (IRC). Section 6694(a) provided a first-tier penalty of $100 against a return preparer who understates a taxpayer's liability by the negligent or intentional disregard of rules and regulations. Negligence is defined by IRS as the lack of due care or failure to do what a reasonable and prudent person would do under the circumstances.

IRC Section 6694(b) provided a second-tier penalty of $500 against a return preparer who willfully understates a taxpayer's liability. A willful understatement includes situations where a preparer disregards

[3]An enrolled agent is a preparer who has demonstrated special competence in tax matters on a written examination administered by IRS.

information furnished by the taxpayer in an attempt to wrongfully reduce the tax due. This penalty may be applied concurrently with the negligent or intentional disregard penalty, but if this occurs, the total amount collected for the two penalties per return may not exceed $500.

Recent Legislative Changes

In November 1989, the Improved Penalty Administration and Compliance Tax Act was enacted as part of the Omnibus Budget Reconciliation Act of 1989. The act affected many of the civil penalty provisions of the IRC, including the preparer penalty provisions in section 6694.

The new law, which is applicable to returns prepared after December 31, 1989, retained the two tiers of return preparer penalties but revised the definitions and the dollar amounts of the penalties. The first-tier penalty has been increased to $250 and applies to returns with an understatement of tax liability where the preparer knew or reasonably should have known that a position taken did not have a realistic possibility of being sustained on its merits, and such position was not disclosed or was frivolous.

The second-tier penalty for willful understatement has been increased to $1,000 and expanded to include cases of reckless or intentional disregard of rules and regulations by a preparer. The two penalties may still be assessed concurrently, but the total amount collected for the two penalties per return may not exceed $1,000.

Although the new law changed the definition and dollar amounts of the preparer penalties, IRS' process for administering these penalties will remain essentially the same.

Objectives, Scope, and Methodology

At the request of the Subcommittee on Private Retirement Plans and Oversight of the IRS, Senate Committee on Finance, we reviewed IRS' administration of the preparer penalty provisions of the IRC. Our objectives were to (1) determine whether IRS imposed preparer penalties appropriately and consistently, (2) evaluate the quality of information IRS used when determining if penalties were warranted, (3) evaluate the quality of guidance available for examiners' use in making penalty decisions, and (4) determine whether proper referrals were being made as required to potentially initiate disciplinary actions against penalized preparers.

We obtained and reviewed information from IRS'

- National Office in Washington, DC;
- service centers in Covington, KY; Fresno, CA; Kansas City, MO; Ogden, Utah; and Philadelphia; and
- district offices in Baltimore; Cincinnati; Denver; Ft. Lauderdale, FL; St. Louis; and San Francisco.

To accomplish our objectives we

- analyzed IRS' policies and procedures relative to preparer penalty cases to determine how such cases should be processed.
- interviewed the return preparers coordinators at the IRS National Office and five district offices to further document procedures relative to preparer penalties and to obtain their views on the effectiveness of such penalties.
- obtained extracts from IRS' Individual and Business Master Files for fiscal year 1987—the latest year available at the time of our review. We used these extracts to identify the universe of fiscal year 1987 preparer penalty assessment and abatement transactions. Additionally, we used these extracts to identify the universe from which we randomly selected a sample of paid preparer returns for which IRS assessed additional tax of $5,000 or more but did not open a preparer penalty case.
- contacted service center and district return preparers coordinators and Appeals officers to identify and obtain fiscal year 1987 case files in which a preparer penalty case was opened but no penalty assessed.
- analyzed 200 fiscal year 1987 case files in which a preparer penalty case was opened and a penalty assessed and 30 case files in which a preparer penalty case was opened but no penalty assessed. These case files included all preparer penalty cases closed during fiscal year 1987 in four IRS district offices that included at least some justification for the penalty determination. We selected IRS offices in Baltimore; Denver; Ft. Lauderdale, FL; St. Louis; and San Francisco. Subsequently, we determined that the number of assessment transactions we could review from the Ft. Lauderdale District was very limited. Therefore, we excluded the Ft. Lauderdale District from our review. We reviewed these cases to determine whether (1) examiners followed established procedures, (2) IRS' penalty decisions were appropriate on the basis of IRS' criteria, and (3) required referrals of penalized preparers were made. In evaluating the information IRS used when determining if penalties were warranted, we were limited to the documentation contained in the case files at the time of our review. Appendix I provides a detailed discussion of how the four district offices were selected and the number of cases we had to exclude from our review for various reasons.

- analyzed a random sample of 113 paid preparer returns from five IRS districts where IRS assessed the taxpayers additional tax of $5,000 or more but did not open preparer penalty cases. We used the criteria of $5,000 because the IRC provides that $5,000 constitutes the minimum threshold for a substantial understatement of tax liability. We projected the sample results to a universe of 455 such cases in those five districts. We limited our universe to case files from the same four districts we used to analyze assessment and no-change case files and included the Cincinnati District because of its low reported preparer penalty activity. We reviewed the case files related to these returns to determine whether (1) preparer penalty cases should have been opened as a result of Examination's findings and (2) examiners documented the reasons for not opening preparer penalty cases. Appendix II provides a detailed discussion of our sample selection methodology and sampling errors.
- analyzed all selected case files using the same criteria IRS examiners and reviewers originally used in determining whether (1) a preparer penalty was warranted or (2) a preparer penalty case should have been opened. We also discussed with IRS quality review and Appeals staff those cases for which we disagreed with IRS' penalty determination or decision not to open a preparer penalty case. As a result of those discussions, we changed our determinations on some cases to agree with IRS' action.
- sent questionnaires to tax examiners and their first-line supervisors (group managers) in five IRS district offices. About 89 percent of the 1,480 examiners and 92 percent of the 157 group managers responded. Our purpose was to obtain their views on the administration of preparer penalties, including referrals. Appendix III provides a detailed discussion of our sampling methodology and questionnaire response rates. Questionnaire results for group managers are presented in appendix IV and in appendix V for tax examiners.
- analyzed Treasury Department Circular 230, which governs the practice of attorneys, CPAs, and enrolled agents before IRS. In addition, we interviewed the Director of Practice to determine how penalty cases requiring referral to the Director for consideration of disciplinary action are processed and what disciplinary actions the Director of Practice may take.
- reviewed the Commissioner's 1989 Study of Civil Penalties to determine if the findings and recommendations would have any impact on our review.
- reviewed recent legislative changes in the Omnibus Budget Reconciliation Act of 1989 and analyzed their impact on IRS' administration of preparer penalties. Discussion of these changes is incorporated throughout this report where appropriate.

We originally planned to analyze 100 percent of fiscal year 1987 preparer penalty abatements in the four district offices where we reviewed penalty assessments and no-change case files to determine if IRS' decisions to abate were appropriate. In addition, we planned to include abatement cases from the Phoenix District because it accounted for over two-thirds of the amount of penalties abated nationwide. However, we were unable to review abatement cases primarily because most of the case files contained insufficient documentation.

Our review of preparer referrals to Treasury's Director of Practice and IRS' local district director was limited to those referrals that resulted from preparer penalty assessments, although referrals may be made for other reasons.

The findings discussed throughout this report are based on our analysis of IRS' administration of the preparer penalty provisions in the IRC as of fiscal year 1987. However, even though the law affecting preparer penalties recently changed the definition and dollar amounts of the penalties, the legislation did not resolve the administrative problems discussed in this report.

We did our work between February and November 1989 in accordance with generally accepted government auditing standards.

IRS provided written comments on a draft of this report. Its comments are included in appendix VI and are evaluated on pages 28 to 30 and 35.

Improvements Needed in IRS' Administration of Preparer Penalties

IRS' administration of return preparer civil penalties needs improvement to ensure that preparers engaged in negligent and abusive tax practices are identified and penalized. Our review showed that when a preparer penalty case was opened, IRS generally made the correct penalty determination. However, we found that preparer penalty cases, the vehicle IRS uses to identify and penalize problem preparers, were frequently not opened as required. Even though the IRM requires examiners to consider the applicability of preparer penalties during every taxpayer audit and open a preparer penalty case when misconduct exists, this is not always done.

IRS' failure to open all warranted penalty cases results from the perception on the part of examiners and group managers that pursuit of the penalties does not justify the effort required, particularly in view of the low dollar amounts of the penalties. However, this view may be shortsighted. We found, on the basis of discussions with IRS officials and preparers, that another factor to consider regarding the value of penalties is their potential long-term effect on encouraging voluntary compliance by preparers and their client taxpayers.

In addition, we found that IRS district offices may assess different penalties and penalty amounts for similar misconduct. Inconsistent penalty assessments result from difficulty in differentiating between penalties, differing district office policies, and differing interpretations of the IRC.

Penalty Determinations Generally Correct

As shown in table 2.1, we found, through reviewing 200 closed preparer penalty assessment cases and 30 preparer penalty no-change cases, that most of the time IRS made the correct penalty determination. Most cases in which IRS made an incorrect determination involved instances where all warranted penalties were not assessed.

Table 2.1: Results of GAO Analysis of Assessment and No-Change Cases

Assessment cases	IRS' determination correct	Assessed penalty not warranted	Warranted penalty not assessed	Total number of cases
Penalty assessed				
Negligence	121	1	28	150
Willful understatement	12	2	n/a	14
Negligence and willful understatement	29	0	n/a	29
Total	**162**	**3**	**28**	**193[a]**
No-change cases	16	n/a	13	29[b]
Total all cases	**178**	**3**	**41**	**222**

[a]In 7 of the 200 assessment cases, the documentation in the files was inadequate to determine if IRS made the correct penalty determination.

[b]In 1 of the 30 no-change cases, the documentation in the files was inadequate to determine if IRS made the correct penalty determination.

We determined that IRS made the correct penalty determination in 178 of 222 preparer penalty cases we reviewed. While we agreed with IRS' determination 84 percent of the time when there was an assessment (162 of 193 cases), the percentage dropped to 55 percent for no-change cases (16 of 29 cases).

In three cases, IRS assessed penalties that were not warranted. In 28 cases, a negligent or intentional disregard penalty was assessed; however, our analysis of the case files and IRS' criteria indicated that a willful understatement penalty was also warranted.

For example, in two related cases the taxpayer provided the preparer with detailed check registers to compute the taxpayer's expenses. However, the preparer grossly overstated expenses on the returns. After adjustments by IRS, the tax liability increased about $18,000. The examiner concluded that the returns were not prepared from available records, and the preparer was assessed a negligent or intentional disregard penalty. Treasury regulations state that a willful understatement penalty is warranted when a preparer disregards information provided by a taxpayer. Therefore, because the preparer disregarded information provided in the check registers, a willful understatement penalty should also have been assessed in these cases.

IRS district office representatives disagreed; they said their district office policy, unlike other districts, requires examiners to obtain the preparer's position and a signed affidavit from the taxpayer before assessing the willful understatement penalty. Because the examiner did

not obtain the required documents, according to this district office, the additional penalty was not warranted. However, we found no National Office guidance requiring that these documents be obtained before a willful understatement penalty is assessed and that other districts assessed the penalty without such documents. We maintain, therefore, that the willful understatement penalty was warranted and should have been assessed even without the additional documents. Our determination is in accordance with IRS National Office guidance, which states that a penalty is warranted when a preparer disregards information provided by a taxpayer that consequently results in an understatement of the taxpayer's tax liability.

In 13 of the 29 no-change cases, we found that IRS incorrectly determined that no penalty was warranted. For example, no penalties were assessed against a preparer who, for 2 consecutive years, incorrectly expensed items—such as a furnace, a refrigerator, a stove, and a lawn mower—that should have been capitalized and depreciated. According to documentation in the case file, the taxpayer provided worksheets to the preparer summarizing the items to be included in repairs expense. The nature of the above items should have caused the preparer to question the taxpayer about them. Because the preparer did not question the treatment of the items and because their mistreatment ultimately resulted in an understatement of tax, we believe a preparer penalty should have been assessed. However, the examiner closed the case without assessing penalties. IRS district office representatives concurred with our position that a negligence penalty should have been assessed.

Through case file analysis and discussion with IRS representatives of cases where we did not agree with IRS' penalty decision, we attempted to determine why appropriate penalties were not always assessed. For the no-change cases, we were unable to identify the reasons why IRS incorrectly determined that no penalty was warranted. For the assessment cases, we determined that IRS did not always assess appropriate penalties because (1) examiners had difficulty differentiating between the applicability of the negligent or intentional disregard penalty and the willful understatement penalty (see discussion on p. 23) and (2) there were overly stringent policies in one district office regarding the level of evidence required to assess the penalty for willful understatement (see discussion on p. 24).

Warranted Penalty Cases Often Not Opened

Preparer penalty cases are the key component of IRS' process of identifying and penalizing problem preparers. It is in the preparer penalty cases that IRS focuses on the conduct of the preparer rather than the taxpayer and determines if that conduct warrants penalties. However, our review showed that district office examiners were frequently not opening preparer penalty cases when warranted. As a result, problem preparers may not be identified and penalized, and return preparers coordinators may not have the information necessary to identify patterns of noncompliance and initiate Program Action Cases.

District Offices Not Always Opening Warranted Penalty Cases

The IRM requires that during every taxpayer audit the district office examiner determine if potential preparer misconduct exists. The examiner should consider various items, including whether the preparer exercised due diligence in preparing the return. If there are indications of misconduct, the examiner should open a preparer penalty case to determine if penalties against the preparer are warranted.

To determine if district office examiners are identifying potential preparer misconduct and opening warranted penalty cases, we analyzed, from 5 district offices, a random sample of 113 individual income tax returns found to have a tax deficiency of $5,000 or more during audit and for which a preparer penalty case was not opened. We estimated the sample results to a universe of 455 such cases in the 5 districts.

When a preparer penalty case is not opened, the IRM requires that the reasons for not opening the case be documented by the examiner. However, we estimated that in 78 percent of the 455 cases in our universe, the file did not contain any explanation of why a preparer penalty case was not opened.[1]

We reviewed the cases to make our own judgment as to whether a preparer penalty case should have been opened. On the basis of our review, we estimated that in 64 percent of the 455 cases the case file did not contain enough information regarding the preparer's role in completing the return to determine if a preparer penalty case should have been opened. Consequently, potential problem preparers may not have been identified for further review.

[1]Appendix II shows the sampling errors and confidence intervals for all estimates included in this report.

We estimated that in 36 percent of the 455 cases, the case file contained enough information on the preparer's role in completing the return for us to determine if a preparer penalty case should have been opened. Our review of these cases showed that, in an estimated 52 percent of them, a preparer penalty case should have been opened but was not. For example, in one case the preparer failed to compute the alternative minimum tax (AMT) as required by the IRC and as explained in the Form 1040 instruction booklet. This resulted in about $4,100 of the taxpayer's total tax understatement of about $9,100. The examiner's notes indicated that the preparer failed to compute the AMT on both the 1987 and the prior year's returns.

The 1040 instruction booklet states that if the adjusted gross income plus the amount of accelerated depreciation totals more than $40,000 when a joint return is filed, the AMT form should be completed to determine if, in fact, the taxpayer is liable for the AMT. Since the taxpayer's return met this criteria, the preparer should have completed the form. Because the preparer failed to follow the requirements for computing the tax, there clearly were indications of preparer negligence, but the examiner did not open a preparer penalty case to determine why the AMT was not computed and if penalties should have been assessed.

IRS district office representatives disagreed with our position that a preparer penalty case should have been opened. According to them, the amount of the accelerated depreciation deduction compared to straight line depreciation was negligible because it was for a 5-year property in the fifth year. Therefore, in their opinion, the preparer's failure to compute the AMT did not indicate potential misconduct. We disagree with IRS' position. Although the accelerated depreciation deduction was negligible, the AMT computation resulted in about $4,100 of additional tax due. Had the preparer made the computation as required, the resulting tax liability would not have been understated by the $4,100 on which the taxpayer was consequently assessed penalties and interest. Therefore, we maintain that the preparer's failure to compute the AMT as required is an indication of preparer misconduct and that a preparer penalty case should have been opened to determine if penalties were warranted against the preparer.

In another example, the taxpayer was missing a Form 1099 for nonemployee compensation. Although taxpayers are required to include all income on their tax return, the preparer recommended that the taxpayer exclude this income from the return and file an amended return

when he found the Form 1099. Because approximately $24,800 in compensation was not included on the return, taxes were understated by over $10,500. A Treasury regulation states that if a preparer disregards information furnished by the taxpayer concerning items of taxable income, the preparer may be subject to a preparer penalty. Therefore, because the preparer disregarded information provided by the taxpayer regarding the nonemployee income and did not estimate on the return the amount of income on the missing Form 1099, a preparer penalty case should have been opened but was not. IRS district office representatives agreed with our position.

Inconsistency in Opening Warranted Penalty Cases Hinders Exposure of Problem Preparers

In addition to not penalizing preparers who are guilty of misconduct on a single return, the failure to open warranted penalty cases also adversely impacts IRS' ability to detect and deter preparers who consistently violate the law. Such preparers are of particular concern to IRS because their actions may undermine taxpayers' voluntary compliance with tax laws. Because IRS audits only a limited number of returns, returns completed by a specific preparer may come to IRS' attention only occasionally. Since occasional penalty assessments may not effectively deter preparers who consistently violate the law, IRS has a special compliance program to assess multiple penalties against such preparers. Such actions against these preparers are referred to as Program Action Cases.

In a program action case, the returns completed by preparers who have shown a pattern of noncompliance are targeted for audit. To identify preparers who consistently violate the law, IRS assigned responsibility to the district office return preparers coordinators for monitoring open and closed preparer penalty cases against individual preparers. The coordinators serve as IRS' focal point to ensure that return preparer penalties are given the proper attention. However, if IRS examiners do not open warranted preparer penalty cases when auditing taxpayer returns, the opportunities of return preparers coordinators to identify patterns of preparer misconduct and to initiate Program Action Cases are very limited. Consequently, IRS' ability to identify and discipline problem preparers and correspondingly protect taxpayers and the tax system is undermined.

Examiners and Group Managers Say Penalties Not Worth the Effort

Responses to our questionnaires indicated that examiners are discouraged from opening preparer penalty cases because they believe that the amounts of the penalties do not justify the time and effort required to assess them. Compared with the $100 or $500 yield from the preparer penalty, an examiner can realize several thousand dollars more, on average, from pursuing regular taxpayer audits.[2] Over 66 percent of the examiners responding to our questionnaire indicated that the amount of the negligent or intentional disregard penalty discourages them from opening a case. Likewise, about 45 percent responded that the amount of the willful understatement penalty discourages them. Additionally, about 61 percent of the examiners responding indicated that the time required to develop a preparer penalty case also discourages them from opening cases. Group manager responses further supported that these factors discourage examiners from opening preparer penalty cases. The following statements are examples of the views held:

"I do not pursue these penalties as often as I should because the amount of the penalties, to me, do not warrant the time and effort you need to put forth to develop and finish the case." (Examiner)

"The amount of paperwork involved in proposing . . . a preparer . . . penalty . . . is time prohibitive and discourages the assertion of penalties except in the most severe of cases . . . ." (Examiner)

"A real obstacle with the . . . penalty is the lack of motivation and interest associated with pursuing the penalties. While we teach the penalty, as managers we are not doing enough to encourage pursuit . . . ."

"The dollar value or lack of one is a real deterrent to examiners; . . . agents take an attitude that it's too much time and hassle for the dollars involved." (Group Manager)

Although recent legislation increased the dollar amounts of the penalties from $100 and $500 to $250 and $1,000 respectively, the increases, in our opinion, are not sufficient to offset examiner and group manager concerns about the low yield. However, based on the congressional debate before the 1989 increase in the dollar amounts of the penalties, it is unlikely that the yield realized from opening preparer penalty cases will ever match the thousands of dollars that can be realized from regular taxpayer audits. At any rate, discussions with preparers reveal that preparer penalties may be viewed as overly harsh relative to the

[2]Based on IRS' Examination yield statistics.

fees charged per return by most small preparers. As a result, IRS examiners could be even more reluctant to assess the penalties.

The amount of the penalty is only one factor to be considered in allocating IRS' limited resources. According to preparers and IRS officials, a better overall measure is the long-term effect of the penalties on encouraging voluntary compliance by preparers and their client taxpayers. We agree that compliance is a factor to consider in deciding to initiate penalty cases given (1) that almost half of the individual tax returns filed are prepared by paid preparers, (2) that there is declining audit coverage, and (3) the enforcement program's generally accepted deterrent effect.

Penalties Assessed Inconsistently

Inconsistent treatment of preparers results from different penalties and amounts being assessed for similar misconduct and can adversely affect IRS' relationship with preparers. During our case file review and on the basis of responses to our questionnaire, we found that examiners had difficulty distinguishing between preparer penalties because separate penalties existed for a preparer who understated a taxpayer's liability due to "intentional disregard" of the rules ($100 penalty) and one who "willfully understated" a taxpayer's liability ($500 penalty). Similarly, a preparer's willful attempt to understate a tax liability also meets criteria for a $1,000 penalty under IRC Section 6701 for aiding and abetting in an understatement of tax liability.[3] Lack of a clear distinction between these penalties forced examiners to subjectively determine which penalty to assess. As a result, different penalties were assessed for similar misconduct. Although the Omnibus Budget Reconciliation Act of 1989 revised the penalty provisions, the new definitions still may not clearly distinguish between the preparer penalties. (See discussion on p. 26.)

Inconsistencies in penalty assessments also occurred among local offices because in one district office a more stringent level of evidence was required to assess the willful understatement penalty. There were also different interpretations of the penalty provisions regarding the amount to be assessed for the willful understatement penalty when both the negligence and willful understatement penalties were assessed. As a

[3]Section 6701 establishes a $1,000 penalty per document against persons who directly aid or abet in the preparation of tax documents that they know will produce an understatement of tax liability in connection with a material matter arising under the internal revenue laws. We address this penalty because it may apply to preparer misconduct warranting the willful understatement penalty.

result, similar misconduct may bring different penalties on the basis of the location of the preparer rather than the severity of the offense.

Examiners Find It Difficult to Differentiate Between Penalties

Because there is not a clear distinction between the "intentional disregard" and "willful understatement" penalty definitions, examiners have to make subjective determinations in selecting which penalty to assess. However, we found that examiners have difficulty determining which penalty is warranted. About 62 percent of the examiners and 44 percent of the group managers responding to our questionnaire indicated that it is difficult to distinguish between conduct warranting only the negligent or intentional disregard penalty and conduct warranting the willful understatement penalty. This creates a high potential for inconsistent treatment of preparers. While one preparer's misconduct may have resulted in a $100 negligent or intentional disregard penalty, similar misconduct by another preparer may have resulted in a $500 willful understatement penalty. Inconsistency such as this can adversely affect IRS' relationship with preparers.

Additionally, there is a lack of distinction between the penalty for willful understatement and the penalty contained in IRC Section 6701 for aiding and abetting in the understatement of another's tax liability. When examiners were asked to what extent they felt they were able to make the correct determination whether to pursue the section 6701 penalty for aiding and abetting against a preparer versus the penalty for willful understatement, about 32 percent responded "to little or no extent."

When group managers were asked to what extent examiners in their group were correctly determining when to pursue the section 6701 penalty against a preparer versus the willful understatement penalty, 44 percent responded "to little or no extent." An IRS Chief Counsel representative concurred, stating that when penalizing preparer misconduct there is no discernable difference in the appropriate application of one penalty over another. As a result, one preparer may have been assessed a $500 willful understatement penalty while another preparer may have been assessed a $1,000 section 6701 penalty for similar misconduct.

Local Policies Differ on Standards of Evidence Needed to Support Willful Understatement

We found that district offices' local policies require different standards of evidence to support the willful understatement penalty. A representative in one district told us that, unlike other districts, a willful understatement penalty will not be assessed unless the taxpayer provides a signed affidavit documenting the circumstances surrounding preparation of the return. The district also requires that the preparer be contacted before the penalty can be assessed. If the preparer cannot be contacted or there is no affidavit from the taxpayer, only the $100 negligent or intentional disregard penalty is to be considered. In this district office, only one willful understatement penalty was assessed during fiscal year 1987, and that was the result of a preparer pleading guilty to preparing false tax returns. Our review of the case files in this district indicated that a willful understatement penalty was warranted but not assessed due to the stricter standards in 21 additional cases.

We found no National Office guidance stating that these requirements are to be met before a willful understatement penalty is assessed. Other districts assessed the willful understatement penalty without obtaining an affidavit from the taxpayer. For example, in one case where the preparer was assessed only the negligent or intentional disregard penalty for not preparing the return from available records (see p. 26), a district office representative said that a willful understatement penalty was not assessed because there was no affidavit or preparer contact. However, we identified two cases, with similar circumstances, from another district office where both the negligence and willful understatement penalties were assessed, but no affidavit was obtained from the taxpayer.

IRC Language Also Causes Inconsistent Penalty Assessment

Differing interpretations of the IRC also result in district offices assessing different amounts for the willful understatement penalty when both a negligence and willful understatement penalty are assessed for the same return. In two districts, when a negligence and willful understatement penalty were both assessed on the same return, the total amount assessed was $600—$100 for the negligent or intentional disregard penalty and $500 for the willful understatement penalty. In a third district, the total amount assessed was $500—$100 for the negligent or intentional disregard penalty and $400 for the willful understatement penalty.[4]

[4]In the fourth district we did not find any cases where both a negligence and willful understatement penalty were assessed against the same preparer for the same return.

The inconsistency in the amount assessed occurs because of differing district interpretations of the IRC. The IRC states that when both penalties apply to the same return, the amount payable for the willful understatement penalty should be reduced by the amount of the negligent or intentional disregard penalty paid. The congressional intent as expressed in the legislative history was to limit the total amount collected to $500 per return when both the negligent or intentional disregard penalty and the willful understatement penalty are assessed. Thus, when both of the penalties are assessed, the willful understatement penalty should be reduced by the amount of the negligent or intentional disregard penalty collected.

In practice, the districts we reviewed administered the provision differently. Two districts assessed $100 and $500 when the penalties were assessed against one return because no collections had been made and, consequently, no offset of the willful understatement penalty was required. These districts relied on Collection staff to limit the amount collected to $500. However, under current procedures, when the penalties are collected, the Collection staff has no way of knowing whether the willful understatement penalty should be offset. As a result, in some cases in these two districts, $600 was collected. A third district assessed $100 and $400 to prevent collection in excess of $500. Because of these differing interpretations and differing assessment amounts, IRS collected different amounts for these two preparer penalties.

Recent Legislative Changes Will Not Resolve Most Administrative Problems

In the Omnibus Budget Reconciliation Act of 1989, Congress redefined and increased the amounts of the preparer conduct penalties. The revisions apply to returns prepared after December 31, 1989. The first-tier preparer penalty previously required IRS to show preparer negligence or intentional disregard of the rules or regulations. The revised penalty applies to returns with an understatement of tax liability in cases where the preparer knew or reasonably should have known that a position taken did not have a realistic possibility of being sustained on its merits and such position was not disclosed or was frivolous. The second-tier preparer penalty retains the prior provisions for willful understatement but was expanded to include reckless and intentional disregard of the rules or regulations. This may help distinguish application of the two penalties because, prior to the 1989 revisions, the penalty provision for intentional disregard of the rules or regulations was included in the first-tier penalty but was difficult to distinguish from willful understatement in the second tier.

Although the Omnibus Budget Reconciliation Act of 1989 revised these penalty provisions, the new definitions do not clearly distinguish between the two preparer penalties. If IRS can prove that the preparer knowingly took an unsustainable position—a first-tier penalty, the preparer may also be guilty of willful understatement—a second-tier penalty. Also, under the new provisions, there is still a lack of definitional distinction between the willful understatement penalty and the section 6701 penalty for aiding and abetting, although the amounts of the penalties are now the same.

Although the amount of the first-tier penalty was increased to $250 and the second-tier penalty to $1,000, the impact of the increases in the penalty amounts is not yet known. However, as previously noted, examiners can realize several thousand dollars more, on average, by working on a regular taxpayer audit. On the basis of that estimate, responses to our questionnaire, and interviews with IRS district office representatives, we do not believe that the increases will be large enough to offset examiners' concerns about the low yields from these penalties. Accordingly, IRS should consider not just the penalties' monetary amounts but also their potential contributions to future compliance.

Further, under the new legislation, the amount assessed for the second-tier penalty continues to be offset by the amount collected for the first-tier penalty.

Conclusions

Our review of preparer penalty activities at selected IRS district offices showed that IRS is not always opening return preparer penalty cases when warranted. In the cases we reviewed where no preparer penalty case was opened and a determination could be made on whether one was warranted, we estimated that a case should have been opened 48 percent of the time. Additionally, in a majority of the cases we found a lack of documentation explaining the role of the preparer and the examiner's decision not to open a preparer penalty case. Consequently, potential problem preparers may not have been identified for further review. According to IRS examiners and group managers, the reasons for not pursuing preparer penalties included the low dollar amounts of the penalties and the time required to develop the cases.

In addition to not penalizing preparers who are guilty of misconduct on a single return, the failure to open warranted penalty cases reduces the opportunity of district office return preparers coordinators, who play a pivotal role in IRS' preparer oversight, to identify patterns of preparer

misconduct and to initiate Program Action Cases. The effectiveness of the coordinators is then limited because preparer penalty cases are not being opened when warranted.

To help resolve the problems we found, in addition to emphasizing the potential role preparer penalties play in achieving compliance, IRS should strengthen the role of the coordinators in monitoring and reviewing cases in which preparer penalties are assessed and in no-change cases in which there is a substantial adjustment in the taxpayer's tax liability.

When cases are opened, IRS is not always appropriately and consistently assessing all justified penalties. A penalty was warranted in about 45 percent of the no-change cases, and harsher penalties were justified in 15 percent of the cases where penalties were assessed. In addition, because different penalties and penalty amounts may be assessed for similar misconduct, preparers may be treated inconsistently. These problems result from the lack of clear distinction in penalty definitions, differing district office policies regarding the standard of evidence required to assess the willful understatement penalty, and differing interpretations of the IRC.

Although the 1989 Omnibus Budget Reconciliation Act modified the dollar amounts and definitions of return preparer penalties, the administrative problems discussed in this chapter will, for the most part, not be resolved by those modifications to the IRC.

Recommendations to the Commissioner of Internal Revenue

To emphasize the contribution of preparer penalties to future compliance and to help ensure that IRS opens warranted preparer penalty cases, we recommend that the Commissioner of Internal Revenue

- take actions to ensure that examiners consider the penalties and document their decisions regarding the opening of preparer penalty cases. These actions could include a memorandum to examiners and group managers emphasizing existing penalty requirements as well as other communications.
- ensure that district office return preparers coordinators are opening Program Action Cases where appropriate against preparers who demonstrate patterns of misconduct. In particular, the coordinators should be directed to review Examination cases where there is a substantial adjustment to the taxpayer's liability to determine if a preparer penalty case is warranted.

To ensure that preparer penalties are assessed appropriately and consistently, we recommend that the Commissioner of Internal Revenue

- develop National Office guidance that to the greatest extent possible clearly defines and differentiates between the preparer penalties as defined in section 6694(a) for taking an unrealistic position and section 6694(b) for willful or reckless conduct,
- develop National Office guidance that to the greatest extent possible differentiates between the section 6694(b) penalty for willful or reckless conduct and the section 6701 penalty for aiding and abetting an understatement of tax liability, and
- review district office policies on return preparer penalties to ensure that those policies are consistent with National Office guidance.

To ensure compliance with the IRC, we also recommend that IRS adopt procedures to ensure that no more than the maximum amount allowable under the IRC is collected for these penalties. If IRS determines the problem cannot be eliminated administratively, IRS should request Congress to modify the statute to limit the total amount IRS can assess, rather than collect, for these penalties.

Agency Comments and Our Evaluation

In general, IRS agreed with our recommendations for enhancing examiner awareness of the return preparer penalties and for improving the quality and availability of related examiner guidance and training. IRS stated that many of our recommendations will be incorporated into the multifunctional Civil Penalty Handbook, which is being developed, and that additional training will be given to examiners in the 1991 Continuing Professional Education Program.

In addition, in response to our recommendation that action be taken to ensure examiners consider penalties and document their decisions regarding the opening of preparer penalty cases, the Assistant Commissioner (Examination) will issue a memorandum to the Assistant Regional Commissioners (Examination) emphasizing the existing penalty requirements.

IRS also agreed to develop guidance that differentiates to the greatest extent possible between the penalties in sections 6694(a) and 6694(b) and between 6694(b) and 6701. This guidance will be included in the regulations implementing the 1989 Omnibus Budget Reconciliation Act

as well as the Penalty Handbook. IRS will also review district office guidance on preparer penalties to ensure consistency with the National Office policy directives contained in the Penalty Handbook.

The actions IRS agreed to take to implement our recommendations for enhancing examiner awareness of the penalties and to improve IRS guidance and training are responsive to these recommendations.

IRS agreed to take administrative actions to reduce the possibility that no more than the maximum amount allowable under the IRC is collected for these penalties. IRS was concerned, however, that there may be no administrative measures available at this time to eliminate the possibility of excess collections in all cases. Given IRS' concern, we modified our final recommendation to reflect the need for IRS to request that Congress modify the statute if the problem cannot be eliminated administratively.

IRS disagreed with our recommendation that the return preparers coordinators review exam cases with a substantial change in tax liability, indicating that workload constraints make this impracticable. According to IRS, this concern should be addressed in the normal quality review process. That process entails a sampling approach.

We are sympathetic to workload considerations and agree that a sampling approach is feasible. We also agree that the normal quality review process should focus on this issue. We note, however, that in the districts we analyzed an estimated 60 percent of the cases having an adjustment exceeding $5,000 and for which a preparer penalty case should have been opened but was not were quality reviewed, but the problem was not corrected. Thus, it appears that the attitude expressed by examiners concerning the merits of preparer penalties was shared by the quality review function.

The actions proposed by IRS to enhance examiner awareness of the penalties should improve IRS penalty administration, including quality review. However, given the pervasiveness of the attitude across the organization concerning the merits of preparer penalties, management may need an interim mechanism for assuring itself that its actions have been effective or for determining whether other actions are needed. One way to do this would be for IRS to establish, for an interim period, a procedure whereby those cases having a substantial change in tax liability that are subjected to the quality review process would in turn be sampled by the return preparer coordinators. If on the basis of these

reviews, the return preparer coordinators determined the proposed actions sufficiently improved penalty administration, their involvement in the process could be reduced or eliminated.

Effectiveness of IRS' Process for Referring Penalized Preparers Is Questionable

To monitor potential problem preparers, IRS has established a process for referring penalized preparers for consideration of further disciplinary action. CPAs, lawyers, and enrolled agents should be referred to Treasury's Director of Practice. All other paid preparers should be referred to the local IRS district director. According to IRS officials, referrals motivate preparer compliance more than penalties. However, the effectiveness of the process is questionable because referrals are not always made when penalties are assessed. This is due to examiners' lack of familiarity with the referral process and inadequate IRS guidance on when a referral should be made and by whom. Further, IRS has no internal controls to ensure that referrals are made as required.

Referral Process

IRS guidance requires that referrals be made when there are indications that a preparer is incompetent, disreputable, or noncompliant with Treasury regulations. According to the IRM, indicators of these attributes include a preparer penalty assessment, a criminal conviction under the revenue laws, or the giving of false or misleading information to the Department of the Treasury. The IRM also states that CPAs, lawyers, and enrolled agents should be referred to Treasury's Director of Practice when a preparer penalty is assessed.

All other paid preparers are defined as unenrolled preparers and, according to the IRM, should be referred to the local district director when their conduct may render them ineligible to represent taxpayers before IRS. The standards of conduct for eligibility require that unenrolled preparers exercise due diligence in the preparation of returns. An assessment of a preparer penalty indicates the lack of due diligence. Therefore, in our opinion, a referral to the local district director should be made when a penalty is assessed.

The Director of Practice or district director is to track the preparer referrals and determine whether disciplinary action is warranted. A single referral does not necessarily result in disciplinary action. The determination may be based on a number of referrals received for similar violations against the preparer or on one referral where the act was so serious in nature that it alone justifies disciplinary action.

If an enrolled practitioner's misconduct is determined to warrant disciplinary action, the Director of Practice may reprimand the practitioner. A reprimand is a warning to discontinue the noncompliant behavior. In more serious cases, the Director of Practice can institute a proceeding to prohibit the practitioner from representing taxpayers before IRS for a

specified period of time. In disciplining an unenrolled preparer, a district director may prohibit the preparer from representing taxpayers before IRS. However, IRS cannot preclude practitioners or unenrolled preparers from preparing tax returns for a fee without getting a court-ordered injunction.

Required Referrals Not Always Made

According to IRS group managers, referrals motivate compliance more than penalties. About 69 percent of the group managers responding to our questionnaire indicated that a referral to the Director of Practice motivates compliance more than a single penalty assessment. Likewise, about 30 percent of the group managers responding believed that a referral to a district director motivates compliance more than an assessment.

However, although deemed to be important, the effectiveness of the referral process is not being maximized because referrals when penalties are assessed are often not made as required by IRS procedures. In 137 of the 200 preparer penalty assessment case files (see p. 24) where we could determine the type of preparer, 47 cases warranted a referral to the Director of Practice.[1] However, in 18 (38 percent) of the 47 cases, the required referral to the Director of Practice was not made. Ninety cases warranted referral to the district director, but in 70 (78 percent) of the 90 cases, the case file documentation did not indicate that the required referral was made. Information obtained from representatives in three district offices indicated that district directors seldom, if ever, receive referrals of penalized unenrolled preparers.

Why Referrals Not Always Made

Examiners fail to make referrals because they are unfamiliar with the referral process and are provided guidance that does not adequately define when referrals should be made and who is required to make them. In addition, the lack of internal controls to ensure that referrals are made as required exacerbates the problem.

Examiners Not Familiar With Referral Process

The results of our questionnaire showed that about 62 percent of examiners responding were unfamiliar with the process for referring penalized practitioners to the Director of Practice, and 71 percent of them were unfamiliar with the process for district director referrals.

[1] In the remaining 63 case files, we could not determine to whom the required referral should have been made because the type of preparer was not documented.

Examiners' lack of familiarity may result from limited exposure to preparer penalty cases and inadequate training. Our questionnaire results showed that about 74 percent of the examiners responding indicated they had not pursued a negligent or intentional disregard penalty in the preceding 12 months. The percentage of examiners who had not pursued the willful understatement penalty was even higher at approximately 88 percent. Because many examiners have not pursued these penalties, it is not surprising that examiners are unfamiliar with the referral process.

In response to our questions about referral training, 49 percent of examiners responding indicated that they had not received training on when to refer practitioners to the Director of Practice. For those examiners who received training, about 50 percent indicated that the training was less than adequate. About 55 percent of examiners responding indicated that they did not receive training on when to refer unenrolled preparers to the district director. Of those who received training, about 52 percent indicated that the training was not adequate. Over 45 percent of the group managers agreed with the examiners that training on referrals was less than adequate.

When Referrals Are Required Is Unclear

We found that IRS' guidance concerning referrals does not clearly define when examiners are required to make referrals to district directors for unenrolled preparers. However, the guidance clearly states that referrals to the Director of Practice are required when a penalty is assessed.

The IRM says that unenrolled preparers should be referred to district directors when their conduct is such that it would render the preparer ineligible to represent taxpayers. However, it does not specifically say that assessment of a penalty indicates conduct that may render a preparer ineligible and, therefore, should result in a referral. As a result, the IRM does not adequately define for examiners when referrals to district directors are required.

The standards of conduct for eligibility, however, do require that unenrolled preparers exercise due diligence in the preparation of returns. An assessment of a preparer penalty indicates the lack of due diligence. Therefore, in our opinion, a referral to the local district director should be made when a penalty is assessed. On that basis, we used a preparer penalty assessment against an unenrolled preparer as the criteria to determine if a referral to the district director was warranted.

Responsibility for Making Referrals Is Unclear

Additionally, referrals are not always made when penalties are assessed because the IRM does not designate responsibility for making referrals. No designation of responsibility increases the likelihood that a required referral will not be made.

The IRM states that Appeals is responsible for making a referral when Appeals determines that a penalty is warranted. However, the IRM does not state who is responsible for making the referral in cases that do not go to Appeals. These include cases agreed at the Examination level and unagreed cases where the preparer does not request an appeal. Although not designated in agreed cases, the examiner's responsibility for making the referral is implied because it is known that a penalty will be assessed.

The responsibility is not implied in unagreed cases where the preparer does not request an appeal. Therefore, designating responsibility is especially important in these cases. When the preparer does not agree, the examiner often does not complete a referral, and the case goes to the district quality review staff, which notifies the preparer of the right to appeal. In cases where the preparer does not request an appeal, there is no IRS guidance on whether the examiner or the quality review staff should make the referral in these unagreed cases. As a result, required referrals are often not made in these cases.

The problems with the referral process are compounded by IRS' lack of internal controls to ensure that referrals are made when preparer penalties are assessed. Even though district return preparers coordinators are responsible for monitoring preparer penalty actions, their responsibilities do not include ensuring that required referrals are made.

Conclusions

According to IRS group managers, referrals motivate preparer compliance more than penalties. However, the effectiveness of the referral system is not being maximized because referrals are not always made when required. In the cases we reviewed, 38 percent of the required referrals to the Director of Practice were not made. Additionally, in about 78 percent of the cases involving an unenrolled preparer, we found no evidence that referrals to district directors were made.

Referrals were not always made because examiners lack familiarity with the requirements and because of inadequate guidance on the referral process. Most of the examiners responding to our questionnaire said they were not familiar with the process for both the Director of

Practice and district director referrals. IRS guidance, although clear on when referrals to the Director of Practice are required, is less specific on when referrals to district directors are appropriate. Also, the guidance does not define who is responsible for making the referrals. Furthermore, the problem is exacerbated because IRS lacks internal controls to ensure that referrals are made as required.

Recommendations

To ensure that referrals are made when required, we recommend that the Commissioner of Internal Revenue

- clarify the IRM to clearly state that referrals are required when preparer penalties are assessed and designate responsibility for making them and
- assign the district return preparers coordinators the responsibility for ensuring that required referrals are made to the proper authority when penalties are assessed.

Additionally, to further ensure that referrals are made when required, examiners need to become more familiar with the referral requirements. To increase examiners' familiarity, we recommend that the Commissioner of Internal Revenue ensure that examiners receive training that clearly communicates the referral requirements.

Agency Comments and Our Evaluation

IRS agreed to take actions to clarify when preparer referrals are required and who is responsible for making referrals. IRS indicated that the referrals would be made through the examiners and that the coordinators would have responsibility for ensuring referrals are made. IRS also stated that several actions would be taken to improve examiner awareness of the referral process and its importance, including training.

IRS questioned whether it was appropriate for all penalized preparers to be referred to the Director of Practice because of apparent congressional concern that such referrals should not be based on a single or isolated occurrence. We do not believe that concern is warranted. Discussions we have had with the appropriate congressional committee indicates that its concern was whether a referral automatically would result in disciplinary action. Since referrals do not automatically result in disciplinary action, we believe IRS could implement this recommendation and explain to the appropriate committee how this process still safeguards the rights of preparers.

Methodology for Selecting Assessment and No-Change Case Files

This appendix describes how we identified closed preparer penalty assessment and no-change case files. Included in this appendix is table I.1, which shows by district the universes of such case files and the number that we were not able to review.

Sample Selection and Scope

We planned to review all of the case files in which preparer penalties (1) were assessed and (2) were considered but not assessed (no-change cases) in fiscal year 1987 in five IRS district offices. We selected geographically dispersed district offices that had a universe of preparer penalty assessment transactions that we thought would allow us to complete a 100-percent review within established time frames. We used preparer penalty assessment transactions to select the sample districts because IRS does not maintain data identifying no-change cases, and we believed the number of no-change case files would not significantly affect our ability to complete a 100-percent review.

To identify the universe of assessment transactions by location, we used extracts from IRS' Individual and Business Master Files. We selected IRS offices in Baltimore; Denver; Ft. Lauderdale, FL; St. Louis; and San Francisco. Subsequently, we determined that the number of assessment transactions we could review from the Ft. Lauderdale District was very limited. Therefore, we excluded the Ft. Lauderdale District from our review.

Once we had chosen district offices, we contacted the service centers' district return preparers coordinators and Appeals officers to identify the no-change cases that could not be identified from IRS' master files. We were not able to identify the universe of fiscal year 1987 no-change cases in the five districts, but we identified and reviewed 30 no-change case files, which represented all of the no-change case files identified in three district offices (Denver, St. Louis, and San Francisco).[1]

Universe for Assessment Cases

Table I.1 shows the universe of assessment transactions and case files reviewed at the four IRS district offices in our review.

[1]In 1 of the 30 no-change cases identified, the documentation in the files was inadequate to determine if IRS made the correct penalty determination.

Table I.1: Universe of Fiscal Year 1987 Assessment Transactions and Case Files Reviewed

IRS district office	Original universe	Transactions removed from universe	Usable universe of transactions reviewed	Case files reviewed[a]
Baltimore	194	158	36	30
Denver	44	18	26	48
St. Louis	164	54	110	102
San Francisco	87	63	24	20
Total	**489**	**293**	**196**	**200[b]**

[a]We defined a case file as the information relating to a penalty or penalties against a single return. As a result, the number of case files reviewed differed from the number of transactions reviewed because in some instances one transaction related to penalties against several returns and in other instances penalties against one return were assessed in several transactions.

[b]In 7 of the 200 assessment cases identified, the documentation in the files was inadequate to determine if IRS made the correct penalty determination.

As shown in table I.1, we initially identified a universe of 489 fiscal year 1987 assessment transactions. However, we found that a large number of them had to be excluded from our review. The primary reason that case files were excluded was because the files did not contain the examiners' justifications for the penalty decisions. Cases were also excluded because the files were not received from IRS or the preparer penalty was assessed by a district other than one of those we selected.

Sampling and Data Analysis Methodology for Paid Preparer Returns With an Understated Tax Liability of $5,000 or More but No Preparer Penalty Case Initiated

This appendix describes how we (1) selected a sample of paid preparer returns where IRS assessed additional tax of $5,000 or more and a negligence penalty against the taxpayer in fiscal year 1987 but did not open a preparer penalty case and (2) projected the sample data.[1] Included in this appendix is a table showing the statistical sampling errors for the estimates in the report.

Sample Selection and Scope

We planned to review a random sample of district Examination case files involving paid preparer returns that did not result in the opening of preparer penalty cases. We limited our universe to case files from the same four districts we used to analyze assessment and no-change case files and included the Cincinnati District because of its low reported preparer penalty activity. To identify a universe from which to select our sample we used a master file extract to identify fiscal year 1987 paid preparer returns where the taxpayer was assessed additional tax of $5,000 or more and a negligence penalty. Additionally, we obtained and reviewed case files related to those returns and excluded the case files that did not meet our criteria.

We planned to take a simple random sample of 25 cases from each IRS district office in our review. We established the arbitrary sample size of 25 cases on the basis of how many we believed we could review and analyze within established time frames. However, we were unable to identify 25 case files for each district office because of the unexpected number of cases that had to be excluded. By combining the five independently determined samples, we created a stratified sample.

Universe and Sample Sizes

Table II.1 shows the universe, the modified universe, and the sample sizes for the five IRS district offices selected. We corrected the original universe on the basis of the percentage of cases removed from the sample, creating a new "modified universe."

[1] Fiscal year 1987 data were the latest available at the time of our review.

Table II.1: Universe and Sample Sizes of Paid Preparer Returns in Which IRS Assessed Additional Tax of $5,000 or More in Fiscal Year 1987 but Did Not Initiate a Preparer Penalty Case

IRS district office	Sample size used	Cases selected for review	Removed from sample	Percent removed	Original universe	Modified universe[a]
Baltimore	20	77	57	0.74	345	90
Cincinnati	25	51	26	0.51	220	108
Denver	20	100	80	0.80	179	36
St. Louis	24	100	76	0.76	220	53
San Francisco	24	100	76	0.76	699	168
Totals	**113**	**428**	**315**		**1,663**	**455**

[a]The modified universe was computed by multiplying the original universe by the percent of cases removed and subtracting that number from the original universe. For example, for the Baltimore District Office, we selected 77 out of 345 possible case files and found that 57 (74 percent) of the case files were not usable. By applying this percentage to the original universe and subtracting the result from the original universe, we arrived at a modified universe of 90 for the Baltimore District.

As shown in table II.1, 315 cases were removed from the sample. These cases were removed because (1) returns were not audited by one of the districts listed, (2) IRS had initiated another audit or litigation, (3) the additional tax assessed was less than $5,000, (4) the negligence penalty was abated, (5) a preparer penalty case had been opened, (6) case files contained limited information, or (7) case files requested were not received.

Sampling Errors for Key Estimates Used in the Report

An estimate's sampling error measures the variability among the estimates obtained for all the possible samples. Sampling error is thus a measure of the precision or reliability with which an estimate from a particular sample approximates the results of a complete census. From the sample estimate, together with an estimate of its sampling error, interval estimates can be constructed with prescribed confidence that the interval includes the average result of all possible samples. Table II.2 shows the projections and confidence intervals for the major attribute estimates reported.

Table II.2: Sampling Errors for Key Attribute Estimates Used in This Report

Description of universe estimates	Weighted universe percent	Sample error	95% confidence interval estimated range	
			Lower limit	Upper limit
Percent of cases where the examiner did not explain the decision to not open a preparer penalty case	78.21	6.13	72.08	84.34
Percent of cases where a determination could not be made about whether a preparer penalty case should have been opened	64.42	8.15	56.27	72.57
Percent of cases where a determination could be made about whether a preparer penalty case should have been opened	35.58	8.15	27.43	43.73
Percent of cases indicating the examiner should have opened a preparer penalty case[a]	52.06	12.05	40.01	64.11

[a]This estimate is based on the universe of cases that had sufficient documentation regarding the preparer's involvement to determine whether or not opening a preparer penalty case was justified.

Methodology of Group Manager and Tax Examiner Questionnaires

This appendix describes how we identified the universes of group managers and tax examiners to whom we sent questionnaires and the purpose of those questionnaires. Included in this appendix is table III.1, which shows the number of questionnaires mailed and the response rates for both the group managers and the tax examiners.

Identification of Universes

We sent questionnaires to all group managers and tax examiners identified by IRS as being assigned to Examination groups that had occasion to audit paid preparer returns in the following five IRS district offices: Baltimore; Denver; Ft. Lauderdale, FL; St. Louis; and San Francisco. District Examination officials provided a listing of all such individuals. In verifying the accuracy of the data, we found some individuals that, in our opinion, should not have been included. For example, the lists included some staff who were assigned to Taxpayer Service and had no role in auditing taxpayers' returns. After discussions with Examination officials in each district and after adjustments to the original listings, we sent questionnaires to 157 group managers and 1,480 tax examiners.

Development and Testing of Questionnaires

We developed two mail-out questionnaires: one for the tax examiners who made preparer penalty determinations and one for the group managers who reviewed and approved the examiners' penalty determinations. We designed the questionnaires to obtain their opinions regarding (1) the adequacy of formal training and guidance relative to the administration of preparer penalties, (2) factors that encourage or discourage them from pursuing preparer penalties, (3) the level of difficulty involved in assessing penalties, (4) the adequacy of the penalty amounts, and (5) the process for referring penalized preparers to the Director of Practice or a district director.

We pretested the questionnaires on two separate occasions in the St. Louis District Office. In addition to the pretests, National Office Examination officials reviewed the questionnaires. From comments received, we made appropriate changes to the questionnaires.

Responses Rates

We initially mailed questionnaires in late June and early July of 1989. We subsequently sent follow-up questionnaires in the latter part of July and August of 1989. Table III.1 shows for group managers and tax examiners by district office the (1) number of questionnaires sent, (2) number returned, (3) response rates, and (4) number of completed questionnaires received.

Table III.1: Response Rates for Group Manager and Tax Examiner Questionnaires

Questionnaire type/ IRS district office	Questionnaires mailed	Questionnaires returned	Response rate	Questionnaires analyzed[a]
Group manager				
Baltimore	35	33	94.3%	26
Denver	26	25	96.2	22
Ft. Lauderdale, FL	45	40	88.9	31
St. Louis	30	28	93.3	22
San Francisco	21	19	90.5	15
Total	**157**	**145**	**92.4**	**116**
Tax examiner				
Baltimore	288	253	87.8	181
Denver	276	256	92.8	221
Ft. Lauderdale, FL	405	357	88.1	260
St. Louis	276	256	92.8	206
San Francisco	235	198	84.3	141
Total	**1,480**	**1,320**	**89.2**	**1,009**
Combined total	**1,637**	**1,465**	**89.5%**	**1,125**

[a]This column excludes questionnaires returned but not analyzed because the group managers or tax examiners who received them indicated that, during the past 12 months, they had spent less than 1 month as members of Examination groups that had the occasion to audit paid preparer returns.

Questionnaire Results for Related Group Manager Questions

U.S. GENERAL ACCOUNTING OFFICE

TAX PREPARER CONDUCT PENALTIES - GROUP MANAGERS QUESTIONNAIRE

INTRODUCTION:

The U.S. General Accounting Office, an agency of Congress, is reviewing the administration by the Internal Revenue Service of preparer conduct penalties. This questionnaire specifically deals with Tax Code Section 6694(a) which covers preparer negligence, Section 6694(b) which covers willful understatement by a tax preparer, and also addresses Section 6701 covering "Aiding and Abetting" of an understatement by a preparer in relation to Section 6694(b). This questionnaire is being sent to a sample of group managers to obtain their views based on their experience with these preparer penalties.

Most of the questions can be easily answered by checking boxes or filling in blanks. Space has been provided for any additional comments at the end of the questionnaire. If necessary, additional pages may be attached.

Your responses will be treated confidentially. They will be combined with others and reported only in summary form. The questionnaire is numbered to aid us in our follow-up efforts and will not be used to identify you with your responses. We cannot develop meaningful information without your frank and honest answers.

The questionnaire should take about 45 minutes to complete. If you have any questions, please call Terry Tillotson or Rose M. Dorlac at our Kansas City Regional Office at (FTS) 757-2600 or (913) 236-2600.

Please return the completed questionnaire in the enclosed pre-addressed envelope within 10 days of receipt. In the event the envelope is misplaced, the return address is:

U.S. General Accounting Office
Kansas City Regional Office
Mr. Terry Tillotson
Suite 600-Broadmoor Place
5799 Broadmoor
Mission, Kansas 66202-2400

Thank you for your help.

I. BACKGROUND

Please enter your telephone number below in case we must contact you to clarify a response.

(FTS) _____

OR

Commercial (___) _____

1. Approximately how long have you been employed by the Examination Branch within the IRS? (CHECK ONE.) (10)

1. [__]	Less than 1 year	0.0%
2. [__]	1 to less than 3 years	0.0%
3. [__]	3 to less than 5 years	1.7%
4. [__]	5 to less than 8 years	8.6%
5. [__]	8 years or more	89.7%

N=116

2. Approximately how long have you been a group manager within the Examination Branch? (CHECK ONE.) (11)

1. [__]	Less than 1 year	8.6%
2. [__]	1 to less than 3 years	42.2%
3. [__]	3 to less than 5 years	15.5%
4. [__]	5 to less than 8 years	9.5%
5. [__]	8 years or more	24.1%

N=116

3. During the past 12 months, how much of the time did you manage a group in which the examiners' duties included following up on activity potentially warranting preparer conduct penalties? (CHECK ONE.) (12)

(NOTE: This question asks about the amount of time you spent as manager of such a group, not the time spent by examiners actually performing the follow-up duties.)

1. [__]	None of the time	→	-- STOP -- RETURN QUESTIONNAIRE
2. [__]	Less than 1 month		
3. [__]	1 month to less than 3 months	→	(CONTINUE WITH Q. #4)
4. [__]	3 to less than 6 months		
5. [__]	6 to less than 9 months		
6. [__]	9 to 12 months		

7.0%
3.5%
10.4%
79.1%

N=115

1

4. What type(s) of examiners are in the group that you manage? (CHECK ONE.) (13)

1. [__] Revenue agents 76.5%

2. [__] Tax auditors 17.4%

3. [__] Both types 6.1%

N=115

5. In the past 12 months, approximately how many preparer penalties have been proposed by the examiners in your group? (ENTER NUMBER. IF NONE, ENTER "0".)

_____ (NUMBER OF 6694(a) PENALTIES PROPOSED) (14-15)

_____ (NUMBER OF 6694(b) PENALTIES PROPOSED) (16-17)

	6694(a)	6694(b)
Zero	31.9%	52.6%
1 - 5	47.4%	22.4%
6 - 10	12.9%	15.5%
Over 10	7.8%	9.5%
	N=116	N=116

6. In your opinion, to what extent do the examiners in your group have a clear understanding of the following? (CHECK ONE BOX IN EACH ROW.)

	VERY GREAT EXTENT (1)	GREAT EXTENT (2)	MODERATE EXTENT (3)	SOME EXTENT (4)	LITTLE OR NO EXTENT (5)	
1. How to pursue* the preparer conduct penalties	6.1%	32.2%	47.8%	10.4%	3.5%	(18) N=115
2. When to pursue the 6694(a) penalties for preparer negligence	7.0%	33.0%	49.6%	8.7%	1.7%	(19) N=115
3. When to pursue the 6694(b) penalties for willful understatement by a preparer	4.3%	25.2%	48.7%	16.5%	5.2%	(20) N=115
4. When a referral to the District Director is required	0.9%	14.0%	43.0%	27.2%	14.9%	(21) N=114
5. When a referral to the Director of Practice is required	0.9%	14.8%	48.7%	23.5%	12.2%	(22) N=115

* (i.e., request group manager approval to formally open a preparer penalty case and perform preparer penalty follow-up.)

7. How adequate or inadequate is the formal <u>training</u> (including entry level training, CPE, and group presentations) that examiners receive in the following areas? (CHECK ONE BOX FOR EACH ROW. IF NO TRAINING IS RECEIVED, CHECK "NONE RECEIVED" FOR THAT ROW.)

	MUCH MORE THAN ADEQUATE (1)	MORE THAN ADE-QUATE (2)	ADEQUATE (3)	LESS THAN ADE-QUATE (4)	MUCH LESS THAN ADEQUATE (5)	NONE RECEIVED (6)	
1. How to assert the IRC Section 6694(a) penalty ($100)	0.9%	10.5%	64.0%	14.9%	9.6%	0	(23) N=114
2. When to apply the IRC Section 6694(a) penalty ($100)	0.0%	11.4%	64.9%	14.9%	8.8%	0	(24) N=114
3. How to assert the IRC Section 6694(b) penalty ($500)	0.0%	8.8%	64.0%	14.9%	12.3%	0	(25) N=114
4. When to apply the IRC Section 6694(b) penalty ($500)	0.0%	7.9%	64.9%	14.9%	12.3%	0	(26) N=114
5. When to refer practitioners to the Director of Practice	0.0%	6.3%	47.7%	27.0%	18.9%	3	(27) N=111
6. When to refer preparers to the District Director	0.0%	4.6%	45.9%	28.4%	21.1%	5	(28) N=109

8. In your opinion, how adequate or inadequate is the formal <u>written guidance</u> (including the Code, IRM, and local handbooks) in defining when to apply the <u>$100 penalty</u> for preparer negligence? (CHECK ONE.) (29)

1. [__] Much more than adequate — 3.5%
2. [__] More than adequate — 19.1% → <u>(SKIP TO QUESTION 10.)</u>
3. [__] Adequate — 66.1%
4. [__] Less than adequate — 9.6%
5. [__] Much less than adequate — 1.7% → <u>(CONTINUE WITH QUESTION 9.)</u>

N=115

9. If the formal written guidance (including the Code, IRM, and local handbooks) on defining when to apply the $100 penalty for preparer negligence is less than adequate, to what extent, if at all, does it result in the following? (CHECK ONE BOX FOR EACH ROW. IF THE FACTOR DOES NOT EXIST, CHECK THE 'NOT APPLICABLE" COLUMN FOR THAT ROW.)

	NOT APPLICABLE (1)	LITTLE OR NO EXTENT (2)	SOME EXTENT (3)	MODERATE EXTENT (4)	GREAT EXTENT (4)	VERY GREAT EXTENT (6)	
1. Inconsistent penalty application	28.6%	0.0%	21.4%	21.4%	21.4%	7.1%	(30) N=14
2. Increased time and effort for the penalty case development	7.1%	0.0%	21.4%	35.7%	35.7%	0.0%	(31) N=14
3. Discouragement of penalty proposal	21.4%	7.1%	7.1%	28.6%	14.3%	21.4%	(32) N=14
4. Consulting other sources for guidance	14.3%	7.1%	14.3%	7.1%	35.7%	21.4%	(33) N=14

Skipped=102

10. In your opinion, how adequate or inadequate is the formal written guidance (including the Code, IRM, and local handbooks) in defining when to apply the $500 penalty for willful understatement by a preparer? (CHECK ONE.) (34)

1. [__] Much more than adequate
2. [__] More than adequate
3. [__] Adequate

2.6% + 9.5% + 71.6% → (SKIP TO QUESTION 12.)

4. [__] Less than adequate
5. [__] Much less than adequate

14.7% + 1.7% → (CONTINUE WITH QUESTION 11.)

N=116

11. If the formal written guidance (including the Code, IRM, and local handbooks) on defining when to apply the $500 penalty for willful understatement is less than adequate, to what extent, if at all, does it result in the following? (CHECK ONE BOX FOR EACH ROW. IF THE FACTOR DOES NOT EXIST, CHECK THE 'NOT APPLICABLE" COLUMN FOR THAT ROW.)

	NOT APPLICABLE (1)	LITTLE OR NO EXTENT (2)	SOME EXTENT (3)	MODERATE EXTENT (4)	GREAT EXTENT (4)	VERY GREAT EXTENT (6)	
1. Inconsistent penalty application	5.3%	5.3%	26.3%	21.1%	31.6%	10.5%	(35) N=19
2. Increased time and effort for the penalty case development	10.5%	5.3%	15.8%	26.3%	36.8%	5.3%	(36) N=19
3. Discouragement of penalty proposal	5.3%	15.8%	10.5%	31.6%	15.8%	21.1%	(37) N=19
4. Consulting other sources for guidance	10.5%	10.5%	15.8%	15.8%	26.3%	21.1%	(38) N=19

Skipped=97

12. Do the following factors encourage, discourage, or have no effect on the pursuit of the $100 penalty for preparer negligence by examiners in your group? (CHECK ONE BOX IN EACH ROW. IF THE FACTOR DOES NOT EXIST IN YOUR GROUP OR OFFICE, CHECK BOX #6, "NOT A FACTOR".)

	GREATLY ENCOURAGE (1)	ENCOURAGE (2)	HAVE NO EFFECT (3)	DISCOURAGE (4)	GREATLY DISCOURAGE (5)	NOT A FACTOR (6)	
1. Time required to develop case	0.9%	1.7%	35.3%	36.2%	20.7%	5.2%	[39] N=116
2. Amount of penalty	0.9%	0.0%	24.1%	37.1%	34.5%	3.4%	[40] N=116
3. Effectiveness in achieving compliance	3.5%	35.7%	17.4%	23.5%	15.7%	4.3%	[41] N=115
4. Level of evidence required to support negligence assertion	0.9%	10.4%	38.3%	32.2%	14.8%	3.5%	[42] N=115
5. Requirement to confront preparer	1.7%	2.6%	47.8%	27.0%	13.9%	7.0%	[43] N=115
6. Availability of a clear definition of negligence	1.7%	11.3%	36.5%	32.2%	10.4%	7.8%	[44] N=115
7. Availability of clear procedural guidance	1.7%	27.8%	35.7%	23.5%	3.5%	7.8%	[45] N=115
8. Level of support from management	12.1%	40.5%	25.0%	12.1%	2.6%	7.8%	[46] N=116
9. Level of support from Appeals	1.7%	12.1%	25.9%	31.0%	17.2%	12.1%	[47] N=116
10. Time constraints imposed by management (i.e., need to work as many audit cases as possible)	0.9%	0.0%	50.0%	24.1%	7.8%	17.2%	[48] N=116
11. Lack of practitioner/ preparer cooperation	1.7%	5.2%	50.0%	29.3%	6.9%	6.9%	[49] N=116
12. Need to work cases with maximum revenue return	0.9%	0.0%	46.6%	20.7%	7.8%	24.1%	[50] N=116
13. Other (Specify) _____	0.0%	0.0%	0.0%	16.7%	16.7%	66.7%	[51] N=6

13. Do the following factors encourage, discourage, or have no effect on the pursuit of the $500 penalty for willful understatement by examiners in your group? (CHECK ONE BOX IN EACH ROW. IF THE FACTOR DOES NOT EXIST IN YOUR GROUP OR OFFICE, CHECK BOX #6, "NOT A FACTOR".)

	GREATLY ENCOURAGE (1)	ENCOURAGE (2)	HAVE NO EFFECT (3)	DISCOURAGE (4)	GREATLY DISCOURAGE (5)	NOT A FACTOR (6)	
1. Time required to develop case	0.9%	1.7%	31.9%	35.3%	24.1%	6.0%	(52) N=116
2. Amount of penalty	0.9%	12.9%	29.3%	26.7%	25.9%	4.3%	(53) N=116
3. Effectiveness in achieving compliance	2.6%	39.7%	18.1%	20.7%	15.5%	3.4%	(54) N=116
4. Level of evidence required to support willfulness assertion	0.9%	6.9%	24.1%	45.7%	20.7%	1.7%	(55) N=116
5. Requirement to confront preparer	2.6%	2.6%	48.7%	27.8%	11.3%	7.0%	(56) N=115
6. Availability of a clear definition of willfulness	1.7%	12.9%	31.9%	37.9%	10.3%	5.2%	(57) N=116
7. Availability of clear procedural guidance	1.7%	23.3%	37.1%	25.0%	4.3%	8.6%	(58) N=116
8. Level of support from management	6.9%	41.4%	30.2%	12.9%	1.7%	6.9%	(59) N=116
9. Level of support from Appeals	1.7%	9.5%	31.0%	33.6%	13.8%	10.3%	(60) N=116
10. Time constraints imposed by management (i.e., need to work as many audit cases as possible)	0.9%	0.0%	49.1%	27.2%	7.0%	15.8%	(61) N=114
11. Lack of practitioner/ preparer cooperation	1.7%	4.3%	49.1%	28.4%	7.8%	8.6%	(62) N=116
12. Need to work cases with maximum revenue return	0.9%	0.0%	45.7%	21.6%	6.9%	25.0%	(63) N=116
13. Other (Specify) _____	0.0%	0.0%	14.3%	14.3%	14.3%	57.1%	(64) N=7

14. How easy or difficult is it to distinguish between conduct warranting only 6694(a) (i.e., negligent or intentional disregard of rules or regulations) and conduct warranting 6694(b) (i.e., willful attempt to understate tax liability)? (CHECK ONE.) (65)

1. [__] Very easy 0.9%
2. [__] Easy 16.5%
3. [__] Neither easy nor difficult 38.5%
4. [__] Difficult 39.4%
5. [__] Very difficult 4.6%

---

6. [__] No basis to judge 7

N=109

15. Overall, how easy or difficult is it to administer the following preparer penalties? (CHECK ONE BOX IN EACH ROW.)

	VERY EASY (1)	EASY (2)	NEITHER EASY NOR DIFFICULT (3)	DIFFICULT (4)	VERY DIFFICULT (5)	NO OPINION (6)	
1. 6694(a)	1.8%	18.6%	44.2%	28.3%	7.1%	3	(66) N=113
2. 6694(b)	0.0%	8.3%	31.2%	38.5%	22.0%	7	(67) N=109

16. In your opinion, how often or not is the assertion of a single preparer conduct penalty for the 6694(a) and 6694(b) worth the effort given the result? (ENTER THE NUMBER OF THE RESPONSE IN THE SPACES PROVIDED BELOW.)

RESPONSE SCALE

	6694(a)	6694(b)
1 = ALMOST ALWAYS WORTH THE EFFORT GIVEN THE RESULT	9.3%	6.9%
2 = WORTH THE EFFORT MOST OF THE TIME GIVEN THE RESULT	15.9%	24.5%
3 = WORTH THE EFFORT ABOUT HALF THE TIME GIVEN THE RESULT	3.7%	10.8%
4 = SOMETIMES WORTH THE EFFORT GIVEN THE RESULT	35.5%	37.3%
5 = ALMOST NEVER WORTH THE EFFORT GIVEN THE RESULT	35.5%	20.6%
6 = NO OPINION	9	14
	N=107	N=102

ENTER NUMBER

1. 6694(a) ..... /_____/ (68)

2. 6694(b) ..... /_____/ (69)

17. In your opinion, when assessed against a CPA, attorney, enrolled agent, or unenrolled agent, is the amount of a single preparer conduct penalty too high, too low, or about right to assure compliance? (CHECK ONE BOX IN EACH ROW.)

A. 6694(a) Penalty - $100

	MUCH TOO HIGH (1)	SOMEWHAT TOO HIGH (2)	ABOUT THE RIGHT AMOUNT (3)	SOMEWHAT TOO LOW (4)	MUCH TOO LOW (5)	NO OPINION (6)	
1. Against CPAs, attorneys, and/or enrolled agents	0.0%	0.9%	7.0%	21.7%	70.4%	0	(70) N=115
2. Against unenrolled agents	0.0%	1.7%	17.4%	31.3%	49.6%	0	(71) N=115

B. 6694(b) Penalty - $500

	MUCH TOO HIGH (1)	SOMEWHAT TOO HIGH (2)	ABOUT THE RIGHT AMOUNT (3)	SOMEWHAT TOO LOW (4)	MUCH TOO LOW (5)	NO OPINION (6)	
1. Against CPAs, attorneys, and/or enrolled agents	0.0%	0.0%	15.7%	28.7%	55.7%	0	(72) N=115
2. Against unenrolled agents	0.0%	0.9%	26.1%	33.0%	40.0%	0	(73) N=115

8

18. In your opinion, for a single penalty assessment against a CPA, attorney, or enrolled agent, what motivates compliance more: the fine or the referral to the Director of Practice? (ENTER THE NUMBER OF THE RESPONSE IN THE SPACES PROVIDED BELOW.)

RESPONSE SCALE	6694(a)	6694(b)
1 = THE FINE MOTIVATES COMPLIANCE MUCH MORE THAN THE REFERRAL TO THE DIRECTOR OF PRACTICE	5.6%	5.6%
2 = THE FINE MOTIVATES COMPLIANCE SOMEWHAT MORE THAN THE REFERRAL TO THE DIRECTOR OF PRACTICE	1.9%	3.7%
3 = THE FINE AND THE REFERRAL TO THE DIRECTOR OF PRACTICE MOTIVATE COMPLIANCE ABOUT EQUALLY	13.0%	16.7%
4 = THE REFERRAL TO THE DIRECTOR OF PRACTICE MOTIVATES COMPLIANCE SOMEWHAT MORE THAN THE FINE	22.2%	21.3%
5 = THE REFERRAL TO THE DIRECTOR OF PRACTICE MOTIVATES COMPLIANCE MUCH MORE THAN THE FINE	50.9%	48.1%
6 = NEITHER THE REFERRAL NOR THE FINE MOTIVATES COMPLIANCE	6.5%	4.6%
7 = NO OPINION	7	7
N =	108	108

A. 6694(a)

ENTER NUMBER

1. Against CPAs, attorneys, and/or enrolled agents ... /_____/ (7a)

B. 6694(b)

1. Against CPAs, attorneys, and/or enrolled agents ... /_____/ (7b)

19. In your opinion, for a single penalty assessment against an unenrolled agent, what motivates compliance more: the fine or the referral to the District Director? (ENTER THE NUMBER OF THE RESPONSE IN THE SPACES PROVIDED BELOW.)

RESPONSE SCALE	6694(a)	6694(b)
1 = THE FINE MOTIVATES COMPLIANCE MUCH MORE THAN THE REFERRAL TO THE DISTRICT DIRECTOR	21.2%	25.0%
2 = THE FINE MOTIVATES COMPLIANCE SOMEWHAT MORE THAN THE REFERRAL TO THE DISTRICT DIRECTOR	18.3%	18.3%
3 = THE FINE AND THE REFERRAL TO THE DISTRICT DIRECTOR MOTIVATE COMPLIANCE ABOUT EQUALLY	15.4%	15.4%
4 = THE REFERRAL TO THE DISTRICT DIRECTOR MOTIVATES COMPLIANCE SOMEWHAT MORE THAN THE FINE	16.3%	14.4%
5 = THE REFERRAL TO THE DISTRICT DIRECTOR MOTIVATES COMPLIANCE MUCH MORE THAN THE FINE	13.5%	15.4%
6 = NEITHER THE REFERRAL NOR THE FINE MOTIVATES COMPLIANCE	15.4%	11.5%
7 = NO OPINION	11	11
N =	104	104

A. 6694(a)

ENTER NUMBER

1. Against unenrolled agents ..... /_____/ (76)

B. 6694(b)

1. Against unenrolled agents ..... /_____/ (77)

Questionnaire Results for Related Tax Examiner Questions

U.S. GENERAL ACCOUNTING OFFICE

TAX PREPARER CONDUCT PENALTIES - TAX EXAMINERS QUESTIONNAIRE

INTRODUCTION:

The U.S. General Accounting Office, an agency of Congress, is reviewing the administration by the Internal Revenue Service of preparer conduct penalties. This questionnaire specifically deals with Tax Code Section 6694(a) which covers preparer negligence, Section 6694(b) which covers willful understatement by a tax preparer, and also addresses Section 6701 covering "Aiding and Abetting" of an understatement by a preparer in relation to Section 6694(b). This questionnaire is being sent to a sample of tax examiners to obtain their views based on their experience with these preparer penalties.

Most of the questions can be easily answered by checking boxes or filling in blanks. Space has been provided for any additional comments at the end of the questionnaire. If necessary, additional pages may be attached.

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The questionnaire should take about 50 minutes to complete. If you have any questions, please call Terry Tillotson or Rose M. Dorlac at our Kansas City Regional Office at (FTS) 757-2600 or (913) 236-2600.

Please return the completed questionnaire in the enclosed pre-addressed envelope within 10 days of receipt. In the event the envelope is misplaced, the return address is:

U.S. General Accounting Office
Kansas City Regional Office
Mr. Terry Tillotson
Suite 600-Broadmoor Place
5799 Broadmoor
Mission, Kansas 66202-2400

Thank you for your help.

Please enter your telephone number below in case we must contact you to clarify a response.

(FTS) _____

OR

Commercial (___) _____

I. BACKGROUND

1. Are you a revenue agent or a tax auditor? (CHECK ONE.) (10)

1. [__]	Revenue agent	81.5%
2. [__]	Tax auditor	18.5%

N=1008

2. How many years of experience do you have as a revenue agent and/or tax auditor? (CHECK ONE.) (11)

1. [__]	Less than 1 year	2 2%
2. [__]	1 to less than 3 years	41.7%
3. [__]	3 to less than 5 years	13.2%
4. [__]	5 to less than 8 years	12.3%
5. [__]	8 years or more	30.6%

N=1009

3. During the past 12 months, how much of the time were you assigned to an exam group where your duties included following up on activity potentially warranting preparer conduct penalities? (CHECK ONE.) (12)

(NOTE: This question asks about the amount of time assigned to such a group, not the amount of time spent actually performing the follow-up duties.)

1. [__]	None of the time	→ -- STOP -- RETURN QUESTIONNAIRE
2. [__]	Less than 1 month	→ -- STOP -- RETURN QUESTIONNAIRE
3. [__]	1 month to less than 3 months	5.4%
4. [__]	3 to less than 6 months	5.9% → (CONTINUE WITH Q. 84)
5. [__]	6 to less than 9 months	9.0%
6. [__]	9 to 12 months	79.7%

N=1000

II. TRAINING

4. To what extent, if at all, do you feel that formal training (including entry level training, CPE and group presentations) for examiners is necessary in the following areas for the proper administration of preparer conduct penalties? (CHECK ONE BOX IN EACH ROW.)

	VERY GREAT EXTENT (1)	GREAT EXTENT (2)	MODERATE EXTENT (3)	SOME EXTENT (4)	LITTLE OR NO EXTENT (5)	NO BASIS TO JUDGE (6)	
1. How to assert the IRC Section 6694(a) penalty ($100)	15.6%	28.6%	33.3%	17.7%	4.8%	15	(15) N=985
2. When to apply the IRC Section 6694(a) penalty ($100)	17.7%	32.0%	31.1%	15.8%	3.4%	12	(16) N=990
3. How to assert the IRC Section 6694(b) penalty ($500)	16.6%	31.0%	32.1%	16.3%	4.0%	16	(13) N=983
4. When to apply the IRC Section 6694(b) penalty ($500)	19.3%	34.1%	29.4%	14.5%	2.7%	14	(14) N=986
5. When to refer practitioners to the Director of Practice	20.9%	34.2%	27.6%	13.4%	4.0%	18	(17) N=983
6. When to refer preparers to the District Director	20.7%	34.1%	27.5%	13.6%	4.1%	25	(18) N=976

5. Did you receive any formal training (including entry level training, CPE and group presentations) in the following areas pertaining to the proper administration of preparer conduct penalties?
If "YES", How adequate or inadequate was the training you received?
(CHECK THE "YES" OR "NO" COLUMN FOR EACH AREA, FOR EACH "YES" CHECK A BOX SPECIFYING THE LEVEL OF ADEQUACY.)

	Percent YES (1)	Percent NO (2)	MUCH MORE THAN ADEQUATE (1)	MORE THAN ADEQUATE (2)	ADEQUATE (3)	LESS THAN ADEQUATE (4)	MUCH LESS THAN ADEQUATE (5)	
1. How to assert the IRC Section 6694(a) penalty ($100) N=998	71.3	28.7	0.3%	4.5%	54.4%	32.8%	8.0%	(19-20) N=711 Skipped=286
2. When to apply the IRC Section 6694(a) penalty ($100) N=996	73.3	26.7	0.3%	4.7%	53.3%	33.8%	8.0%	(21-22) N=728 Skipped=266
3. How to assert the IRC Section 6694(b) penalty ($500) N=996	66.4	33.6	0.3%	3.8%	51.1%	35.9%	8.9%	(23-24) N=660 Skipped=335
4. When to apply the IRC Section 6694(b) penalty ($500) N=994	67.6	32.4	0.3%	4.2%	48.7%	37.5%	9.4%	(25-26) N=670 Skipped=322
5. When to refer practitioners to the Director of Practice N=995	51.0	49.0	0.6%	2.8%	46.2%	37.9%	12.5%	(27-28) N=506 Skipped=488
6. When to refer preparers to the District Director N=992	44.6	55.4	0.5%	2.9%	45.1%	38.1%	13.4%	(29-30) N=441 Skipped=550

2

WILLFUL UNDERSTATEMENT PENALTY - SECTION 6694(b) VS. AIDING AND ABETTING PENALTY - SECTION 6701

20. How familiar or unfamiliar are the examiners in your group with when to apply the Aiding and Abetting penalty established by Section 6701 of the code? (CHECK ONE.) (78)

1. [__]	Very familiar	0.9%
2. [__]	Familiar	27.8%
3. [__]	Neither familiar nor unfamiliar	22.6%
4. [__]	Unfamiliar	38.3%
5. [__]	Very unfamiliar	10.4%

N=115

21. In the last 12 months, approximately how many times have examiners in your group proposed the Section 6701 (Aiding and Abetting) penalty against a return preparer? (ENTER NUMBER. IF NONE, ENTER "0".)

N=115 (NUMBER) (79-80)

Zero	78.3%
1-5	18.3%
6-10	1.7%
Over 10	1.7%

22. How adequate or inadequate is the written guidance in assisting examiners in deciding when to pursue the Section 6701 Aiding and Abetting penalty against a return preparer as opposed to the Section 6694(b) penalty for willful understatement? (CHECK ONE.) (81)

1. [__]	Much more than adequate	1.0%
2. [__]	More than adequate	1.0%
3. [__]	Adequate	45.0%
4. [__]	Less than adequate	45.0%
5. [__]	Much less than adequate	8.0%
6. [__]	No basis to judge	15

N=100

23. To what extent, if at all, do you feel the examiners in your group are correctly determining when to pursue the Section 6701 Aiding and Abetting penalty against a return preparer as opposed to the 6694(b) penalty for willful understatement? (CHECK ONE.) (82)

1. [__]	Very great extent	0.0%
2. [__]	Great extent	9.9%
3. [__]	Moderate extent	20.9%
4. [__]	Some extent	25.3%
5. [__]	Little or no extent	44.0%
6. [__]	Don't know	24

N=91

24. Please describe the circumstances that should prompt proposal of the Section 6701 Aiding and Abetting penalty in lieu of the Section 6694(b) willful understatement penalty against a return preparer.

Not listed due to the number and diversity of responses

__ __ (83-84) __ __ (85-86) __ __ (87-88)

__ __ (89-90) __ __ (91-92) __ __ (93-94)

25. Do you encourage or discourage examiners in your group to pursue the Section 6701 Aiding and Abetting penalty against a return preparer in lieu of the Section 6694(b) penalty for willful understatement? (CHECK ONE.) (%)

1. [__]	I strongly encourage pursuit of the Section 6701 penalty	5.3%
2. [__]	I encourage pursuit of the Section 6701 penalty	31.6%
3. [__]	I neither encourage nor discourage the pursuit of the Section 6701 penalty	60.5%
4. [__]	I discourage pursuit of the Section Section 6701 penalty	1.8%
5. [__]	I strongly discourage pursuit of the Section 6701 penalty	0.9%

N=114

26. If you have any comments concerning any question in this questionnaire or any general comments about any of the preparer penalties covered, please use the space below. If necessary, you may attach additional sheets. (%)

THANK YOU FOR YOUR ASSISTANCE.
PLEASE RETURN YOUR COMPLETED QUESTIONNAIRE IN THE ENCLOSED ENVELOPE.

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GGD-SMK-5/89

III. PREPARER NEGLIGENCE - SECTION 6694(a)

6. In the past 12 months, approximately how many $100 preparer penalties have you pursued (i.e., requested your group manager authorize a preparer penalty case be opened) and/or proposed? (ENTER NUMBER. IF NONE, ENTER "0".)

_____ (NUMBER OF $100 PENALTIES PURSUED) (31-32)

_____ (NUMBER OF $100 PENALTIES PROPOSED) (33-34)

	Pursued	Proposed
Zero	74.4%	76.0%
1-5	21.3%	17.8%
6-10	3.1%	5.2%
Over 10	1.3%	1.0%
	N=1002	N=999

7. How much formal written guidance (including the Code, IRM, and local handbooks) covering the $100 penalty for preparer negligence is made available by your district office? (CHECK ONE.) (35)

1. [__] Extensive written guidance	14.2%	
2. [__] Moderate written guidance	45.4%	→ (CONTINUE WITH QUESTION 8.)
3. [__] Some written guidance	29.5%	
4. [__] Limited written guidance	10.7%	
5. [__] No written guidance	0.2%	→ (SKIP TO QUESTION 12.)
6. [__] Don't know	141	

N=861

8. How adequate or inadequate is the formal written guidance (including the Code, IRM, and local handbooks) covering the $100 penalty for preparer negligence in assisting you to determine <u>when</u> to apply the penalty? (CHECK ONE.) (36)

1. [__] Much more than adequate	1.5%	
2. [__] More than adequate	11.9%	→ (SKIP TO QUESTION 10.)
3. [__] Adequate	56.1%	
4. [__] Less than adequate	27.0%	→ (CONTINUE WITH QUESTION 9.)
5. [__] Much less than adequate	3.5%	

N=858
Skipped=143

9. If the formal written guidance (including the Code, IRM, and local handbooks) on <u>when</u> to apply the $100 penalty for preparer negligence is less than adequate, to what extent, if at all, does this result in the following? (CHECK ONE BOX IN EACH ROW.)

	LITTLE OR NO EXTENT (1)	SOME EXTENT (2)	MODERATE EXTENT (3)	GREAT EXTENT (4)	VERY GREAT EXTENT (5)	NO BASIS TO JUDGE (6)	
1. Inconsistent penalty application	10.0%	12.9%	21.9%	34.3%	20.9%	60	(37) N=201 Skipped=739
2. Increased time and effort to develop the case	6.1%	7.0%	14.4%	40.6%	31.9%	33	(38) N=229 Skipped=739
3. Discouragement of penalty proposal	6.9%	7.8%	9.4%	30.6%	45.3%	18	(39) N=245 Skipped=739
4. Consulting other sources for guidance	5.8%	9.8%	21.9%	35.7%	26.8%	37	(40) N=224 Skipped=739

10. How adequate or inadequate is the formal written guidance (including the Code, IRM, and local handbooks) covering the $100 penalty for preparer negligence in assisting you to determine how to apply the penalty? (CHECK ONE.) (41)

1. [__] Much more than adequate	1.8%	
2. [__] More than adequate	12.4%	[SKIP TO QUESTION 12.]
3. [__] Adequate	61.8%	
4. [__] Less than adequate	20.4%	[CONTINUE WITH QUESTION 11.]
5. [__] Much less than adequate	3.6%	

N=857
Skipped=143

11. If the formal written guidance (including the Code, IRM, and local handbooks) on how to apply the $100 penalty for preparer negligence is less than adequate, to what extent, if at all, does this result in the following? (CHECK ONE BOX IN EACH ROW.)

	LITTLE OR NO EXTENT (1)	SOME EXTENT (2)	MODERATE EXTENT (3)	GREAT EXTENT (4)	VERY GREAT EXTENT (5)	NO BASIS TO JUDGE (6)	
1. Inconsistent penalty application	9.7%	14.5%	20.0%	32.7%	23.0%	42	(42) N=165 Skipped=794
2. Increased time and effort to develop the case	2.3%	5.7%	11.4%	36.9%	43.8%	32	(43) N=176 Skipped=794
3. Discouragement of penalty proposal	3.7%	4.7%	11.1%	28.9%	51.6%	19	(44) N=190 Skipped=794
4. Consulting other sources for guidance	3.4%	10.3%	18.9%	35.4%	32.0%	33	(45) N=175 Skipped=794

12. Other than formal written guidance (including the Code, IRM, and local handbooks), what sources, if any, do you usually consult to assist you in the application of the $100 penalty for preparer negligence? (CHECK ALL THAT APPLY.)

	Used source	Did not use source (44-51)
1. [__] No other sources	8.0%	92.0%
2. [__] Other experienced examiners	58.5%	41.5%
3. [__] Group manager	58.5%	41.5%
4. [__] Return Preparer Coordinator	25.4%	74.6%
5. [__] Personal files or notes	46.8%	53.2%
6. [__] Other (Specify) _____	4.2%	95.8%

N=1007

13. Do the following factors encourage, discourage, or have no effect on your pursuing the $100 penalty for preparer negligence? (CHECK ONE BOX IN EACH ROW. IF THE FACTOR DOES NOT EXIST IN YOUR GROUP OR OFFICE, CHECK BOX #6, "NOT A FACTOR".)

	GREATLY ENCOURAGE (1)	ENCOURAGE (2)	HAVE NO EFFECT (3)	DISCOURAGE (4)	GREATLY DISCOURAGE (5)	NOT A FACTOR (6)	
1. Time required to develop case	1.1%	2.3%	27.9%	37.5%	23.6%	7.6%	(52) N=1003
2. Amount of penalty	1.1%	3.3%	22.8%	33.2%	32.9%	6.7%	(53) N=1005
3. Effectiveness in achieving compliance	6.7%	31.2%	18.5%	23.2%	14.2%	6.2%	(54) N=997
4. Level of evidence required to support negligence assertion	2.6%	6.6%	33.3%	39.0%	14.6%	3.9%	(55) N=995
5. Requirement to confront preparer	0.8%	5.0%	62.7%	16.4%	4.6%	10.5%	(56) N=1000
6. Availability of a clear definition of negligence	1.4%	9.5%	30.5%	40.8%	10.2%	7.5%	(57) N=997
7. Availability of clear procedural guidance	1.7%	15.1%	28.5%	35.2%	11.7%	7.8%	(58) N=991
8. Level of support from group manager	6.7%	37.4%	30.8%	10.8%	4.1%	10.3%	(59) N=995
9. Level of support from Appeals	1.7%	7.2%	34.0%	22.7%	15.2%	19.1%	(60) N=987
10. Time constraints imposed by group manager (i.e., need to work as many audit cases as possible)	1.1%	1.8%	35.0%	27.3%	16.5%	18.3%	(61) N=1000
11. Lack of practitioner/ preparer cooperation	1.2%	5.1%	54.6%	19.6%	5.4%	14.0%	(62) N=993
12. Need to work cases with maximum revenue return	1.0%	1.8%	36.3%	26.2%	13.1%	21.6%	(63) N=1002
13. Other (Specify) _____	3.8%	1.9%	0.0%	30.8%	63.5%	0.0%	(64) N=52

14. In your opinion, is the $100 penalty for preparer negligence too high, too low or about right to assure compliance? (CHECK ONE.) (65)

1. [__] Much too high	0.0%
2. [__] Somewhat too high	0.1%
3. [__] About right	10.4%
4. [__] Somewhat too low	27.5%
5. [__] Much too low	62.0%
6. [__] No opinion	36

N=970

15. Overall, how easy or difficult is it for you to administer the $100 penalty for preparer negligence? (CHECK ONE.) (66)

1. [__] Very easy	2.1%
2. [__] Easy	6.0%
3. [__] Neither easy nor difficult	40.0%
4. [__] Difficult	38.0%
5. [__] Very difficult	13.8%

N=982

IV. WILLFUL UNDERSTATEMENT BY A PREPARER - SECTION 6694(b)

16. In the past 12 months, approximately how many $500 preparer penalties have you pursued (i.e., requested your group manager authorize a preparer penalty case be opened) and/or proposed? (ENTER NUMBER. IF NONE, ENTER "0".)

		Pursued	Proposed
_____ (NUMBER OF $500 PENALTIES PURSUED) N=1008	(67-68) Zero	88.1%	86.5%
	1-5	7.8%	6.5%
_____ (NUMBER OF $500 PENALTIES PROPOSED) N=997	(69-70) 6-10	2.5%	5.7%
	Over 10	1.6%	1.3%

17. How much formal written guidance (including the Code, IRM, and local handbooks) covering the $500 penalty for willful understatement is made available by your district office? (CHECK ONE.) (71)

1. [__] Extensive written guidance	5.7%	
2. [__] Moderate written guidance	38.2%	→ (CONTINUE WITH QUESTION 18.)
3. [__] Some written guidance	35.0%	
4. [__] Limited written guidance	19.5%	
5. [__] No written guidance	1.6%	→ (SKIP TO QUESTION 22.)
6. [__] Don't know	210	

N=795

18. How adequate or inadequate is the formal written guidance (including the Code, IRM, and local handbooks) covering the $500 penalty for willful understatement in assisting you to determine when to apply the penalty? (CHECK ONE.) (72)

1. [__] Much more than adequate	0.9%	
2. [__] More than adequate	8.6%	→ (SKIP TO QUESTION 20.)
3. [__] Adequate	56.7%	
4. [__] Less than adequate	30.9%	→ (CONTINUE WITH QUESTION 19.)
5. [__] Much less than adequate	2.9%	

N=781
Skipped=223

19. If the formal written guidance (including the Code, IRM, and local handbooks) on when to apply the $500 penalty for willful understatement is less than adequate, to what extent, if at all, does this result in the following? (CHECK ONE BOX IN EACH ROW.)

	LITTLE OR NO EXTENT (1)	SOME EXTENT (2)	MODERATE EXTENT (3)	GREAT EXTENT (4)	VERY GREAT EXTENT (5)	NO BASIS TO JUDGE (6)	
1. Inconsistent penalty application	6.3%	13.7%	20.5%	36.6%	22.9%	57	(73) N=205
2. Increased time and effort to develop the case	4.3%	10.3%	14.2%	36.6%	34.5%	30	(74) N=232
3. Discouragement of penalty proposal	7.0%	10.3%	11.9%	28.8%	42.0%	20	(75) N=243
4. Consulting other sources for guidance	5.4%	12.1%	18.8%	37.7%	26.0%	39	(76) N=223

Skipped=740

20. How adequate or inadequate is the formal written guidance (including the Code, IRM, and local handbooks) covering the $500 penalty for willful understatement in assisting you to determine how to apply the penalty? (CHECK ONE.) (77)

1. [__] Much more than adequate	1.3%	
2. [__] More than adequate	9.9%	→ (SKIP TO QUESTION 22.)
3. [__] Adequate	61.1%	
4. [__] Less than adequate	25.7%	→ (CONTINUE WITH QUESTION 21.)
5. [__] Much less than adequate	2.1%	

N=779
Skipped=223

21. If the formal written guidance (including the Code, IRM, and local handbooks) on how to apply the $500 penalty for willful understatement is less than adequate, to what extent, if at all, does this result in the following? (CHECK ONE BOX IN EACH ROW.)

	LITTLE OR NO EXTENT (1)	SOME EXTENT (2)	MODERATE EXTENT (3)	GREAT EXTENT (4)	VERY GREAT EXTENT (5)	NO BASIS TO JUDGE (6)	
1. Inconsistent penalty application	8.0%	12.0%	22.3%	32.6%	25.1%	41	(78) N=175
2. Increased time and effort to develop the case	1.6%	7.4%	13.8%	34.9%	42.3%	27	(79) N=189
3. Discouragement of penalty proposal	5.6%	6.6%	12.7%	29.9%	45.2%	20	(80) N=197
4. Consulting other sources for guidance	5.0%	12.8%	19.6%	34.6%	27.9%	36	(81) N=179

Skipped=786

22. Other than formal written guidance (including the Code, IRM, and local handbooks), what sources, if any, do you usually consult to assist you in the application of the $500 penalty for willful understatement? (CHECK ALL THAT APPLY.)

	Used source	Did not use source	(82-87)
1. [__] No other sources	8.2%	91.8%	
2. [__] Other experienced examiners	57.1%	42.9%	
3. [__] Group manager	58.7%	41.3%	
4. [__] Return Preparer Coordinator	27.2%	72.8%	
5. [__] Personal files or notes	43.3%	56.7%	
6. [__] Other (Specify) _____	4.0%	96.0%	

N=1004

*g (1-9)

23. Do the following factors encourage, discourage, or have no effect on your pursuing the $500 penalty for willful understatement? (CHECK ONE BOX IN EACH ROW. IF THE FACTOR DOES NOT EXIST IN YOUR GROUP OR OFFICE, CHECK BOX #6, "NOT A FACTOR".)

	GREATLY ENCOURAGE (1)	ENCOURAGE (2)	HAVE NO EFFECT (3)	DISCOURAGE (4)	GREATLY DISCOURAGE (5)	NOT A FACTOR (6)	
1. Time required to develop case	0.8%	1.5%	30.1%	36.7%	23.8%	7.1%	(10) N=987
2. Amount of penalty	1.7%	14.7%	31.3%	28.2%	16.6%	7.5%	(11) N=989
3. Effectiveness in achieving compliance	6.8%	34.2%	20.5%	21.5%	10.4%	6.5%	(12) N=984
4. Level of evidence required to support willfulness assertion	2.0%	4.9%	24.3%	45.2%	19.5%	4.2%	(13) N=987
5. Requirement to confront preparer	0.7%	4.3%	63.2%	16.9%	3.7%	11.1%	(14) N=987
6. Availability of a clear definition of willfulness	1.1%	7.5%	25.5%	45.5%	14.1%	6.3%	(15) N=985
7. Availability of clear procedural guidance	1.3%	12.9%	31.6%	35.1%	12.0%	7.2%	(16) N=979
8. Level of support from group manager	5.3%	34.7%	34.2%	10.6%	4.8%	10.4%	(17) N=980
9. Level of support from appeals	1.7%	7.1%	35.2%	23.0%	13.9%	19.1%	(18) N=974
10. Time constraints imposed by group manager (i.e., need to work as many audit cases as possible)	0.7%	1.7%	37.0%	29.0%	13.3%	18.2%	(19) N=982
11. Lack of practitioner/ preparer cooperation	1.0%	4.9%	56.0%	19.6%	5.6%	12.9%	(20) N=981
12. Need to work cases with maximum revenue return	0.6%	1.4%	40.3%	25.9%	11.1%	20.7%	(21) N=985
13. Other (Specify) _____	0.0%	0.0%	0.0%	38.7%	61.3%	0.0%	(22) N=31

8

24. In your opinion, is the $500 penalty for willful understatement too high, too low or about right to assure compliance? (CHECK ONE.) (23)

1. [__]	Much too high	0.1%
2. [__]	Somewhat too high	0.5%
3. [__]	About right	28.4%
4. [__]	Somewhat too low	34.3%
5. [__]	Much too low	36.7%
6. [__]	No opinion	56

N=951

25. Overall, how easy or difficult is it for you to administer the $500 penalty for willful understatement? (CHECK ONE.) (24)

1. [__]	Very easy	1.0%
2. [__]	Easy	3.0%
3. [__]	Neither easy nor difficult	39.2%
4. [__]	Difficult	39.8%
5. [__]	Very difficult	16.9%

N=974

26. How easy or difficult is it to distinguish between conduct warranting only 6694(a) (i.e., negligent or intentional disregard of rules or regulations) and conduct warranting 6694(b) (i.e., willful attempt to understate tax liability)? (CHECK ONE.) (25)

1. [__]	Very easy	1.5%
2. [__]	Easy	10.0%
3. [__]	Neither easy nor difficult	26.9%
4. [__]	Difficult	48.8%
5. [__]	Very difficult	12.7%
6. [__]	No basis to judge	167

N=840

V. REFERRALS

27. How familiar or unfamiliar are you with the process of referring penalized practitioners to the Director of Practice? (CHECK ONE.) (26)

1. [__]	Very familiar	1.9%
2. [__]	Familiar	21.8%
3. [__]	Neither familiar nor unfamiliar	14.8%
4. [__]	Unfamiliar	34.7%
5. [__]	Very unfamiliar	26.8%

N=1008

28. In the past 12 months how many times have you referred a practitioner to the Director of Practice as a result of a preparer conduct penalty? (ENTER NUMBER. IF NONE, ENTER "0".)

_____ (NUMBER) (27-28)

N=1009

Zero	94.1%
1 to 5	5.1%
6 to 10	0.8%
Over 10	0.1%

29. How adequate or inadequate is the written guidance in assisting you to determine when to refer penalized practitioners to the Director of Practice? (CHECK ONE.) (29)

1. [__]	Much more than adequate	0.7%
2. [__]	More than adequate	3.6%
3. [__]	Adequate	45.1%
4. [__]	Less than adequate	37.1%
5. [__]	Much less than adequate	13.4%
6. [__]	No basis to judge	316

N=692

30. How familiar or unfamiliar are you with the process of referring penalized preparers to the District Director? (CHECK ONE.) (50)

1. [__]	Very familiar	0.6%
2. [__]	Familiar	12.3%
3. [__]	Neither familiar nor unfamiliar	16.0%
4. [__]	Unfamiliar	36.8%
5. [__]	Very unfamiliar	34.2%

N=1005

31. In the past 12 months how many times have you referred a preparer to the District Director as a result of a preparer conduct penalty? (ENTER NUMBER. IF NONE, ENTER "0".)

_____ (NUMBER) (51-52)
N=1007

Zero	96.0%
1-5	3.3%
6-10	0.6%
Over 10	0.1%

32. How adequate or inadequate is the written guidance in assisting you to determine when to refer penalized preparers to the District Director? (CHECK ONE.) (53)

1. [__]	Much more than adequate	0.5%
2. [__]	More than adequate	1.9%
3. [__]	Adequate	41.4%
4. [__]	Less than adequate	37.6%
5. [__]	Much less than adequate	18.7%
6. [__]	No basis to judge	363

N=638

VI. WILLFUL UNDERSTATEMENT PENALTY - SECTION 6694(b) VS. AIDING AND ABETTING PENALTY - SECTION 6701

33. How familiar or unfamiliar are you on when to apply the "Aiding and Abetting" penalty established by Section 6701 of the Code? (CHECK ONE.) (54)

1. [__]	Very familiar	2.2%
2. [__]	Familiar	20.9%
3. [__]	Neither familiar nor unfamiliar	19.9%
4. [__]	Unfamiliar	32.8%
5. [__]	Very unfamiliar	24.3%

N=1002

34. In the past 12 months, approximately how many times have you pursued the Section 6701 penalty against an income tax return preparer? (ENTER NUMBER. IF NONE, ENTER "0".)

_____ (NUMBER) (55-56)
N=1006

Zero	93.8%
1-5	4.4%
6-10	1.3%
Over 10	0.5%

35. How much written guidance covering the Aiding and Abetting penalty is made available by your district office? (CHECK ONE.) (57)

1. [__]	Extensive written guidance	2.0%
2. [__]	Moderate written guidance	23.9%
3. [__]	Some written guidance	38.4%
4. [__]	Limited written guidance	30.9%
5. [__]	No written guidance	4.8%
6. [__]	Don't know	402

N=602

IF NO WRITTEN GUIDANCE AVAILABLE OR "Don't know" ——→ SKIP TO QUESTION 37.

36. How adequate or inadequate is the written guidance in assisting you to decide when to pursue the Section 6701 Aiding and Abetting penalty against a preparer as opposed to the 6694(b) penalty for willful understatement? (CHECK ONE.) (58)

1. [__]	Much more than adequate	1.0%
2. [__]	More than adequate	4.1%
3. [__]	Adequate	47.2%
4. [__]	Less than adequate	41.4%
5. [__]	Much less than adequate	6.4%
6. [__]	No basis to judge	55

N=515
Skipped=431

37. To what extent, if at all, do you feel you are able to make the correct determination whether to pursue the 6701 penalty for Aiding and Abetting against a preparer versus the 6694(b) penalty for willful understatement? (CHECK ONE.) (59)

1. [__]	Very great extent	1.3%
2. [__]	Great extent	6.7%
3. [__]	Moderate extent	28.8%
4. [__]	Some extent	31.8%
5. [__]	Little or no extent	31.5%
6. [__]	No basis to judge	301

N=705

38. Please describe the circumstances that would prompt you to propose the Aiding and Abetting penalty in lieu of the willful understatement penalty against a preparer.

Not listed due to the number and diversity of responses

__ __ (40-41) __ __ (42-43) __ __ (44-45)

__ __ (46-47) __ __ (48-49) __ __ (50-51)

39. Does your group manager encourage or discourage you to pursue the 6701 penalty for Aiding and Abetting against a preparer in lieu of the 6694(b) penalty for willful understatement? (CHECK ONE.) (52)

1. [__]	Strongly encourages me to pursue 6701 penalty over the 6694(b) penalty	2.2%
2. [__]	Encourages me to pursue 6701 penalty over the 6694(b) penalty	9.2%
3. [__]	Neither encourages nor discourages me to pursue either penalty over the other	86.4%
4. [__]	Discourages me to pursue the 6701 penalty over the 6694(b) penalty	0.8%
5. [__]	Strongly discourages me to pursue the 6701 penalty over the 6694(b) penalty	1.4%
6. [__]	Issue has not been addressed	511

N=491

40. If you have any comments concerning any question in this questionnaire or any general comments about any of the preparer penalties covered, please use the space below. If necessary, you may attach additional sheets. (85)

THANK YOU FOR YOUR ASSISTANCE.
PLEASE RETURN YOUR COMPLETED QUESTIONNAIRE IN THE ENCLOSED ENVELOPE.

12

Comments From the Internal Revenue Service

Note: A GAO comment supplementing those in the report text appears at the end of this appendix.

COMMISSIONER

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

SEP 1 7 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled, "Tax Policy: Effectiveness of IRS' Return Preparer Penalty Program Questionable".

The report makes various recommendations to improve the Civil Penalty Program. Many of these recommendations will be incorporated in the multi-functional Civil Penalty Handbook which is presently being drafted. In addition, we basically agree with your recommendation to assign to our Return Preparer Coordinators the responsibility for ensuring that appropriate referrals are made to the Director of Practice. Also, additional training on referral requirements will be given to examiners.

Our detailed comments on the specific recommendations and actions that the Service is taking in response thereto are enclosed.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX POLICY: EFFECTIVENESS OF IRS' RETURN PREPARER
PENALTY PROGRAM QUESTIONABLE"

Recommendation:

Take action to ensure that examiners consider the penalties and document their decisions regarding the opening of a preparer penalty case. These actions could include a memorandum to examiners and group managers emphasizing existing penalty requirements as well as other communications.

Comment:

The Assistant Commissioner (Examination) will issue a memorandum to the Assistant Regional Commissioners (Examination) emphasizing the existing penalty requirements. Examination also plans to include a training module on return preparer penalties in the FY 1991 Continuing Professional Education (CPE) program that is given to all field personnel. Preparer penalties will also be covered extensively in a multi-functional Civil Penalty Handbook now being drafted.

Recommendation:

Ensure that district office returns preparer coordinators are opening program action cases, where appropriate, against preparers who demonstrate patterns of misconduct. In particular, the coordinators should be directed to review exam cases where there is a substantial adjustment to the taxpayer's liability to determine if a preparer penalty case is warranted.

Comment:

Due to volumes, and the time necessary to perform those reviews, we do not believe that it is practicable for coordinators to review all cases where there is a substantial tax increase. Among the items considered by Quality Review, within its list of Auditing Standards, is the examiner's consideration of appropriate penalties, including the preparer penalties. This auditing standard is covered in the IRM, will be discussed in the Penalty Handbook, as well as in the memorandum mentioned in the prior comment.

Recommendation:

Develop National Office guidance that, to the extent possible, clearly defines and differentiates between preparer penalties as defined in section 6694(a) for taking an unrealistic position and section 6694(b) for willful or reckless conduct; and

Develop National Office guidance that, to the extent possible, differentiates between the section 6694(b) penalty for willful or reckless conduct and the section 6701 penalty for aiding and abetting an understatement of tax liability.

Comment:

We agree with the need for this guidance which will be contained in regulations being prepared to implement the 1989 Omnibus Budget Reconciliation Act. Those regulations will provide the basis for the guidance provided in the Penalty Handbook. Interim guidance will be issued as part of the 1991 CPE training package.

Recommendation:

Review local district office policies on return preparer penalties to ensure that those policies are consistent with the National Office guidance.

Comment:

Program review visits are planned to six of the seven regions during FY 1991. Consistency of policies and procedures are reviewed during that process. In addition, the Penalty Handbook is designed to supplant any and all local policy guidance. Any local items issued after the Penalty Handbook is in place will have to conform with the nationally mandated policy directives found in the Penalty Handbook.

Recommendation:

To ensure compliance with the Code, we also recommend that IRS adopt procedures to ensure that no more than the maximum amount allowable under the Code is collected for these penalties.

Comment:

We agree with your analysis of the problem presented by the manner in which the statute is drafted, under which it would appear that both the section 6694(a) penalty and the section 6694(b) penalty may be assessed in any single case, but only the higher amount (the 6694(b)) penalty can be collected. We also

See comment 1.

agree with the recommendation you made to the Congress in your draft report that this anomaly be cured by legislation.

Also, the Assistant Commissioner (Examination) is requesting a computer change which will reject the assessment (or combination of assessments) if it exceeds the maximum amount collectible under the statute. It should be noted, however, that the current structure of our computer programs may not allow us to provide information to the Collection officer, absent research of the initial preparer penalty case, which will ensure that the Collection officer collects only the 6694(b) amount. This is an extremely complicated situation, exacerbated by the appeals procedures found in section 6703 (under which a partial payment may be made in order to perfect a court appeal). There may be no effective administrative correction available at this time to eliminate the possibility of excess collections in all cases.

Recommendation:

Clarify guidance to clearly state that referrals are required when preparer penalties are assessed and designate who is responsible for making referrals; and

Assign the district Return Preparer Coordinators the responsibility for ensuring that required referrals are made to the proper authority when penalties are assessed.

Comment:

The Committee Report accompanying the 1989 Act contains several administrative recommendations.[1] One is that the IRS recognize that a preparer should ordinarily not be referred to the Director of Practice based on a single or isolated occurrence. In light of Congress' concern, we question the efficacy of this recommendation, which seems to indicate that a referral should be made in every case where a preparer penalty is assessed.

We are revising the IRM to clarify that it is the responsibility of the examining officer (who, is in a position to have the best knowledge of the case and the preparer's role therein) to prepare the referral. We will also recommend that these referrals be transmitted through the Return Preparer Coordinator.

Referrals emanating from the examination process are made, and, in our view, properly made, by the examiner at the conclusion of the examination action -- whether or not the penalty is assessed at that time. We do not believe that

[1] See Conference Committee Report on the Act, page 661ff.

referrals should depend solely on whether the preparer prevails on appeal. Referrals are proper in some instances based on the entire case examination, whether or not a penalty is ultimately assessed.

Another point we feel should be made is that the referral to the Director of Practice is limited to practitioners who are covered by Circular 230. Many of the preparer penalty cases which arise involve unenrolled preparers. Those cases are referred to the District Director for action. Our IRM revision will address the differences in those activities and provide more procedural direction with respect to both types of referral. Again, the Penalty Handbook will contain extensive information on the referral programs.

Finally, to emphasize the importance of preparer referrals, especially those involving Circular 230 covered practitioners, and the role of the Director of Practice in policing preparer activities, Form 4318, Examination Workpapers, has been revised to include among the list of "Reminders" for examiners, the legend: "Referrals, Director of Practice, IRM 4297.9." This will bring the issue of practitioner referrals to the examiner's attention in every case that is examined. It will also assist the examiner in locating the IRM instructions quickly.

Recommendation:

Additionally, to further ensure that referrals are made when required, examiners need to become more familiar with the referral requirements. To increase examiners' familiarity, we recommend the Commissioner of Internal Revenue ensure that examiners receive training which clearly communicates the referral requirements.

Comment:

The Assistant Commissioner (Examination) will ensure that training on all of the new penalty rules, including preparer penalties and the referral procedures, are included in the CPE for 1991. The Penalty Handbook distribution will also be effective in response to this recommendation.

The following is GAO's comment on the letter from the Internal Revenue Service dated September 17, 1990.

GAO Comment

1. At the exit conference with IRS officials, the need for congressional action to remedy this problem was discussed. However, the draft report provided to IRS for comment did not contain a recommendation for congressional action.

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