

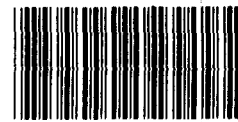
GAO

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

July 1991

TAX  
ADMINISTRATION

Negligence and  
Substantial  
Understatement  
Penalties Poorly  
Administered



144289

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United States  
General Accounting Office  
Washington, D.C. 20548

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**General Government Division**

B-242716

July 3, 1991

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 negligence and substantial understatement penalties. The report discusses whether IRS correctly assessed these penalties when warranted and whether IRS adequately explained to taxpayers the reasons for assessing these penalties. 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 III. If you have any questions, please call me on (202) 272-7904.

Sincerely yours,

Paul L. Posner  
Associate Director  
Tax Policy and Administration  
Issues

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# Executive Summary

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## Purpose

Declining audit coverage coupled with an estimated annual \$100 billion gap between taxes owed and taxes voluntarily paid has raised concerns about how to improve taxpayer compliance with the tax laws.

According to the Internal Revenue Service (IRS), civil penalties promote compliance by helping taxpayers understand that noncompliance is wrong, imposing economic costs on noncompliance, and establishing fairness in the tax system by giving the noncompliant his just desserts.

At the request of the Chairman of the Subcommittee on Private Retirement Plans and Oversight of IRS, Senate Committee on Finance, GAO reviewed IRS' administration of the negligence and substantial understatement penalties. On the basis of a sample of audit case files, this report evaluates whether the negligence and substantial understatement penalties have been assessed in accordance with IRS policies and procedures, whether IRS' internal controls are adequate to ensure these penalties are properly assessed, and ways to improve IRS penalty administration.

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## Background

IRS may assess a negligence penalty if a taxpayer demonstrates disregard of rules and regulations, including failure to make a reasonable attempt to comply with the provisions of the code and failure to exercise the level of care that a reasonable and ordinarily prudent taxpayer would use under the circumstances. The substantial understatement penalty can be assessed against individual taxpayers if the understatement of tax exceeds the greater of \$5,000 or 10 percent of the corrected tax.

Partially as a result of a series of changes made in the 1980s, concerns have grown over the role and use of these penalties. Penalty reform legislation passed in 1989 addressed many of these policy concerns. GAO's review focused on IRS penalty administration. GAO analyzed randomly selected examination case files from three IRS districts in which the negligence and/or substantial understatement penalties were either assessed or not assessed.

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## Results in Brief

The role of the negligence and substantial understatement penalties in enhancing compliance is being undermined by errors in IRS penalty administration. GAO estimates that, in the districts reviewed, about

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one-third of the cases contained erroneous penalty determinations. IRS generally was too lenient and either did not assess penalties that were warranted or assessed penalties that were too small. GAO's findings mirror those contained in two earlier IRS internal audit reports.

The high error rate is puzzling because GAO found IRS guidance to examiners adequate and the cases generally did not involve complex tax law issues. In addition, IRS has in place a system of internal controls that, if properly implemented, should identify and correct the problems GAO identified. However, GAO estimates that over 60 percent of the cases in the universe were reviewed at least once without the errors being corrected.

IRS officials cited various factors that could have caused the problems GAO found, including emphasis on other parts of the examination, workload pressures, and staff turnover and inexperience. These factors may have contributed to the problem, but GAO believes the fundamental cause may have been the attitude of exam personnel on the value of pursuing penalties in relation to other examination issues.

The solution to the problem should produce a fundamental change in the belief and behavior of IRS exam personnel. GAO recommends that IRS initiate a Quality Improvement Program project on penalty administration because of that Program's premise that employee involvement in problem analysis is more likely to result in the determination of root cause and successful solutions. We also recommend changes to penalty explanations provided to taxpayers.

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## Principal Findings

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### Penalties Decisions Often Incorrect

GAO estimates that in 33 percent of the cases in the universe reviewed, IRS examiners made an error when determining whether a penalty was warranted and/or when determining the amount of such penalties. Eighty-five percent of the time the error was in the taxpayer's favor. In almost 75 percent of the cases in which warranted penalties were not assessed, the taxpayer either did not show up for the examination or could not substantiate expenses. In both of these cases, IRS guidance requires a penalty to be assessed. (See pp. 17-19.)

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## Internal Control Not Effectively Implemented

GAO found that IRS internal controls, including supervisory and quality assurance reviews and district office penalty screening committees, designed to ensure that penalties are properly assessed have not been effectively implemented. As a result, examiner errors had not been corrected, which brings the practical value of the internal controls into question. For example, IRS requires that examiners document their reasons for assessing or not assessing all applicable penalties. This documentation forms the basis for subsequent review of the examiner's decisions. Yet GAO estimates that approximately one in five of the cases did not have adequate documentation. The problem was more prevalent in cases with no penalty assessment. (See pp. 19-21.)

GAO estimates that over 60 percent of the cases in the universe with incorrect penalty determinations went through at least one internal control review. In 1985 and 1987, IRS' Internal Audit Division issued reports that identified problems similar to those that GAO found and recommended IRS management take steps to emphasize the importance of assessing penalties when warranted. (See pp. 21-23.)

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## Solutions to Problems Uncertain

According to IRS officials, heavy workload, a lack of emphasis on penalties, employee turnover and lack of experience, and the limited scope of the penalty screening committee reviews were the causes of the problems. GAO believes that while these factors may have contributed to the problem, the underlying cause may have been the attitude of IRS staff regarding penalty administration. For example, in a past review of IRS' administration of preparer penalties, IRS staff responses to a GAO questionnaire indicated that those penalties were not being assessed as often as they should have been because the staff believed the time and effort required were better spent on other examination issues. (See pp. 23-24.)

Given that IRS has taken action to emphasize the need to better administer these penalties and that the framework of internal controls is adequate in concept, it could be that the exam personnel's negative perception of the preparer penalties also extends to these penalties. Thus, GAO believes that an effective solution to the problem should include a change in staff attitude regarding penalty administration overall. (See pp. 24-25.)

IRS has developed a Quality Improvement Program to improve the quality of agency operations. GAO believes that a Quality Improvement

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Program would be an appropriate avenue for improving penalty administration. (See p. 25.)

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### Reasons for Assessing Penalties Not Adequately Explained to Taxpayers

IRS examiners are required to explain to taxpayers why penalties were assessed against them. However, in an estimated 76 percent of the cases in GAO's universe, the written explanations provided did not adequately explain to the taxpayer the particular facts, circumstances, and criteria that warranted penalties in their case. (See pp. 29-30.)

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### Recommendations

GAO recommends that the Commissioner of Internal Revenue establish a Quality Improvement Project to clarify the root causes of these problems and identify and test effective solutions. (See p. 27.)

GAO also recommends that the Commissioner of Internal Revenue take action to ensure that the penalty explanations in IRS' examination reports provide taxpayers with the specific facts, circumstances, and criteria that warranted the assessment of the penalty. (See p. 31.)

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### Agency Comments

IRS officials agreed with GAO's recommendation that the root causes of the problems need to be clarified. IRS suggested, however, that a Quality Improvement Project be considered only if actions taken to implement recommendations contained in a 1989 Commissioner's Civil Penalty Task Force are not effective. While anticipated IRS actions to improve penalty administration may be effective, GAO is concerned that if actions are taken without an empirical staff-level analysis of the root causes of the problems, such actions may be inefficiently designed and targeted and may not benefit from staff support and buy-in. The task force report explicitly recognized that its effort was only a start because of a lack of data on the nature and cause of the problems. This report provides information on the nature and extent of the problem. However, the data on root causes needed to improve IRS' administration of the penalties are still lacking. (See pp. 27-28.)

# Contents

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<b>Executive Summary</b>		2
<hr/>		
<b>Chapter 1</b>		8
<b>Introduction</b>	Negligence and Substantial Understatement Penalties	9
	Accuracy/Conduct Penalties Revised Several Times in the 1980s	12
	Objectives, Scope, and Methodology	13
<hr/>		
<b>Chapter 2</b>		17
<b>Penalty Contribution to Compliance Was Limited by Poor Penalty Administration</b>	One-Third of Penalty Determinations Were Erroneous	17
	Internal Controls Not Effective	19
	Similar Problems Previously Identified by IRS Internal Audit	21
	Solutions to Problems Uncertain	23
	Conclusions	25
	Recommendations	27
	Agency Comments and Our Evaluation	27
<hr/>		
<b>Chapter 3</b>		29
<b>Examination Reports Do Not Adequately Explain IRS' Reasons for Assessing Penalties</b>	Standard Penalty Explanations in Examination Reports Are Inadequate	29
	Conclusions	31
	Recommendations	31
	Agency Comments and Our Evaluation	31
<hr/>		
<b>Appendixes</b>		
	Appendix I: Methodology for Selecting Negligence, Substantial Understatement, and No-Penalty Sample Cases	32
	Appendix II: Comments From the Internal Revenue Service	36
	Appendix III: Major Contributors to This Report	39
<hr/>		
<b>Tables</b>		
	Table 2.1: Percentage of Errors for Each Type of Case	17
	Table 2.2: Percentage of Cases With Errors Having Unassessed or Underassessed Penalties	18
	Table I.1: Universes, Samples, and Related Confidence Measures Used in the Study	32



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Table I.2: Sampling Errors for Estimates Used in the  
Report

33

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**Abbreviations**

IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
QIP	Quality Improvement Program

# Introduction

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Between 1982 and 1987, the percentage of individual tax returns audited by the Internal Revenue Service (IRS) declined by almost 30 percent. Currently, IRS audits only about 1 percent of individual tax returns filed. Declining audit coverage coupled with a tax gap projected by IRS to exceed \$100 billion in 1992 has raised concerns about how to improve taxpayer compliance with the nation's tax laws.<sup>1</sup>

Our nation's tax system is based on the principles of self-assessment and voluntary compliance. Civil tax penalties are intended to help achieve compliance by encouraging taxpayers to meet the standards of behavior required by the Internal Revenue Code (IRC). According to IRS, penalties help taxpayers understand that noncompliance is wrong, impose economic costs on noncompliance, and establish the fairness of the tax system by giving the noncompliant his just desserts. To encourage voluntary compliance, penalties should be used when warranted. This practice could help ensure that taxpayers are treated consistently and that they learn the behavior expected of them. The full use of penalties gains even greater importance as the use of other incentives to voluntary compliance, such as examination coverage, declines.

While penalties serve an important compliance function, in recent years, Congress and the tax community have raised many concerns regarding the role and use of penalties. Congress and the tax community said they believed that many penalties were added piecemeal over the years without full consideration being given to the overall penalty structure. The use of penalties as revenue sources, rather than as a means of encouraging voluntary compliance, was also raised as a concern. Other concerns were that (1) penalties were too complex; (2) multiple penalties could be assessed for the same act of noncompliance (penalty stacking); (3) there were too many different penalties; (4) there was insufficient guidance for taxpayers to understand penalties and for IRS to appropriately assess them; and (5) depending on who was expressing the concern, penalties were either too harsh or too lenient.

The Improved Penalty Administration and Compliance Tax Act contained in the Omnibus Budget Reconciliation Act of 1989 addressed many of the policy concerns related to civil tax penalties. However, the legislation did not address concerns regarding IRS administration of penalties. These concerns focus on the appropriateness and consistency of IRS actions in assessing and abating penalties.

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<sup>1</sup>The tax gap is the difference between taxes owed the federal government and taxes reported and voluntarily paid.

This report evaluates the assessment aspects of IRS administration of the negligence and substantial understatement penalties, which are assessed against taxpayers who understate their tax liability.

## Negligence and Substantial Understatement Penalties

Throughout the history of the modern federal income tax, there have been penalties for tax understatement. The negligence and substantial understatement penalties are the two major accuracy/conduct penalties IRS uses against taxpayers who understate the amount of tax that should have been reported on their returns.

According to IRS data, 200,000 negligence penalties were assessed in fiscal year 1985 for a total of \$154 million. By fiscal year 1988, the number of assessments had increased 50 percent to 300,000, and the dollar value had increased 85 percent to \$284 million. In fiscal year 1985, IRS also assessed 1,660 substantial understatement penalties. By fiscal year 1988, the number of assessments had increased 2,292 percent to 39,700. During this period, the dollar value of the substantial understatement penalties increased 5,850 percent from \$2 million to \$119 million.<sup>2</sup>

## Negligence Penalty

Negligence is a term borrowed from tort law and may be defined as the failure to exercise care that a reasonable and ordinarily prudent person would use under the circumstances. The Internal Revenue Manual (IRM) defines negligence as "the omission to do something which a reasonable person, guided by those considerations which ordinarily regulate the conduct of human beings, would do, or doing something that a prudent, reasonable person would not do." Tax deficiencies arise for different reasons, from honest mistakes to fraud. Within these two extremes are varying degrees of culpability.

The determination of negligence requires a subjective evaluation of all the facts and circumstances surrounding the underpayment and requires IRS to weigh multiple factors. Factors taken into account include the taxpayer's education, manner in which the return was prepared, amount of earnings, and the taxpayer's response. A taxpayer who is

<sup>2</sup>From 1986 to 1988, the published IRS statistics included a presumptive negligence penalty that took effect on 1984 returns. This penalty was assessed against taxpayers who omitted from their returns income reported on certain information returns. The 1989 act repealed the presumptive negligence penalty. For fiscal year 1988, presumptive negligence constituted 74 percent of the total number of negligence penalties assessed and 29 percent of the total dollar value of penalties. The presumptive negligence penalties were deleted from the statistics contained in this report. Our statistics report only the traditional negligence penalty, which is assessed primarily after an examination.

unsophisticated in the realm of tax law and acts in good faith should not receive a negligence penalty.

In establishing negligence, IRS specifies the acts it found that warranted the penalty. The burden of proof is on the taxpayer to rebut IRS' determination by a preponderance of evidence.

IRS may impose the negligence penalty when the deduction of expenses or omission of income is clearly incorrect. IRS may also impose it when an excessive deduction is taken or income is omitted as a result of inadequate or improper records. It is also negligent to deduct expenses that were reimbursed or to omit income that is obviously taxable. Large adjustments to a taxpayer's net income are also strong evidence of negligence. The penalty may be applied if records were carelessly kept and the taxpayer failed to make even a reasonable attempt to fairly and correctly present his or her tax situation. The penalty should not be imposed when there is merely an error or a difference of opinion on some controversial question and a willful attempt to evade is not present. It may not be imposed if the state of the law was not settled at the time the deductions were taken. The negligence penalty does not apply if a taxpayer placed reasonable and justifiable reliance on a lawyer or accountant for preparation and filing of the return and if the taxpayer provided the accountant or lawyer with all the necessary facts to prepare a complete and accurate return.

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## Substantial Understatement Penalty

The substantial understatement penalty was enacted in 1982 in response to a perception that many taxpayers were filing returns that relied on marginal support or positions with the expectation that the return would escape audit. Before the law, if audited, the worst that could happen is that additional tax and interest would be owed because the marginal support would be enough to avoid the negligence and fraud penalties. This "playing" of the "audit lottery" caused what IRS perceived to be a major compliance problem. The substantial understatement penalty was intended to make the possibility of losing the audit lottery more costly.

The substantial understatement penalty may be assessed against individual taxpayers when the understatement exceeds the greater of (1) 10 percent of the corrected tax or (2) \$5,000. The understatement is reduced by any amounts for which the taxpayer had substantial

authority or for nontax shelter items for which the taxpayer's position was adequately disclosed on the return.<sup>3</sup>

Substantial authority exists if an analysis supporting the position concludes that the weight of the authorities supporting the taxpayer's position is substantial in comparison to the weight given authorities supporting opposing positions. Sources of substantial authority include the IRC, court opinions, Department of the Treasury regulations and proposed regulations, revenue rulings, revenue procedures, private letter rulings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices and documents published by IRS in the Internal Revenue Bulletin, and congressional intent as reflected in committee reports. A taxpayer's belief or opinion regarding the existence of substantial authority is irrelevant. Substantial authority is an objective test without regard to factors such as fault, intent, or purpose.

Disclosure is adequate if the relevant facts affecting the item's tax treatment are made clear on the return or a statement attached to the return.

IRS must abate all or any part of the penalty if the taxpayer acted in good faith and had reasonable cause for the understatement, as was evident by the extent of the taxpayer's good faith efforts to determine his proper tax liability.<sup>4</sup>

The previously mentioned rules on substantial authority, disclosure, and abatements place the burden of proof on the taxpayer to show that the penalty should not apply. Unlike the negligence penalty, the substantial understatement penalty contains an objective rather than a subjective standard for its assessment because substantial authority does not take into account the taxpayer's state of mind. However, the abatement provision is based on the subjective standard of reasonable cause and good faith.

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<sup>3</sup>If the item involved a tax shelter, the understatement is reduced by amounts for which the taxpayer had both substantial authority and a reasonable belief that the position taken was more likely than not correct. A taxpayer is considered to have a reasonable belief if (1) the taxpayer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes that there is a greater than 50-percent chance that the tax treatment of the item will be upheld in court if challenged by IRS or (2) the taxpayer relies in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of facts and authorities and the taxpayer unambiguously states that the tax advisor concluded that there was a greater than 50-percent chance that the tax treatment of the item would be upheld.

<sup>4</sup>An abatement is when IRS forgives a penalty.

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## Process for Assessing the Negligence and Substantial Understatement Penalties

The penalties are considered during the examination of the taxpayer's return and are treated as part of the overall deficiency proposed by the examiner. If the taxpayer does not agree with the examiner's proposed tax deficiency and penalties, IRS sends the taxpayer a preliminary, or "30-day," letter along with the examiner's report explaining the basis for the determinations. The 30-day letter is a form letter that informs taxpayers of their appeal rights if they disagree with an examiner's proposed determinations.

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## Accuracy/Conduct Penalties Revised Several Times in the 1980s

The penalties for understating tax liability, known as the accuracy/conduct penalties, were changed on several occasions in the 1980s. The negligence penalty, which had been the same since 1954, was revised in 1981, 1986, 1988, and 1989. The substantial understatement penalty, enacted in 1982, was revised in 1986 and 1989. Changes made to both penalties before 1989 focused primarily on their economic value and generally increased the amount of the penalties. The 1989 legislation addressed not only the economic value of the penalties but also other policy concerns.

After remaining unchanged for almost 30 years, the negligence penalty underwent significant modifications in the 1980s. In 1981, an interest surcharge was added to the existing penalty (5 percent of the total understatement of tax if any portion of the understatement was due to negligence.)<sup>5</sup> The effect of this change was to substantially increase the economic value of the penalty. In 1986, the negligence penalty was made applicable to all types of taxes, negligence was statutorily defined, and the definition of presumptive negligence was expanded. In 1988, legislation was passed rescinding the interest surcharge and instead charging interest on the penalty from the due date of the return. This change reduced the economic value of the penalty. In 1989, the negligence penalty was targeted to only the portion of the tax understatement resulting from negligence, and the penalty rate was increased to 20 percent. This last change also increased the economic value of the penalty.

When enacted in 1982, the substantial understatement penalty was set at 10 percent of the tax understatement if the amount of understatement exceeded statutory thresholds after reducing it by amounts for which the taxpayer had substantial authority or for which the facts were adequately disclosed on the return. In 1986, the rate was increased to 25 percent; and in 1989, it was decreased to 20 percent. Before the

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<sup>5</sup>The surcharge was 50 percent of the interest on the portion of the tax deficiency due to negligence.

Omnibus Budget Reconciliation Act of 1989, both the negligence and substantial understatement penalties could be assessed against the same tax understatement.

In the 1989 act, the negligence penalty was targeted. Now it applies only to the portion of the understatement attributable to negligence, not the entire understatement. The act expanded the sources of substantial authority taxpayers could rely on, and prohibited the assessment of both penalties against the same tax understatement. While the change in the act did address many of the policy concerns related to the accuracy/conduct penalties, they did not address many of the concerns related to IRS administration of these penalties, including whether the penalties were being properly and consistently assessed.

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## Objectives, Scope, and Methodology

This report responds to a request from the Chairman of the Senate Committee on Finance, Subcommittee on Private Retirement Plans and Oversight of IRS, for us to review IRS' administration of the negligence and substantial understatement penalties.<sup>6</sup> The objectives of this report were to evaluate

- whether the negligence and substantial understatement penalties were assessed in accordance with IRS procedures and guidelines,
- the effectiveness of IRS' internal controls in ensuring correct penalty decisions, and
- ways of improving IRS penalty administration.

To accomplish our objectives, we obtained and reviewed information from IRS' National Office in Washington, D.C., and district offices in Brooklyn; Jacksonville, Florida; and Los Angeles. These three districts were chosen for geographic dispersion and because the districts assessed more negligence and substantial understatement penalties than most other districts.

In the course of our review, we did the following:

- We reviewed extensive source material to gain an understanding of the negligence and substantial understatement penalties and the penalty assessment process. These sources included the IRC, regulations, revenue

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<sup>6</sup>Our review was limited to penalties assessed by examiners during the course of auditing a taxpayer's return. Accordingly, we did not review the presumptive negligence penalty, which is assessed almost exclusively through the separate underreporter program.

procedures, IRS manuals and penalty handbooks, IRS memoranda, internal audit reports, publications from commercial tax services, and IRS penalty training material.

- We also researched changes in the law to the negligence and substantial understatement penalties and obtained information on the history and growth of penalties in general. We obtained penalty studies, discussion papers, and similar reports prepared by IRS and nongovernmental organizations to develop an understanding of penalties and to identify penalty concerns and issues.
- We interviewed IRS officials at the National Office and three districts to further document procedures for these penalties.
- We reviewed quality management research and IRS quality management efforts.
- We obtained extracts from IRS Individual and Business Master Files for fiscal years 1985 through 1988. We used these extracts to identify trends in IRS penalty assessments, the universe of fiscal year 1987 penalty transactions, and the universe of tax returns for which IRS assessed an additional tax of \$5,000 or more as the result of an examination but did not assess either a negligence or a substantial understatement penalty.
- We analyzed a stratified random sample of 141 individual tax return cases in the three districts that were assessed either a negligence or a substantial understatement penalty as a result of an examination. Twenty-five case files were randomly selected from each of three districts for each of the penalties. The substantial understatement penalty sample had 66 instead of 75 cases we received because 9 of the cases did not meet our selection criteria. Time constraints did not allow us to replace these cases.
- We analyzed a random sample of 75 cases in the three districts that had an increase of at least an additional \$5,000 in tax as a result of an examination but had not been assessed either penalty. We analyzed these cases to determine if IRS was assessing penalties when warranted.

All cases analyzed were randomly selected from IRS' master file computer tapes covering fiscal year 1987 penalty and tax assessments. Fiscal year 1987 was selected because it was the latest year for which IRS master file tapes were available at the time we selected our sample. Additional information on our sampling methodology is provided in appendix I.

We limited our review to cases in which penalties were assessed against individual taxpayers because according to IRS fiscal year 1987 penalty



statistics, 99.7 percent and 98.9 percent of the negligence and substantial understatement penalties, respectively, were assessed against individual taxpayers.

We excluded cases in which IRS assessed the penalties against nonfilers for whom IRS prepared substitute returns because these did not result from an examination. In addition, the 1989 act made any findings on such cases obsolete because it permits the use of negligence and substantial understatement penalties only if a return has been filed.

For the sample of cases not assessed penalties, we excluded cases with tax deficiencies under \$5,000 because substantial understatement penalties cannot be assessed unless the tax deficiency exceeds \$5,000. This exclusion allowed us to review IRS' actions when penalties were assessed and when they were not assessed. We reviewed individual tax returns, master file account transcripts, and IRS' examination workpapers and reports on the cases that were randomly selected. We used this data to do the following:

- We determined whether the assessment or nonassessment of the penalty was in accordance with the rules and criteria governing its assessment. If we disagreed with the assessment, we discussed our conclusions with experienced examiners at each of the three districts. We also had them recompute the penalty and try to explain why any error occurred.
- We ascertained whether the workpapers indicated that penalties were considered and whether they contained appropriate and complete reasons for assessing the penalty unless the reason was obvious. We discussed our conclusions with experienced examiners when we believed cases contained inadequate explanations.
- We determined whether the examination reports contained explanations of the penalties, how the taxpayers' actions met the criteria for the penalty assessment, and how the penalty was computed.
- We determined whether the case files showed evidence of supervisory review, quality review, or review by penalty screening committees.
- We compiled information on the type of examination adjustments upon which the penalties were and were not assessed.

We concentrated our efforts on assessments rather than abatements because our initial analysis of 50 cases in the Los Angeles district with negligence penalty abatements in fiscal year 1987 and a similar sample of substantial understatement penalty abatement cases showed that well over half were actually penalty recomputations resulting from

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reductions in the underlying tax deficiency. While IRS master files classify these actions as abatements, they do not represent an IRS decision to abate the penalty on the basis of reasonable cause. Therefore, the files do not reflect how well IRS is abating the penalties.

Our work was done between March 1989 and October 1990, in accordance with generally accepted government auditing standards.

IRS provided written comments on a draft of this report. Its comments are included in appendix II and are evaluated on pages 27 to 28 and 31.

# Penalty Contribution to Compliance Was Limited by Poor Penalty Administration

The contribution of the negligence and substantial understatement penalties to future taxpayer compliance has been undermined by errors and oversights in IRS administration of the penalties. As a result, opportunities to educate taxpayers about their responsibilities, provide economic disincentives for noncompliance, and enhance future compliance have been lost. In addition, IRS errors resulted in taxpayers being treated inconsistently.

We estimate that IRS made incorrect penalty determinations in 33 percent of our universe of cases.<sup>1</sup> IRS errors overwhelmingly resulted in warranted penalties not being assessed or penalties assessed being too small. Our results are consistent with two earlier IRS Internal Audit Division reports. Assessment errors occurred despite internal control mechanisms or checks that existed to ensure proper penalty decisions.

IRS officials cited various factors to explain why its rules and standards for assessing, documenting, and reviewing penalties were not followed. These factors included heavy workload; emphasis on other areas of examination; employee turnover, quality, and inexperience; and the limited scope of penalty screening committee reviews. While we agree that these factors may be a concern, they do not fully explain the problems we found.

## One-Third of Penalty Determinations Were Erroneous

We estimate that IRS' penalty determination was wrong in 33 percent of the cases in our universe. As shown in table 2.1, the error rate was similar for cases with penalty assessments and for no-penalty cases. There was not a significant difference among the overall district error rates for the negligence, substantial understatement, and no-penalty cases.

**Table 2.1: Percentage of Errors for Each Type of Case**

Negligence	33%
Substantial understatement	31
No penalty but \$5,000 or greater additional tax	33
Overall rate	33

There was also no significant difference in negligence error rates nor in the substantial understatement error rates among the districts. The

<sup>1</sup>Appendix II shows the sampling errors and confidence intervals for all estimates included in this report.

error rate for the no-penalty cases did differ significantly among districts, ranging from a low of 20 percent to a high of 64 percent. We discussed with IRS officials each sample case that we determined contained an incorrect penalty assessment and had them review the case file. IRS agreed with our position in 97 percent of the sample cases with errors.

### Most Errors Favored Taxpayer

IRS penalty assessment errors can benefit either the taxpayer or the government. An error benefits the taxpayer when a warranted penalty is not assessed or the penalty assessed is too low. Penalty errors favor the government when unwarranted penalties are assessed or penalties are too high. We estimate that 85 percent of the erroneous cases in our universe were in the taxpayer's favor. Table 2.2 shows how often IRS errors resulted in underpenalizing taxpayers for each type of case.

**Table 2.2: Percentage of Cases With Errors Having Unassessed or Underassessed Penalties**

No penalty cases	100%
Negligence penalty cases	81
Substantial understatement penalty cases	65
All cases	85

For the most part, cases in which warranted penalties were not assessed did not involve complex tax law questions. We estimate that in 74 percent of the cases, the taxpayer either did not appear for the examination or could not substantiate expenses. We estimate that in 53 percent of the cases in which a penalty was correctly assessed, the taxpayer also either did not appear for the examination or could not substantiate expenses.

In these cases, IRS guidance to examiners requires assessment of a negligence penalty and that a substantial understatement penalty be considered and assessed when appropriate. For example, in one case, the taxpayer reported gross receipts of about \$50,000, offset by business expenses of \$35,000. During the examination, the taxpayer was unable to establish that over \$27,000 of the business expenses was actually incurred or, if so, was for ordinary and necessary business expenses. For instance, depreciation on office furnishings was disallowed because the taxpayer refused to show IRS the business premises that, according to the return, were at the same address as the taxpayer's personal residence. A negligence penalty and a substantial understatement penalty

should have been assessed in this case but were not.<sup>2</sup> IRS officials who reviewed the case with us agreed both penalties should have been assessed.

In another case, the taxpayer reported gross receipts of almost \$1,000 but had a net loss of almost \$7,000 after deducting business expenses. IRS disallowed almost \$6,000 in business expenses primarily because the taxpayer could not justify them as actually incurred or ordinary and necessary expenses. While IRS assessed a negligence penalty for income not reported on the return, the examiner also should have assessed a negligence penalty for the disallowed expenses, but did not. IRS reviewers also agreed with our findings in this case.

In some cases, IRS overpenalized taxpayers, but to a much lesser extent. We estimate that 15 percent of the cases with errors in our universe were in the government's favor. These types of errors occurred for various reasons, as follow:

- Examiners incorrectly computed penalties on the corrected tax rather than on the tax deficiency.
- For substantial understatement, disallowed items were adequately disclosed on the return.
- The tax deficiency was less than the substantial understatement penalty's \$5,000 criterion.
- A return preparer made a technical error of which the taxpayer could not reasonably be expected to be aware.

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## **Internal Controls Not Effective**

The high percentage of erroneous penalty determinations we found was perplexing because IRS had in place management procedures and techniques (internal controls) which, if properly implemented, should have ensured correct penalty decisions. These controls included requirements that examiners document in their workpapers that penalties were considered and provide reasons for assessing or not assessing them. This documentation provided the basis for subsequent controls, including supervisory reviews, the quality review program, and penalty screening

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<sup>2</sup>In 1989, legislation was enacted prohibiting the assessment of both a negligence and substantial understatement penalty against the same understatement—penalty stacking. If stacking errors were eliminated from our sample, the overall estimated error rate would fall to approximately 27 percent. In our sample, we counted these cases as erroneous because IRS rules in place at the time required assessment of both penalties.

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committees. However, we found these internal controls did not effectively detect or correct the problems we found, including inadequate documentation and incorrect penalty decisions.

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## Types of Internal Controls

Proper documentation by the examiner of penalty determinations is a critical first step in IRS' system of internal controls. For each case, examiners are required to document their decisions to assess or not assess a penalty and the basis for that decision. Documentation helps ensure that examiners consider all aspects of a case, including penalties, and provides the basic data used in subsequent reviews designed to ensure that examiners are making correct decisions. IRS stresses its documentation requirements in the Internal Revenue Manual (IRM), the Quality Assurance Rating Guide, National Office and local memoranda, and training materials.

Supervisory review is the initial IRS mechanism for identifying and correcting incorrect penalty decisions and insufficient workpaper documentation. IRS' first-line supervisors are responsible for the quality and accuracy of all cases worked by the examiners they supervise. Supervisors are required to review a judgmental sample of examination cases large enough to ensure that the examiners' work, including penalty administration, is of acceptable quality and done in conformance with IRS audit quality standards.

In addition to the reviews by IRS line supervisors, each district office also has a quality review program, which requires the review of a random sample of examination cases of the types we analyzed. Quality review is designed to detect audit quality problems and correct them. All aspects of each case are to be reviewed for correctness. The quality review program also provides management with pertinent information on exam quality problems for use in identifying areas in which corrective actions are needed. Ensuring that an examiner's penalty decisions are correct is an important part of the quality review of an exam case. Quality reviews are also done by examiners.

IRS established penalty screening committees in each district office to review assessments for several penalties, including substantial understatement, enacted as a part of the Tax Equity and Fiscal Reform Act of 1982. All substantial understatement penalty cases are to be reviewed by the district's penalty screening committee to ensure that the penalty assessments are warranted. However, the penalty screening committees are not required to review cases in which a substantial understatement

penalty was not assessed, even though such a penalty may have been appropriate. According to the IRM, penalty screening committee members are to be management level exam officials.

Because the supervisory, quality, and penalty screening committee reviews are selective, not all cases are reviewed. We estimate that 54 percent of all the cases in our universe had one or more review.

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### **Internal Controls Not Working Properly**

Despite IRS' stress on proper workpaper documentation, the examiners' reasons to assess or not assess a penalty were not documented as required by the IRM in an estimated 18 percent of the cases in our universe. The workpapers for these cases either did not indicate whether penalties were considered, or if penalties were considered, did not give the reasons for assessing or not assessing them as required by IRS. Failure to document was most common in the cases with tax deficiencies over \$5,000 for which no penalty was assessed. In an estimated 35 percent of these cases, the examiner's reasons for not assessing a penalty were not documented.

Although we estimate that IRS supervisors, quality review program members, and penalty screening committees reviewed 54 percent of the cases in our universe, these reviews were not effective in identifying or correcting inadequately documented and incorrect penalty assessment decisions. We estimate that 62 percent of the cases with incorrect penalty determinations went through at least one internal review process, but the errors were not corrected. Of the cases in our universe that did not have properly documented workpapers, we estimate that 64 percent received one or more internal control review.

The fact that the internal controls in place were not correcting the errors we found raises serious questions about how IRS is holding examiners, supervisors, and others accountable for quality penalty decisions. On the basis of our review, there appears to be little if any incentive to make a correct decision or to document the basis for the decision.

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### **Similar Problems Previously Identified by IRS Internal Audit**

Our findings on the quality of IRS penalty determinations are consistent with the conclusions of previously issued IRS Internal Audit reports. In a May 1985 report dealing specifically with the substantial understatement penalty, Internal Audit reported that substantial understatement penalties should have been, but were not, assessed in 43 percent of the

177 cases reviewed.<sup>3</sup> In addition, Internal Audit reported that 71 percent of the case files reviewed contained no documentation that the penalty had been considered by the examiners.

To resolve these problems, Internal Audit recommended that the Office of that Assistant Commissioner for Examination emphasize the assessment of substantial understatement penalties on all appropriate cases, require examiners to properly document consideration of the penalty, require special reviews of cases without the penalty, and clarify certain policies. IRS management concurred with the findings and issued a memorandum to all regions to emphasize the use of the penalty whenever applicable in order to remind examiners about workpaper documentation and urge managers and quality reviewers to be alert for penalty situations. This memorandum was issued before IRS processed the cases we ultimately reviewed.

In a December 1987 Internal Audit report that dealt with substantial understatement, negligence, and four other penalties in five districts and one service center, all within the Western Region, Internal Audit found that

- examiners did not assess penalties when appropriate in 57 percent of the cases reviewed,
- quality control reviews did not effectively identify errors, and
- examiners did not adequately support penalty determinations in 56 percent of the cases reviewed.

Internal Audit recommended that regional management could better administer penalties by ensuring that examiners assess all appropriate penalties, adequately document penalty determinations, and accurately calculate the penalty amounts.

The Regional Commissioner agreed to emphasize to districts that adequate emphasis be given to asserting all appropriate penalties and instructing districts to reevaluate their internal controls to ensure that reviews by group managers, quality reviewers, and the penalty screening committee are adequate. In addition, the Regional Commissioner said that the region would issue procedures to ensure that case files include sufficient information so that a review team could determine whether penalties were considered, applied correctly, and computed accurately. Because our sample cases were processed in 1987, any

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<sup>3</sup>The 177 cases were selected from 11 districts and 2 service centers.



improvements in the region from these steps would not be reflected in our findings.

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## **Solutions to Problems** **Uncertain**

As we stated before, IRS appeared to have in place the internal controls needed to ensure correct penalty decisions. It is unclear why these controls were not working to prevent or catch the errors we found. IRS officials, in the districts we reviewed, provided several explanations for the problems we found. These explanations centered on heavy workload, IRS emphasis on other areas of the examination, staff turnover and inexperience, and the limited scope of penalty screening committees' reviews. While we agree that these factors may have contributed to the high error rate, we believe the fundamental cause may be the attitude of IRS staff regarding the value of pursuing penalties in relation to other examination issues. An IRS Quality Improvement Program (QIP) project, as discussed in the following section, could allow IRS to identify the most efficient and effective methods for resolving the root causes of the problems.

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## **Reasons Identified by IRS** **Officials for Errors**

While we found IRS guidance on the administration of the penalties adequate to prevent the problems we found, it is frequently not followed.<sup>4</sup> IRS district officials attributed this problem to the workload pressures of examiners, their supervisors, and other staff in the quality control functions.

District officials said that examiners may give penalties less emphasis than other aspects of the examination. They believed examiners may bypass workpaper documentation to meet workload pressures. In their view, supervisors, quality review staff, and penalty screening committee members have limited time to review cases.

Human resource concerns were also raised as an issue. IRS officials stated that turnover among examiners and inexperience among supervisors affects the overall level of expertise. In addition, in one district, IRS

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<sup>4</sup>IRS provides its employees with manuals and reference materials that give written guidance to understanding and applying the requirements related to penalties, workpaper documentation, and quality reviews. The guidance explains statutory provisions, regulations, and other rules; provides examples of situations that warrant the assessment of penalties; and explains methods of computing penalties. In addition, these sources specify that workpapers must state the examiner's reasons for assessing or not assessing penalties. These materials provided the basis for our review of cases to determine whether penalty assessments were correct or incorrect.

officials said the quality of new recruits has also declined, as a result of IRS' inability to compete with other employers in certain locations.<sup>5</sup>

IRS district officials also pointed out that penalty screening committees only review substantial understatement cases when a penalty has been assessed. The committee does not review substantial understatement cases for which there was a large tax adjustment but no penalty assessment. In addition, the penalty screening committee checks whether the substantial understatement penalty is justified but does not check the accuracy of the penalty amount. The committees review only substantial understatement penalties, not negligence penalties.

One of the reasons we do not believe the reasons cited by IRS fully explain the problems we identified is because IRS was unable to provide any documentation for them. In addition, the workload of examiners and those in the quality control functions may have been heavy, which could have led to errors and placing emphasis on other aspects of examinations. However, the workload presumably was also heavy when correct penalty decisions were reached in approximately two-thirds of the cases we reviewed. This situation also does not explain the problems we found with the supervisory and quality reviews, which, according to IRS officials, are performed by more experienced staff.

We believe that an underlying cause of the problems we found may have been the attitude of IRS staff regarding penalty administration. The persistence of errors in cases that have undergone quality control reviews and the fact that 62 percent of the penalty cases with errors in our universe had undergone at least one review indicates that correct penalty decisions should be a serious concern.

In a recently issued GAO report evaluating IRS administration of return preparer penalties, questionnaire responses from IRS staff indicated that preparer penalties were not assessed as often as they should have been because the staff believed the time and effort required were better spent on other examination issues.<sup>6</sup> Given that IRS has taken actions in the past

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<sup>5</sup>IRS problems in recruiting entry-level staff are detailed in our report entitled Tax Administration: Need for More Management Attention to IRS' College Recruitment Program (GAO/GGD-90-32, Dec. 22, 1989).

<sup>6</sup>Tax Administration: Effectiveness of IRS Return Preparer Penalty Program Is Questionable (GAO/ GGD-91-12, Jan. 7, 1991).

to emphasize the need to better administer the negligence and substantial understatement penalties and that the framework of internal controls appears to be adequate in design, the negative perception of the preparer penalties also could extend to these penalties.

Research has shown that employee involvement in solving problems related to their jobs results in more effective solutions. Accordingly, we believe that a QIP project on penalty administration may be the best way to clarify the root causes of the problems and determine the most efficient and effective solution.

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## **IRS Quality Improvement Process**

In 1986, IRS implemented a quality improvement process to enhance its emphasis on quality work, making quality concerns equal to other priorities. To achieve this goal, IRS established quality improvement projects in all major functional areas within the service. Project teams use an eight-step process to identify and resolve problems, such as the ones we found with IRS' administration of the negligence and substantial understatement penalties.<sup>7</sup> This process includes analyzing and identifying possible solutions to the root causes of problems.

Building on the problems we identified and the potential causes listed above, a quality improvement team within the Office of the Assistant Commissioner for Examination could analyze the root causes of the problems, assess their importance across various districts, identify possible solutions, select and test a solution, and track its effectiveness.

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## **Conclusions**

The potential benefits of the negligence and substantial understatement penalties to improve future taxpayer compliance were not being fully realized as a result of poor IRS penalty administration. Taxpayers frequently were not assessed all warranted penalties and, as a result, noncompliant behavior went unpunished and the standards required by the Internal Revenue Code were not reinforced. Accordingly, opportunities to educate taxpayers on their responsibilities, provide economic disincentives for noncompliance, and enhance future compliance were lost. In addition, IRS errors resulted in taxpayers being treated inconsistently. In some cases, taxpayers may have been assessed all warranted penalties, while in similar cases, penalties may not have been assessed at all, perhaps as a result of a lack of emphasis on this component of the exam.

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<sup>7</sup>The eight steps are (1) identify problems, (2) select problem, (3) analyze root causes, (4) identify solutions, (5) select solution, (6) test solution, (7) implement solution, and (8) track effectiveness.

Negligence and substantial understatement penalties are key tools provided to IRS to deal with taxpayers who understate their tax liability. These sanctions have become increasingly important as a result of declining audit coverage and a growing tax gap. However, when these penalties are poorly administered, the potential for enhanced compliance levels is not fully realized. The problems we identified are not new; similar findings were reported by IRS in 1985 and 1987.

The effectiveness of IRS' administration of these penalties has been undermined by a high error rate and ineffective internal controls. Almost one-third of the cases we reviewed contained erroneous penalty decisions. About 62 percent of these cases had undergone at least one internal control review without the error being corrected. About 64 percent of the cases in our universe that lacked proper workpaper documentation had also undergone at least one review.

IRS district officials explained that examiners, supervisors, and reviewers did not always adhere to rules governing examinations, workpaper documentation, and quality control reviews as a result of heavy workload, emphasis on other areas of examination, staff turnover and inexperience, and the limited scope of penalty screening committee reviews. All of these factors cited by IRS officials may have contributed to the problem, but we believe that an effective solution to the problem should include a change in exam personnel attitude regarding penalties.

Several factors are critical to resolving the problems we found. The first is renewed top management emphasis on these penalties at both the district and National Office levels. However, IRS' past issuance of national guidance emphasizing the importance of penalties did not eliminate the problems we observed. This experience suggests that such guidance is a necessary, but not a sufficient condition for improvement. IRS needs to go beyond guidance to ensure that examiners, quality reviewers, and others involved in administering the penalties are doing so in accordance with IRS rules and regulations.

A national QIP project within the exam function could be an effective way to clarify the root causes of the problems and identify effective solutions. Starting with the problems presented in the report, a quality improvement project can systematically examine the causes and test alternative solutions. Most importantly, because QIP teams are typically composed of staff involved with the process being studied, the solutions identified could achieve buy-in and support from those staff who actually administer the penalties.

Following implementation of changes arising from the QIP, we believe it is essential to validate the results. Accordingly, IRS should track the effectiveness of actions taken through a subsequent review of a sample of exam cases, perhaps by Internal Audit.

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## **Recommendations**

We recommend that the Commissioner of Internal Revenue do the following:

- He should establish a national QIP project in the exam function to clarify the root causes of the problems we found and identify and implement effective solutions.
- In addition, he should determine the effectiveness of the solutions through a subsequent review of selected exam cases, both with and without penalty assessments. These reviews should focus on the documentation and appropriateness of the penalty decisions so as to determine how well penalties are being administered by the district and the effectiveness of existing internal controls.

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## **Agency Comments and Our Evaluation**

While IRS generally agreed with our recommendation to clarify the root causes of the problems we found, it said that a QIP at this time would be premature. On the basis of external input, the Commissioner's Task Force on Civil Penalties, initiated in 1987, established subgroups responsible for implementing task force recommendations for improving penalty administration. These recommendations, made in a 1989 report to the Commissioner, were designed to give IRS employees guidance on the assessment and abatement of penalties through (1) a penalty policy statement; (2) a penalty handbook, (3) training, (4) staffing, and (5) penalty information systems. IRS said the implementation of the recommendations would be monitored and, if appropriate, a QIP would be considered in the future.

As we testified in September 1988, we have reservations about actions taken to improve penalty administration that are not based on an empirical evaluation of the problem and its causes. As we noted in this report, IRS has previously sought to improve penalty administration through guidance and top management memos reiterating penalty policy, but those top-down initiatives have not substantially improved the quality of penalty determinations. What these past efforts lacked was an empirical analysis of the root causes underlying penalty errors as well as the involvement of affected staff in fashioning a solution.

The need for empirical data was later reflected in the task force report, which stated: "In a sense, this study of civil penalties is only a start towards true analysis, because of the lack of empirical data."

Our report provides IRS with statistically valid data on the nature and extent of the problems we found with IRS' administration of the negligence and substantial understatement penalties. It also provides insights into the potential root causes of the problems. It does not, however, provide an empirical evaluation of the root causes, nor does it guarantee support for changes by exam employees responsible for making penalty determinations. We believe employee support is necessary to ensure that any actions taken are effective. Using only the perceptions of experts, staff intuition, and anecdotal evidence can result in "improvements" that are inefficient, poorly targeted, and a waste of valuable resources. Therefore, we recommended a QIP, which could empirically validate the root causes of the problems we found with IRS' administration of the negligence and substantial understatement penalties and achieve staff buy-in and support for recommended changes. We continue to believe that a QIP empirically evaluating the root causes of the problems we found is the best next step.

In summary, a QIP could provide information critical to ensuring that actions taken by IRS to improve its administration of the negligence and substantial understatement penalties are well designed and targeted to effectively address the problem. In addition, the QIP would provide a mechanism for monitoring the effectiveness of the changes in the future.

# Examination Reports Do Not Adequately Explain IRS' Reasons for Assessing Penalties

At the end of an exam, IRS examiners are required to inform taxpayers about the penalties being assessed and to provide the reasons why the penalties are warranted. However, we estimate that in 76 percent of the cases assessed penalties, the penalty explanations contained in IRS' examination reports provided to taxpayers did not adequately explain reasons for the penalties. As a result, taxpayers may not know why they were assessed penalties or how to avoid penalties in the future.

## Standard Penalty Explanations in Examination Reports Are Inadequate

IRS requires examiners to verbally explain to taxpayers at the conclusion of the examination what penalties are being assessed and why. Written explanations are also required when an examination report is provided to taxpayers. However, in an estimated 77 percent of the cases assessed negligence penalties and an estimated 74 percent of the cases assessed substantial understatement penalties, the examination reports did not sufficiently explain why penalties were assessed.

In the negligence penalty cases, the examination reports stated that the tax deficiency was due to negligence but did not explain why the taxpayer's actions were determined to be negligent. Explanations in the reports were generally one of several standard explanations provided in IRS' report writing handbook and various sections of the Internal Revenue Manual. An example of the negligence penalty explanations we found follows:

"Since all or part of the tax is due to negligence or intentional disregard of rules and regulations, you are liable for a penalty under section 6653(A) of the Internal Revenue Code. The penalty is 5 percent of the full underpayment of tax plus 50 percent of the interest due on the part of the underpayment attributable solely to negligence. The addition to tax under this provision is considered to be a stated amount even though the addition is dependent on the interest due on the underpayment."

This type of explanation states IRS' conclusion but does not explain how or why IRS judged the taxpayer's actions to be negligent. Negligence is defined as the failure of a taxpayer to exercise reasonable care, yet this paragraph does not contain an explanation as to why the taxpayer's actions were judged so.

We believe it is important for IRS' explanations to contain reasons for negligence determinations because the negligence penalty is based on taxpayers' behavior. Taxpayers need to know what behavior is expected of them in order for them to understand and comply with the rules and avoid penalties in the future. For example, if the negligence

penalty was assessed because the taxpayer did not have adequate records to substantiate expenses deducted on the return, the explanation should state the facts and circumstances that caused IRS to determine that the failure to maintain adequate books and records was due to negligence. If the taxpayer explained why he did not have records, we believe IRS' explanation should state why it did not consider the taxpayer's explanation to be reasonable cause for maintaining inadequate records.

In the substantial understatement penalty cases, penalty explanations in examination reports were also insufficient. In these cases, the representative explanation read as follows:

"Since there is a substantial understatement of income tax, you are liable for a penalty of 25 percent under section 6661 of the Internal Revenue Code. In addition, interest is figured on the penalty from the due date of the return (including extensions). See Code section 6601(E)(2)."

This explanation is not sufficient because it does not explain the criteria for assessing the penalty; that is, because the understatement exceeded the greater of \$5,000 or 10 percent of the corrected tax. It also does not explain to taxpayers that the penalty can be avoided by adequately disclosing on the return the relevant facts affecting the tax treatment of certain items or by ensuring that positions are supported by substantial authority.

To improve negligence penalty explanations, examiners need to add an additional sentence or two to the standard paragraph describing the particular reasons why the taxpayer acted negligently. The substantial understatement penalty explanation could be improved by modifying the standard paragraph currently in use to better explain the penalty's criteria and how it can be avoided.

According to IRS guidance, no written explanation is needed if the taxpayer agrees with IRS' examination findings. Verbal explanations are sufficient to close the case. However, if the taxpayer seeks to appeal the examiner's findings, exam officials agree that written reports should contain the reasoning and criteria upon which the penalty is based. We believe a more comprehensive written explanation should be provided in all cases regardless of whether the taxpayer agrees with IRS' findings. This information is important if taxpayers are to understand their misconduct and can serve as a good future reference on how to avoid penalties.



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## **Conclusions**

Penalty explanations contained in examination reports do not provide taxpayers with information needed to understand why their actions justified the assessment of penalties. Standard paragraphs were too general to effectively relate the negligence penalty to the circumstances of specific cases. Substantial understatement penalty explanations omitted important information about the penalty's criteria and the adequate disclosure and substantial authority provisions. As a result, taxpayers may not understand why they received penalties and how to avoid penalties in the future.

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## **Recommendations**

We recommend that the Commissioner of Internal Revenue take actions to ensure that the negligence and substantial understatement penalty explanations in IRS' examination reports provide taxpayers with the specific facts, circumstances, and criteria that warrant the assessment of the penalty. Standard paragraphs should be augmented with written comments that relate the specific conduct and circumstances of taxpayers to the assessment of the penalty. The substantial understatement penalty standard paragraph should be expanded to include information on the penalty's criteria and the substantial authority and adequate disclosure provisions.

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## **Agency Comments and Our Evaluation**

IRS agreed to revise the penalty explanations provided to taxpayers so that the examination reports will provide the specific facts, circumstances, and criteria that warranted the assessment of the penalty.

# Methodology for Selecting Negligence, Substantial Understatement, and No-Penalty Sample Cases

This appendix describes how we identified the negligence, substantial understatement, and no-penalty case universes resulting from district office taxpayer examinations. It also contains the sampling errors for the estimates used in the report.

Using IRS master file computer tapes covering fiscal year 1987, we identified the number of taxpayers who received negligence penalties or substantial understatement penalties and who received tax increases of at least \$5,000 without receiving penalties. Although we were only interested in cases resulting from district office examinations, these figures included all taxpayers assessed and all taxpayers not assessed penalties. To arrive at an estimated universe, we used account information to delete cases that were not district examinations. Rather than analyze account information on every case in the original negligence and substantial understatement universes, we analyzed a sample and then estimated the size of the universe of cases arising from exams in each district. However, the estimated universe of cases not assessed penalties was derived from an analysis of each case in the original universe. We then drew a stratified random sample of 25 cases from each of the 3 estimated universes in each of the districts, except in Jacksonville and Los Angeles, where the substantial understatement penalty samples were 19 and 22, respectively, because of the deletions described above.

Table I.1 lists the original universes, the samples used to estimate the modified universes, the estimated modified universes, and the sampling error<sup>1</sup> at the 95-percent confidence level.<sup>2</sup>

**Table I.1: Universes, Samples, and Related Confidence Measures Used in the Study**

Category	Original universe	Sample	Percent not deleted	Estimated universe	95%-confidence level estimated range	
					Lower limit	Upper limit
Brooklyn negligence	45,208	500	5.6	2,532	1,626	3,438
Jacksonville negligence	44,103	600	5.667	2,499	1,689	3,309
Los Angeles negligence	40,915	550	7.636	3,124	2,222	4,026
Brooklyn substantial understatement	679	238	13.866	94	70	118
Jacksonville substantial understatement	1,241	167	27.545	342	264	420
Los Angeles substantial understatement	1,193	400	7.5	89	64	114

<sup>1</sup>Sampling error is a measure of the precision with which an estimate from a sample approximates the results of a complete census.

<sup>2</sup>The confidence level, expressed as a percentage, is the probability that the estimate obtained from the sample is within the error limits of the actual universe characteristic being estimated.

The actual universe of cases with tax increases of at least \$5,000 without negligence and substantial understatement penalty assessments resulting from district office examinations were Brooklyn-580; Jacksonville-1,123; and Los Angeles-2,288.

## Sampling Errors for Estimates Used in the Report

Table I.2 shows the sampling errors at the 95-percent confidence level for the estimates used in the report.

**Table I.2: Sampling Errors for Estimates Used in the Report**

Description of universe estimate	Weighted universe (in percent)	95%-confidence level estimated range	
		Lower limit	Upper limit
Percent of cases with errors			
No-penalty cases	33.3	21.7	44.9
Negligence penalty cases	33.2	22.6	43.8
Substantial understatement cases	30.5	18.0	43.0
All cases	33.1	25.1	41.1
Percent of cases with errors having unassessed or underassessed penalties			
No-penalty cases	100.0	00.0	00.0
Negligence penalty cases	80.6	42.6	97.2
Substantial understatement cases	65.3	28.1	89.9
All cases	85.2	74.2	96.2
Percent of negligence, substantial understatement, and no-penalty cases with errors in each of the three districts (Percents were not weighted because the districts and stratum were not combined.)			
<b>Negligence error rate</b>			
Brooklyn	32.0	16.2	51.3
Jacksonville	36.0	19.4	55.3
Los Angeles	32.0	16.2	51.3
<b>Substantial understatement error rate</b>			
Brooklyn	36.0	21.2	53.2
Jacksonville	27.3	12.0	47.7
Los Angeles	36.8	19.1	57.8

(continued)

**Appendix I  
Methodology for Selecting Negligence,  
Substantial Understatement, and No-Penalty  
Sample Cases**

Description of universe estimate	Weighted universe (in percent)	95%-confidence level estimated range	
		Lower limit	Upper limit
<b>No-penalty error rate</b>			
Brooklyn	64.0	45.1	80.3
Jacksonville	20.0	7.5	38.7
Los Angeles	32.0	16.2	51.3
Percent of cases with errors in each of the three districts			
Brooklyn	36.6	21.2	52.0
Jacksonville	31.5	18.1	44.9
Los Angeles	32.1	19.0	45.2
Percent of cases with errors if stacking errors are eliminated	26.5	19.1	33.9
Percent of no-penalty cases in which the reasons for not assessing penalties were not documented	34.9	23.1	46.7
Percent of cases with errors having unwarranted penalty assessments and penalty overassessments	14.8	3.8	25.8
Percent of cases with improper workpaper documentation	17.8	12.0	23.6
Percent of cases with incorrect assessments, whose warranted penalties were not assessed, in which taxpayers did not appear for the audit or could not substantiate items deducted on their returns	74.2	49.8	98.6
Percent of cases that were reviewed by either the supervisor of the quality review program or penalty screening committee	54.4	45.9	62.9
Percent of cases with incorrect penalty decisions that had received at least one review	62.1	48.6	75.6
Percent of cases with inadequate workpaper documentation that received at least one review	64.0	43.5	84.5
Percent of cases in which penalty explanations did not adequately explain reasons for the penalties			
Negligence cases	76.6	67.6	85.6
Substantial understatement cases	74.0	61.1	86.9
All cases	76.4	67.9	84.9
Percent of cases correctly assessed penalties in which taxpayers did not appear for audit or could not substantiate items deducted on their returns	52.8	39.9	65.7

# Comments From the Internal Revenue Service



COMMISSIONER

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

APR 26 1991

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 Administration: Negligence and Substantial Understatement Penalties Poorly Administered".

We agree with the report recommendations to look into the root causes of problems associated with the administration of the negligence and substantial understatement penalties. In 1989, we established a Task Force on Civil Penalties which has recommended a number of improvements that coincide with GAO's recommended actions. Many of these recommendations are being incorporated into the Multi-functional Civil Penalty Handbook which is presently being drafted. We will monitor implementation of these recommendations with particular emphasis on the administration of the negligence and substantial understatement penalties. If our review indicates that these actions are not adequate, we will consider other actions that should be taken. In addition, we agree with the recommendation to revise explanations of these penalties in examination reports.

Our detailed comments on the specific report recommendations are enclosed.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Enclosure

See pp. 27-28 and 31.

IRS COMMENTS ON RECOMMENDATIONS  
CONTAINED IN GAO DRAFT REPORT ENTITLED  
"TAX ADMINISTRATION: NEGLIGENCE AND SUBSTANTIAL  
PENALTIES POORLY ADMINISTERED"

See p. 27.

Recommendation: We recommend that the Commissioner of Internal Revenue establish a national QIP project in the exam function to clarify the root causes of the problems we found and identify and implement effective solutions.

Determine the effectiveness of the solutions through a subsequent review of selected exam cases, with and without penalty assessments. These reviews should focus on the documentation and appropriateness of the penalty decisions, to determine how well penalties are being administered by the district and the effectiveness of existing internal controls.

Comment:

We agree with the need for improvement in the administration of civil penalties.

The Commissioner of the Internal Revenue Service established a task force in November 1987 to study penalties which included the negligence and substantial understatement penalties. That task force recommended statutory changes as well as changes in the way we administer penalties.

The task force recommended a number of improvements in the way that IRS educates its employees and gives them guidance on the assertion and abatement of penalties in the following manner: (1) policy statement; (2) penalty handbook; (3) training; (4) staffing; and (5) penalty information systems. Following enactment of penalty reform legislation in late 1989, an executive steering committee was established to oversee implementation of these changes.

The agency will monitor the implementation of the recommendations on the negligence and substantial understatement penalties. We will also consider additional actions including a quality improvement initiative if appropriate.

See p. 31.

Recommendation: We recommend that the Commissioner of Internal Revenue take actions to assure the negligence and substantial understatement penalty explanations in IRS' examination reports provide taxpayers with the specific facts, circumstances, and criteria that warrant the assessment of the penalty. Standard paragraphs should be augmented with written comments that relate the specific conduct of taxpayers and their circumstances to the assessment of the penalty. The substantial understatement penalty standard paragraph should be expanded to include information on the penalty's criteria and the substantial authority and adequate disclosure provisions.

Comment:

We will revise the negligence and substantial understatement penalty explanations in IRS' examination reports to taxpayers so the reports will provide taxpayers with the specific facts, circumstances, and criteria that warranted the assessment of the penalty.

We should also note that the Chief Counsel Appeals office also uses standard paragraphs on notices of deficiency that it issues. Appeals language on the negligence penalty is slightly more detailed but similar to the language cited by GAO in the report. Appeals paragraphs on the substantial understatement penalty already cover all of the recommendations that are made by GAO, i.e. explain the criteria for the penalty, and state that neither substantial authority or adequate disclosure are present.

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