

August 2007

TAX COMPLIANCE

Inflation Has Significantly Decreased the Real Value of Some Penalties





Highlights of [GAO-07-1062](#), a report to the Committee on Finance, U.S. Senate

TAX COMPLIANCE

Inflation Has Significantly Decreased the Real Value of Some Penalties

Why GAO Did This Study

Civil tax penalties are an important tool to encourage taxpayer compliance with the tax laws. A number of civil tax penalties have fixed dollar amounts—a specific dollar amount, a minimum or maximum amount—that are not indexed for inflation. Because of your concerns that civil penalties are not effectively achieving their purposes, we agreed to (1) determine the potential effect of adjusting civil tax penalties for inflation on the Internal Revenue Service’s (IRS) assessment and collection amounts and (2) describe the likely administrative impact of regularly adjusting civil tax penalties on IRS and tax practitioners. GAO examined IRS data on civil tax penalties and conducted interviews with IRS employees and tax practitioners.

What GAO Recommends

Congress should consider requiring IRS to periodically adjust for inflation, and round appropriately, the fixed dollar amounts of civil tax penalties to account for the decrease in real value over time and so that penalties for the same infraction are consistent over time. IRS provided technical comments on a draft of this report that have been incorporated where appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-07-1062.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Adjusting civil tax penalties for inflation on a regular basis to maintain their real values over time may increase IRS collections by tens of millions of dollars per year. Further, the decline in real value of the fixed dollar amounts of civil tax penalties may weaken the deterrent effect of these penalties and may result in the inconsistent treatment of taxpayers over time. If civil tax penalty fixed dollar amounts were adjusted for inflation, the estimated increase in IRS collections would have ranged from \$38 million to \$61 million per year from 2000 to 2005. Almost all of the estimated increase in collections was generated by four penalties. These increases result because some of the penalties were set decades ago and have decreased significantly in real value—by over one-half for some penalties.

Estimated Increase in IRS Assessments and Collections from Inflation Adjusting of Penalties Assessed, 2000 – 2005

Dollars in millions

Assessment year	Penalty adjusted assessment increase	Penalty adjusted collections increase
2000	\$100.4	\$38.2
2001	254.9	42.1
2002	165.3	47.9
2003	267.1	53.2
2004	320.9	61.0
2005	280.5	60.3

Source: GAO analysis of IRS data.

According to those we interviewed, the likely administrative burden associated with adjusting the fixed dollar amounts of civil tax penalties for inflation on a regular basis would not be significant for IRS and would be low for tax practitioners. However, officials from the Office of Penalties, a relatively small office that would be responsible for coordinating the required changes among multiple IRS divisions, said that such adjustments might be considerable depending on the number of penalties being adjusted and would require a reprioritization of work. IRS officials said that the work required would be easier to implement with each subsequent update.

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Abbreviations

CPI-U	Consumer Price Index-Urban
ERIS	Enforcement Revenue Information System
GDP	Gross Domestic Product
IRC	Internal Revenue Code
IRS	Internal Revenue Service
SB/SE	Small-Business/Self-Employed division
W&I	Wage and Investment division

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United States Government Accountability Office
Washington, DC 20548

August 23, 2007

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

Civil tax penalties are an important tool to encourage taxpayer compliance with the tax laws.¹ The Internal Revenue Code (IRC) has over 150 civil penalties that potentially deter taxpayer noncompliance. For some of the penalties, the amount of the penalty is determined as a percentage of tax liability. For others, the amount of the penalty is a specific dollar amount. Still other penalties have minimum or maximum amounts that are specified in dollars. These specific dollar amounts are not indexed for inflation and decline in real value over time because of inflation, which may weaken their deterrent effect. Because of your concerns that civil tax penalties are not effectively achieving their purposes, we agreed to (1) determine the potential effect of adjusting civil tax penalties for inflation on assessment and collection amounts and (2) describe the likely administrative impact on the Internal Revenue Service (IRS) and tax practitioners of regularly adjusting civil tax penalties.

To determine the potential effect of adjusting civil tax penalties for inflation on assessment and collection amounts, we analyzed IRS civil tax penalty assessment and collection data using the Consumer Price Index-Urban as a basis for inflation adjustments. To gather information on the likely administrative impact on IRS officials and tax practitioners of regularly adjusting civil tax penalties, we interviewed officials across IRS and a limited number of tax practitioners affiliated with relevant professional organizations. Our interviews with tax practitioners cannot be used to make inferences about the effect of regular penalty adjustments on the work of all practitioners and those we interviewed were giving personal opinions, not the views of the professional associations of which they are members. We determined that the civil tax penalty assessment

¹For the purposes of this report, civil penalties are defined as any penalties that are not criminal in nature.

and collection data are sufficiently reliable for our purposes. We conducted our work from September 2006 through July 2007 in accordance with generally accepted government auditing standards. For a more detailed description of our scope and methodology, as well as limitations of the penalty data, see appendix I.

Results in Brief

Adjusting civil tax penalties for inflation on a regular basis to maintain their real values over time may increase IRS assessments and collections by tens of millions of dollars per year. Further, the decline in real value of the fixed dollar amounts of civil tax penalties may weaken the deterrent effect of these penalties and may result in the inconsistent treatment of taxpayers over time. Based on our analysis, if the fixed dollar amounts of civil tax penalties had been adjusted for inflation, the potential increase in IRS collections would have ranged from an estimated \$38 million to \$61 million per year from 2000 to 2005. Almost all of the estimated increase in collections was generated by the following four penalties: (1) failure to file tax returns, (2) failure to file correct information returns, (3) various penalties on returns by exempt organizations and by certain trusts, and (4) failure to file partnership returns. For example, our analysis showed that these four penalties would account for 99 percent of the estimated \$61 million in additional IRS collections for assessments made in calendar year 2004. These estimated increases result because some of the penalties were set decades ago and have decreased significantly in real value—by over one-half for some penalties.

According to IRS officials and tax practitioners we spoke with, the likely administrative burden associated with adjusting the fixed dollar amounts of civil tax penalties for inflation on a regular basis would not be large for all but one affected unit within IRS and would be low for tax practitioners. Officials from IRS's relatively small Office of Penalties, which has responsibility for coordinating the changes among multiple IRS divisions, said that such adjustments might be considerable depending on the number of penalties being adjusted and would require a reprioritization of their work. IRS officials from all other affected units, who are responsible for implementing other periodic updates to IRS databases and documents, said that the changes required by regular updates to the fixed dollar amounts of civil penalties would not be significant and some added that changes would be most burdensome initially and easier to carry out with each subsequent update. The limited number of tax practitioners that we spoke with also expected the impact on their work from inflation adjustments to be relatively low.

We believe that Congress should consider requiring IRS to periodically adjust for inflation, and round appropriately, the fixed dollar amounts of civil tax penalties to account for the decrease in real value over time and so that penalties are consistent over time.

We provided a draft of this report to the Acting Commissioner of Internal Revenue. IRS provided technical comments, which have been incorporated where appropriate.

Background

Although Congress has not established mechanisms for regularly adjusting for inflation the fixed dollar amounts of civil tax penalties administered by IRS, it has done so for penalties administered by other agencies. When the Federal Civil Penalties Inflation Adjustment Act of 1990 (Inflation Adjustment Act)² was enacted, Congress noted that inflation had weakened the deterrent effect of many civil penalties. The stated purpose of the 1990 act was “to establish a mechanism that shall (1) allow for regular adjustment for inflation of civil monetary penalties; (2) maintain the deterrent effect of civil monetary penalties and promote compliance with the law; and (3) improve the collection by the Federal Government of civil monetary penalties.” Congress amended the Inflation Adjustment Act in 1996³ and required some agencies to examine their covered penalties at least once every 4 years thereafter and, where possible, make penalty adjustments.⁴ The Inflation Adjustment Act exempted penalties under the IRC of 1986,⁵ the Tariff Act of 1930, the Occupational Safety and Health Act of 1970, and the Social Security Act.

As stated earlier, some civil tax penalties are based on a percentage of liability and therefore are implicitly adjusted for inflation. For example, the penalty for failure to pay tax obligations is 0.5 percent of the tax owed

²Pub. L. No. 101-410 (1990).

³Pub. L. No. 104-134 (1996).

⁴GAO has suggested that Congress consider amending the Inflation Adjustment Act because several provisions of the act prevented some agencies from fully adjusting their penalties for inflation. One of GAO’s suggestions was to permit agencies with exempt penalties to adjust them for inflation. See GAO, *Civil Penalties: Agencies Unable to Fully Adjust Penalties for Inflation Under Current Law*, [GAO-03-409](#) (Washington, D.C.: Mar. 14, 2003).

⁵There is no explanation in the legislative history of the Inflation Adjustment Act for the exclusion of the civil tax penalties.

per month, not exceeding 25 percent of the total tax obligations. However, other civil penalties have fixed dollar amounts, such as minimums or maximums, which are not linked to a percentage of liability. For example, a minimum penalty of \$100 exists for a taxpayer who fails to file a tax return.⁶

Adjusting Civil Tax Penalties for Inflation May Increase IRS Assessments and Collections

Adjusting civil tax penalties for inflation on a regular basis to maintain their real values over time may increase IRS assessments and collections. Based on our analysis,⁷ if the fixed dollar amounts of civil tax penalties had been adjusted for inflation, the increase in IRS assessments potentially would have ranged from an estimated \$100 million to \$320 million and the increase in collections would have ranged from an estimated \$38 million to \$61 million per year from 2000 to 2005, as shown in table 1.⁸

Table 1: Estimated Increase in IRS Assessments and Collections from Inflation Adjusting of Penalties Assessed, 2000–2005

Dollars in millions		
Assessment year	Penalty adjusted assessment increase	Penalty adjusted collections increase
2000	\$100.4	\$38.2
2001	254.9	42.1
2002	165.3	47.9
2003	267.1	53.2
2004	320.9	61.0
2005	280.5	60.3

Source: GAO analysis of IRS data.

Note: Fluctuations in the assessment amounts are largely due to variations with the failure to file partnership returns penalty, for which assessments fluctuate by several hundred million dollars per year. However, collections do not fluctuate in a similar way because only a small portion of the assessed amounts for this penalty are collected.

The majority of the estimated increase in collections from adjusting these penalties for inflation was generated from the following four types of

⁶The penalty for failing to file a tax return is 0.5 percent of the amount owed per month, for up to 5 months, but not more than 25 percent of the amount owed, with a \$100 minimum.

⁷For the limitations of our analysis and the data set, see app. I.

⁸Some periods over which the analysis was conducted were periods of relatively low inflation. If inflation rates had been higher, the real value of fixed penalties would have decreased at a greater rate and we would expect the impact on collections to be greater.

penalties: (1) failure to file tax returns, (2) failure to file correct information returns, (3) various penalties on returns by exempt organizations and by certain trusts, and (4) failure to file partnership returns. The estimated increases in collections associated with these penalties for 2004 are shown in table 2. We highlight 2004 data because, according to IRS officials, approximately 85 percent of penalties are collected in the 3 years following the assessment. The same four penalty types account for the majority of the estimated increase in collections for the prior years. Our analysis showed that these four penalties would account for approximately 99 percent of the estimated \$61 million in additional IRS collections for assessments made in calendar year 2004.

Table 2: 2004 Estimated Increase in IRS Collections from Inflation Adjusting of Four Penalties

Dollars in millions

Penalty	2004 increase in collections	Effective year of latest penalty adjustment
Failure to file tax returns (IRC 6651)	\$37.9	1982
Failure to file correct information returns (IRC 6721)	18.3	1989
Various penalties on returns by exempt organizations and by certain trusts (IRC 6652(c))	3.1	1996
Failure to file partnership returns (IRC 6698)	0.9	1979
Total	\$60.2	

Source: GAO analysis of IRS data.

Because penalty amounts have not been adjusted for decades in some cases, the real value of the fixed dollar amounts of these penalties has decreased. For example, the penalty for failing to file a partnership return was set at \$50 per month in 1979, which is equivalent to about \$18 today, or a nearly two-thirds decline in value, as shown in table 3. If the deterrent effect of penalties depends on the real value of the penalty, the deterrent effect of these penalties has eroded because of inflation. In addition, not adjusting these penalties for inflation may lead to inconsistent treatment of otherwise equal taxpayers over time because taxpayers penalized when the amounts were set could effectively pay a higher penalty than taxpayers with the same noncompliance pay years later. Finally, if the real value of penalties declines, but IRS's costs to administer them do not, imposing

penalties becomes less cost-effective for IRS and could lead to a decline in their use.⁹

Table 3: 2007 Inflation-Adjusted Values of Four Civil Tax Penalties with Fixed Dollar Amounts, by Increase in Collection Amount

Penalty	Penalty amount not adjusted for inflation ^a	Equivalent dollar amount of current penalty, in year of latest adjustment (rounded)	2007 penalty amount if adjusted for inflation (rounded)	Effective year of latest penalty adjustment
Failure to file tax returns (IRC 6651)	\$100 minimum	\$47 minimum	\$214 minimum	1982
Failure to file correct information returns (IRC 6721)	\$15, \$30, or \$50/return	\$9, \$18, or \$30/return	\$25, \$50, or \$83/return	1989
Various penalties on returns by exempt organizations and by certain trusts (IRC 6652(c))	\$20 or \$100/day	\$15 or \$76/day	\$26 or \$131/day	1996
Failure to file partnership returns (IRC 6698)	\$50/partner per month	\$18/partner per month	\$145/partner per month	1979

Source: GAO analysis.

^aThe information return penalty amounts vary depending on how late the taxpayer files the return. If the information return is filed 30 days late, the penalty is \$15 per return, rising to \$30 per return if filed 60 days late, and finally to \$50 per return if filed after August 1. In the case of the penalties on returns by exempt organizations and by certain trusts, the penalty is \$20 per day for organizations with gross receipts under \$1,000,000, and increases to \$100 per day for organizations with gross receipts over \$1,000,000.

In the past, Congress has established fixed penalty amounts, increased fixed penalty amounts, or both in order to deter taxpayer noncompliance with the tax laws. For example, the \$100 minimum for failure to file a tax return was created in 1982 because many persons who owed small amounts of tax ignored their filing obligations. In addition, Congress increased penalties for failure to file information returns in 1989 because it believed that inadequate information reporting of nonwage income was a substantial factor in the underreporting of such income by taxpayers.¹⁰ As recently as 2006, IRS's National Research Program confirmed Congress's

⁹We will be reviewing this and other issues related to civil tax penalties as we continue our work for the Senate Committee on Finance.

¹⁰In 1989, as part of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239), IRC 6721 was substantially changed and the values reaffirmed. Thus, we consider 1989 the year of last penalty adjustment for the failure to file information returns penalties.

belief that compliance is highest where there is third-party reporting.¹¹ Congress has also recently adjusted some civil penalties that have fixed dollar amounts. For example, the minimum penalty for a bad check was raised from \$15 to \$25 in May 2007, and the penalty for filing a frivolous return was raised from \$500 to \$5,000 in December 2006.

Administrative Impact of Implementing Inflation Adjustment to Civil Penalties Is Expected to Be Low

We spoke with officials from offices across IRS whose workloads would be affected if regular adjustments of penalties occurred. IRS officials from all but one unit said that regularly updating the fixed dollar amounts of civil tax penalties would not be a significant burden. Officials from one relatively small office—the Office of Penalties—said that such adjustments might be considerable depending on the number of penalties being adjusted and would require a reprioritization of their work since their office would have lead responsibility for monitoring the administrative steps necessary to implement the adjustments and coordinating tasks among a wide range of functions within IRS. In addition, the limited number of tax practitioners we interviewed told us that the administrative burden associated with adjusting these penalties for inflation on a regular basis would be low.

Administrative Impact on IRS Expected to Be Relatively Low

Officials from all but one unit we spoke to within IRS said that regularly adjusting civil tax penalties for inflation would not be burdensome. Some officials added that adequate lead time and minimally complex changes would reduce the administrative impact. For example, officials from the Office of Forms and Publications and the Office of Chief Counsel said that adjustments to civil penalty amounts would not affect their work significantly. While each office would have to address the penalty changes in documents for which they are responsible, in some cases these documents are updated regularly already. Similarly, officials responsible for programming IRS's computer systems explained that these changes would not require out of the ordinary effort, unless they had little lead time in which to implement the changes.

However, officials from the Office of Penalties within the Small Business/Self-Employed division (SB/SE)—the unit which would be

¹¹GAO has reported that providing IRS with more enforcement tools, particularly withholding and information reporting, has the potential to reduce the tax gap by billions of dollars. See GAO, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, [GAO-06-1000T](#) (Washington, D.C.: July 26, 2006).

responsible for coordinating IRS's implementation of any adjustments to penalties among a wide range of functions within IRS—felt that the administrative burden associated with these changes might be considerable depending on the number of penalties being adjusted. The Office of Penalties, which currently consists of 1 manager and 10 analysts, provides policies, guidelines, training, and oversight for penalty issues IRS-wide, not just within SB/SE. When legislation affecting penalties is enacted, the Office of Penalties creates an implementation team that helps determine what IRS needs to do to implement the new legislation. In the case of adjusting penalties for inflation, the Office of Penalties would work with numerous other IRS units to coordinate the necessary changes to forms, training materials, computer systems, and guidance, among other things. Regularly changing four penalties would take less effort than regularly changing all penalties. In addition, the ability of the office to make these changes would require reprioritization of its work or receiving more resources. While the Office of Penalties has not done a formal analysis of the resources needed, an official stated that the additional work would not require a significant increase in staffing, such as a doubling of the size of the office. As a result, the amount of additional resources necessary for the penalty adjustment do not appear to be of sufficient scale to have a large impact on IRS overall.

Further, officials we interviewed from other IRS units who would perform the work described by the Office of Penalties said that the administrative burden would not be significant for them. Some IRS officials who oversee the implementation of other periodic updates to IRS databases and documents said that the legislative changes requiring regular updates are most burdensome initially but become less of an issue in each subsequent year. Some officials also said that with enough advance notice, they would be able to integrate the necessary changes into routine updates. For example, program changes could be integrated into the annual updates that some Modernization and Information Technology Service programs receive. Other areas in IRS, such as the Office of Forms and Publications, already conduct annual and in some cases quarterly updates of their forms, and according to officials, a change to the tax penalty amount could easily be included in these regularly scheduled updates.

IRS has a variety of experiences that may provide guidance that would be relevant to adjusting civil tax penalties with fixed dollar amounts for inflation. IRS has extensive procedures for implementing statutory changes to the tax code. Further, IRS has experience implementing inflation adjustment calculations. For example, tax brackets, standard deduction amounts, and the itemized deduction limit are among the

inflation adjustments conducted annually by IRS. In addition, the administrative changes associated with regular updates to the interest rate have some similarities to the types of changes that an inflation adjustment may require. For example, the Office of Chief Counsel issues quarterly guidance on interest rates and the Communications & Liaison Office provides regular updates on interest changes to the tax professional community, including practitioner associations. Changes to the civil tax penalty fixed dollar amounts could be handled in a similar manner.

**Tax Practitioners
Expected Administrative
Impact to Be Relatively
Low**

The limited number of tax practitioners that we spoke with also expected the impact on their work from adjustments to the fixed dollar amounts of civil tax penalties for inflation to be relatively low. For example, one tax practitioner said that he expected to spend more time explaining different penalty amounts to clients, particularly in situations where taxpayers who receive the same penalty in different tax years may not understand why different penalty amounts were applied. In addition, three other practitioners we spoke with said that the changes may lead to an increased reliance on software programs that tax preparers often use to assist them with determining penalty amounts since making the calculations involving inflation adjustments could become more onerous for the tax practitioners to do without software.

**Concluding
Observations**

The real value and potential deterrent effect of civil tax penalties with fixed dollar amounts has decreased because of inflation. Periodic adjustments to the fixed dollar amounts of civil tax penalties to account for inflation, rounded appropriately, may increase the value of collections by IRS, would keep penalty amounts at the level Congress initially believed was appropriate to deter noncompliance, and would serve to maintain consistent treatment of taxpayers over time. Regularly adjusting the fixed dollar amounts of civil tax penalties for inflation likely would not put a significant burden on IRS or tax practitioners.

**Matter for
Congressional
Consideration**

Congress should consider requiring IRS to periodically adjust for inflation, and round appropriately, the fixed dollar amounts of the civil penalties to account for the decrease in real value over time and so that penalties for the same infraction are consistent over time.

Agency Comments

On July 30, 2007, we sent a draft of this report to IRS for its comment. We received technical comments that have been incorporated where appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send copies of this report to appropriate congressional committees and the Acting Commissioner of Internal Revenue. We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions concerning this report, please contact me at (202) 512-9110 or at brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

To determine the potential effect that adjusting civil tax penalties for inflation would have on the dollar value of penalty assessments and collections, we used the Consumer Price Index-Urban (CPI-U) to adjust actual penalty assessment and collection information contained in the Enforcement Revenue Information System (ERIS), which was created to track Internal Revenue Service (IRS) enforcement revenues.

We provided inflation-adjusted estimates for penalties that had been assessed for at least \$1 million in any one year from 2000 to 2005 and had either a fixed minimum or set amount. This excluded less than two one-hundredths of a percentage of all assessments each year. In addition, we assumed that assessment rates and collection rates would stay the same regardless of penalty amount. This assumption may bias our estimates upwards because higher penalties may encourage taxpayers to comply with tax laws and, therefore, IRS would not assess as many penalties. However, improved compliance could also increase revenues. For collections, we assumed that a particular collection would increase the inflation-adjusted penalty amount only if the unadjusted penalty assessment had been paid in full. For example, if a taxpayer paid \$50 of a \$100 penalty assessment, we assumed that the \$50 collected was all that would have been collected even with a higher assessment, and therefore did not adjust the collection amount. We made this assumption in order to avoid overstating the effect that adjusting penalties for inflation would have on collections because the data did not tell us why a penalty was partially collected. To the extent that taxpayers who paid the unadjusted penalty amount in full would not pay the adjusted penalty amount in full, our estimates would overstate additional collections. One reason for a partial collection is that it is all the taxpayer can afford.

We did not include penalties that are percentage based but have a fixed maximum in our inflation adjustments. Two penalty categories in the ERIS data set that we received have fixed maximums and had total assessments of over \$1 million for at least 1 year from 2000 to 2005. In both cases, we could not determine how much a penalty assessment for the current maximum would have risen if the maximum had been higher. However, we estimated an upper bound for the potential increase in collections due to adjusting the maximums for inflation by assuming that penalties assessed at the current maximum would have increased by the full rate of inflation. As a result, we concluded that at most, collections would have risen by approximately \$196,000 over the years 2000 to 2005 if these maximums had been adjusted for inflation. We also did not include penalties that are based solely on a percentage of tax liability in our analysis because they are implicitly adjusted for inflation.

The data contained in the ERIS database were reliable for our purposes, but some limitations exist. To assess the reliability of the data, we reviewed relevant documentation, interviewed relevant IRS officials, and performed electronic data testing. One limitation of the ERIS data is that it does not include penalties that are self-assessed and paid at the time of filing. IRS officials estimated that this is about 6 to 7 percent of all penalty assessments, but that a large majority of these are percentage based with no fixed dollar amount. For example, many people self-assess and pay the penalty for withdrawing money from their Individual Retirement Accounts early. Further, IRS officials acknowledged that some penalties were incorrectly categorized in the database making it impossible for us to determine which penalties were being assessed. We determined that 0.4 percent to 1.4 percent of assessments per year from 2000 to 2005 were incorrectly categorized. For example, in 2000, over \$144 million in assessments and over \$28 million in collections were incorrectly categorized. In 2005, over \$343 million in assessments and over \$86 million in collections were incorrectly categorized. These two limitations may bias our estimates downwards.

The federal government produces several broad measures of price changes, including the CPI-U and the Gross Domestic Product (GDP) price deflator. The CPI-U measures the average change over time in the prices paid by consumers for a fixed market basket of consumer goods and services. The GDP price deflator measures changes over time in the prices of broader expenditure categories than the CPI-U. We used the CPI-U for the purposes of this analysis because it is used currently in the tax code to make inflation adjustments to several provisions, such as the tax rate schedule, the amount of the standard deduction, and the value of exemptions.¹

To determine the likely effect that regularly adjusting penalties for inflation would have on the administrative burden of IRS officials, we interviewed officials in offices across IRS who would be affected if regular adjustments of penalties occurred. These offices are the

- Office of Penalties within the Small Business/Self Employed division (SB/SE);

¹Historically, inflation as measured by the CPI-U has tended to outpace inflation as measured by the GDP price deflator. As a result, if the GDP deflator had been used instead in this analysis, the estimated revenue effect of indexing fixed penalties would likely have been somewhat smaller.

- Learning and Education within SB/SE;
- Wage and Investment division (W&I);
- Tax Exempt/Government Entity division;
- Large and Mid-Size Business division;
- Research, Analysis and Statistics division;
- Legislative Analysis Tracking and Implementation Services;
- Office of Chief Counsel;
- Business Forms and Publications within W&I;
- Enforcement Revenue Data;
- Communications and Liaison; and
- Modernization and Information Technology Services, including officials who work on the Business Master File, the Financial Management Information System, the Automated Trust Fund Recovery system, Report Generation Software, Automated Offers in Compromise, Penalty and Interest Notice Explanation, Integrated Data Retrieval System, and the Payer Master File Processing System.

To determine the likely effect that regularly adjusting penalties for inflation would have on the administrative burden of tax practitioners, we interviewed tax practitioners affiliated with the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Society of Tax Professionals, and the American Bar Association. In total, we spoke with 28 practitioners. Results from the nongeneralizable sample of practitioners we selected cannot be used to make inferences about the effect of regular adjustments of penalties on the work of all tax practitioners. Additionally, those we spoke with presented their personal views, not those of the professional associations through which they were contacted.

We conducted our work from September 2006 through July 2007 in accordance with generally accepted government auditing standards.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9039 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Jonda Van Pelt, Assistant Director; Benjamin Crawford; Evan Gilman; Edward Nannenhorn; Jasmine Persaud; Cheryl Peterson; and Ethan Wozniak made key contributions to this report.

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