
June 2009

TAX ADMINISTRATION

IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts



GAO

Accountability * Integrity * Reliability



Highlights of [GAO-09-567](#), a report to the Committee on Finance, U.S. Senate

TAX ADMINISTRATION

IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts

Why GAO Did This Study

Civil tax penalties are an important tool for encouraging compliance with tax laws. It is important that the Internal Revenue Service (IRS) administers penalties properly and determines the effectiveness of penalties in encouraging compliance.

In response to a congressional request, GAO determined (1) whether IRS is evaluating penalties in a manner that supports sound penalty administration and voluntary compliance and, if not, how IRS may be able to do so, and (2) whether IRS's guidance for a new penalty for failure to disclose reportable transactions was issued in a timely manner and was useful to affected parties, and whether and how IRS has assessed the penalty. GAO reviewed IRS documents and guidance, and interviewed IRS officials and tax practitioners.

What GAO Recommends

The Commissioner of Internal Revenue should direct the Office of Servicewide Penalties (OSP) to evaluate penalty administration and penalties' effect on voluntary compliance and develop a plan to focus its efforts. The Commissioner also should use IRS's standard outreach methods to again alert taxpayers of the need to disclose reportable loss transactions.

In commenting on a draft of this report, IRS concurred with GAO's recommendations, and summarized the actions it plans to take.

To view the full product, including the scope and methodology, click on [GAO-09-567](#). For more information, contact Michael Brostek (202) 512-9110 or brostekm@gao.gov.

What GAO Found

OSP does not comprehensively evaluate the administration of civil tax penalties or their impact on voluntary compliance, but a plan could help it do so. OSP has responsibility for administering penalty programs and determining the action necessary to promote voluntary compliance. According to IRS policy, OSP should collect information to evaluate penalties and penalty administration and to determine the effectiveness of penalties in promoting voluntary compliance. This policy is consistent with positions expressed in 1989 by both an IRS Task Force report and by Congress when reforming penalties in 1989, and more recently by the National Taxpayer Advocate. OSP does not fulfill the responsibilities specified in IRS policy. Rather, OSP analysts focus on short-term issues, such as sudden spikes in assessments or abatements. OSP officials said that they have not done more to evaluate the administration of penalties and their effect on voluntary compliance because of resource constraints, methodological barriers, and limitations in available databases.

A plan could help IRS focus its efforts and address the constraints to evaluating penalties. In developing a plan, IRS could identify the analyses it should do and the resources needed to do them. OSP could then determine what resources are available to assist it and what additional resources, if any, are needed. A plan also could lay out feasible research for evaluating the effect of penalties on voluntary compliance. For example, fairness is believed to undergird voluntary compliance. Thus, analyses that determine whether penalties are being consistently applied across IRS would provide pertinent information. Data limitations could be addressed in a plan, as well. The Enforcement Revenue Information System (ERIS) contains substantial data on IRS enforcement activities, but does not include all of the information recommended by the 1989 IRS Task Force report. For example, ERIS does not include readily usable information related to taxpayer income that could be used to determine equitable treatment of taxpayers.

IRS issued guidance regarding its implementation of a penalty for failure to disclose reportable transactions—transactions IRS identified as tax avoidance transactions—within 3 months of the provision's passage. IRS officials said that their criterion for issuing timely guidance is whether it was released in time to meet customers' needs. Tax practitioners from two leading practitioner organizations said the guidance was issued timely and included information they needed. However, the practitioners said more targeted outreach about the penalty was needed, specifically regarding reportable loss transactions caused by the current economic climate in which many taxpayers may experience losses that could trigger the reportable transaction requirements. IRS officials recognize the need to further raise awareness of the penalty, but their planned efforts would reach only a small portion of tax return preparers and taxpayers. As of January 2009, IRS has assessed 98 penalties for \$13.7 million. In addition, 1,188 returns had been assigned to field groups.

Contents

Letter		1
	Background	3
	IRS Does Not Comprehensively Evaluate the Administration of Tax Penalties or Their Impact on Voluntary Compliance, but a Plan Could Help It Do So	5
	Reportable Transaction Guidance Was Timely Issued, but Could Be More Useful to Affected Parties	12
	Conclusions	15
	Recommendations for Executive Action	15
	Agency Comments and Our Evaluation	16
Appendix I	Comments from the Internal Revenue Service	18
Appendix II	GAO Contact and Staff Acknowledgments	21

Abbreviations

ABA	American Bar Association
AICPA	American Institute of Certified Public Accountants
ERIS	Enforcement Revenue Information System
FTA	Federation of Tax Administrators
FTD	Failure to Deposit
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
NAEA	National Association of Enrolled Agents
OSP	Office of Servicewide Penalties
OTSA	Office of Tax Shelter Analysis
SB/SE	Small Business/Self Employed division
TAS	Taxpayer Advocate Service

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



United States Government Accountability Office
Washington, DC 20548

June 5, 2009

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

As a part of the Internal Revenue Service's (IRS) enforcement programs and activities, civil tax penalties are an important tool for encouraging taxpayer compliance with tax laws. It is important that IRS administers penalties properly and determines the effectiveness of penalties in encouraging compliance. The Internal Revenue Code (I.R.C.) has more than 150 penalties. In fiscal year 2007, IRS assessed more than 37.6 million civil penalties, totaling more than \$29.5 billion, while abating—that is, rescinding in whole or in part—more than 4.9 million civil penalties for more than \$11.1 billion. Major reforms to civil tax penalties were last made in 1989.

Your committee has expressed interest in the process IRS follows when administering penalties and the effectiveness of the penalty regime, and about the implementation of a penalty for failing to disclose reportable transactions—transactions IRS has identified as tax avoidance transactions or that are substantially similar thereto—and whether it was being appropriately assessed. Therefore, we agreed to determine (1) whether IRS is evaluating penalties in a manner that supports sound penalty administration and voluntary compliance and, if not, how IRS may be able to do so and (2) whether guidance for a new penalty for the failure to disclose reportable transactions was issued in a timely manner and was useful to affected parties, and whether and how IRS has assessed the new penalty.

To determine whether IRS is evaluating penalties in a manner that supports sound penalty administration and voluntary compliance, we reviewed official documents and guidance, including the Internal Revenue Manual. We interviewed officials from the IRS Office of Servicewide Penalties (OSP) and the four IRS business divisions (Small Business/Self Employed (SB/SE), Large & Mid-Size Business, Tax Exempt and Government Entities, and Wage and Investment) to determine their roles in penalty administration. In addition, we interviewed state officials and reviewed academic studies regarding assessments of penalty effectiveness

and contacted the Federation of Tax Administrators (FTA) for recommendations of states to contact.¹ In all, we spoke with representatives of 25 states.² To determine whether IRS issued guidance for a new penalty for failure to include reportable transactions information with returns³ in a timely manner that was useful to affected parties and whether and how IRS has assessed the new penalty, we reviewed IRS documentation and guidance for implementing the penalty and implementation action plans. We also interviewed officials from IRS's Office of Tax Shelter Analysis (OTSA), Office of Chief Counsel, and the four business units about their roles in implementing the penalty, as well as officials from the Department of the Treasury's (Treasury) Office of Tax Policy. Finally, because they collectively represent a significant portion of tax preparers, we contacted the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), and the National Association of Enrolled Agents (NAEA) and asked to interview members who were knowledgeable about the reportable transaction penalty. We interviewed nine tax practitioners affiliated with the AICPA and the ABA about the timeliness and usefulness of IRS outreach efforts regarding the implementation of the reportable transaction penalty, as well as their observations on IRS's use of the penalty. The NAEA said that its membership had little experience with the reportable transaction penalty, and did not provide names of any members for us to contact. Because we interviewed a nonprobability sample of practitioners, our discussion about the effectiveness of IRS's implementation of the reportable transaction penalty cannot be used to generalize to any other practitioners or group. Additionally, those we spoke with presented their personal views, not those of the professional associations through which they were contacted.

¹ FTA provides services to state tax authorities and administrators. These services include research and information exchange, training, and intergovernmental and interstate coordination. FTA staff members regularly monitor the activities of state tax agencies and the federal government in order to serve as a clearinghouse on topics important to tax administrators.

² We spoke with officials from Alabama, Arizona, California, Delaware, Florida, Hawaii, Illinois, Iowa, Indiana, Louisiana, Maine, Massachusetts, Minnesota, Montana, Nebraska, New York, North Carolina, Oklahoma, Oregon, Tennessee, Texas, Utah, Vermont, Washington, and Wisconsin. To select the states, we reviewed information contained on state tax bureau Web sites, such as press releases related to penalties, and contacted FTA for recommendations.

³ 26 U.S.C. § 6707A.

We conducted our work from October 2007 through May 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The U.S. tax system depends on the principle of voluntary compliance, that is, when taxpayers comply with the law without compulsion or threat. Penalties are intended to encourage compliance by supporting the tax reporting and remittance standards contained in the I.R.C. According to IRS's penalty handbook, in order to advance the fairness and effectiveness of the tax system, penalties should be severe enough to deter noncompliance, encourage noncompliant taxpayers to comply, be objectively proportioned to the offense, and be used to educate taxpayers and encourage their future compliance.

Penalties are assessed either automatically by IRS's systems or as a result of audits that reveal the compliance issues. For example, the penalty for filing a tax return late is usually assessed automatically when IRS's computer system detects a return filed after the filing deadline. Penalties such as those assessed against taxpayers involved with abusive tax shelters are assessed as a result of audits. Supervisors must review and approve the results of an audit to assess a penalty. Most penalties can be abated for reasonable cause if IRS determines that the taxpayer exercised ordinary business care and prudence in determining tax obligations but nevertheless was unable to comply with those obligations. Examples of reasonable cause include, but are not limited to, serious illness or an inability to obtain records.

Following the release of an IRS Task Force report on civil tax penalties in 1989⁴ Congress made its last major effort to reform the tax penalty regime because of concerns that a piecemeal approach to legislating civil tax penalties over the course of many years resulted in a complex penalty system that was difficult for IRS to administer and the taxpayer to comprehend. The legislation, the Improved Penalty Administration and

⁴ See Executive Task Force for the Commissioner's Penalty Study, *Report on Civil Tax Penalties* (Washington, D.C.: Feb. 22, 1989).

Compliance Tax Act,⁵ was enacted in large part to simplify civil tax penalties. For example, the act consolidated into one part of the I.R.C. all of the generally applicable penalties relating to the accuracy of tax returns and reorganized accuracy penalties to eliminate situations where one infraction could receive more than one penalty. Overall, the act reformed information reporting penalties; accuracy-related penalties; preparer, promoter, and protester penalties; and penalties for failure to file, pay, withhold, and make timely tax deposits.

OSP is assigned overall responsibility for IRS's penalty programs. As such, OSP is charged with coordinating policy and procedures concerning the administration of penalty programs, reviewing and analyzing penalty information, researching taxpayer attitudes and opinions, and determining appropriate action to promote voluntary compliance.

Current Treasury regulations⁶ state that every taxpayer that has participated in a reportable transaction⁷ and that is required to file a tax return must attach a disclosure statement to his or her return for the taxable year and send a copy to OTSA.⁸ In 2004, the American Jobs Creation Act⁹ created a new penalty for failing to disclose reportable

⁵ The Improved Penalty Administration and Compliance Tax Act was enacted as part of the Omnibus Budget Reconciliation Act of 1989. Pub. L. No. 101-239 (1989).

⁶ Treasury Regulation § 1.6011-4.

⁷ Currently, reportable transactions include: (1) listed transactions, which are the same as or substantially similar to one of the types of transactions that IRS has determined to be tax avoidance transactions; (2) confidential transactions, which are transactions that are offered to a taxpayer or a related party under conditions of confidentiality and for which a taxpayer or a related party paid an advisor a minimum fee; (3) transactions with contractual protection, which are transactions for which a taxpayer has, or a related party has, the right to a full refund or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained; (4) loss transactions, which are transactions that result in a taxpayer claiming a loss under IRC section 165 exceeding specified amounts; and (5) transactions of interest, which are the same as or substantially similar to one of the types of transactions that IRS has identified by notice, regulation or other form of published guidance as transactions of interest. The regulations state that the fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.

⁸ IRS Form 8886, Reportable Transaction Disclosure Statement. When IRS identifies a transaction as a listed transaction after a taxpayer has filed a return reflecting participation in the transaction, the taxpayer has 90 days to file a disclosure statement with OTSA.

⁹ Pub. L. No. 108-357 (2004).

transactions with a tax return.¹⁰ The purpose of the reportable transaction penalty is to promote compliance with taxpayers' duty to disclose their participation in transactions IRS has determined to have potential for tax avoidance or evasion. For example, a taxpayer claiming a loss on their tax return of at least \$2 million in a single taxable year must separately disclose the transaction to IRS. For most types of reportable transactions, the penalty is \$10,000 for an individual taxpayer's return and \$50,000 for other returns, such as business returns and returns for benefit plans. For one type of reportable transaction, a listed transaction, the amount of the penalty is increased to \$100,000 for individuals and \$200,000 for other returns. The Commissioner of Internal Revenue can abate the penalty for a reportable transaction, other than a listed transaction,¹¹ if abating the penalty would promote compliance with the requirements of the I.R.C. and effective tax administration. The decision to abate must include a record describing the facts and reasons for the action and the amount abated, and any decision to not abate the penalty is not subject to judicial review.

IRS Does Not Comprehensively Evaluate the Administration of Tax Penalties or Their Impact on Voluntary Compliance, but a Plan Could Help It Do So

Although IRS policies state that IRS should collect information to evaluate the administration of penalties and their impact on voluntary compliance, and IRS is collecting some relevant information, OSP is not comprehensively evaluating penalty administration or penalties' impact on voluntary compliance. According to IRS policies, OSP is to do the following:

- Administer the penalty statutes in a manner that is fair and impartial to both the government and the taxpayer, is consistent across taxpayers, and ensures the accuracy of the penalty computation.
- Collect statistical and demographic information to evaluate penalties and penalty administration and to determine the effectiveness of penalties in promoting voluntary compliance.
- Design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.
- Continually evaluate the impact of the penalty program on compliance and recommend changes when the I.R.C. or penalty administration does not effectively promote voluntary compliance.

¹⁰ 26 U.S.C. § 6707A.

¹¹ As of May 2009, there is a bill in the Senate and a bill in the House of Representatives that would eliminate the abatement provisions and add an exception to the penalty for failure to disclose reportable transactions when there is reasonable cause for such failure. See S. 765, April 1, 2009, and H.R. 2143, April 28, 2009.

These policies are consistent with positions expressed in the 1989 IRS Task Force report and by Congress when reforming penalties in 1989 and with more recent views expressed by the National Taxpayer Advocate. All stressed the need for IRS to evaluate the administration of penalties and their impact on voluntary compliance. For example, the task force's report and Congress in the conference report for the act that included the penalty reform recommended that IRS analyze information concerning the administration and impact of penalties for the purpose of suggesting changes in compliance programs, educational programs, penalty design, and penalty administration. The task force also recommended that IRS analyze data to enable IRS, Treasury, and Congress to evaluate how well penalties operate and what impact they have on voluntary compliance. Similarly, in her 2008 annual report, the National Taxpayer Advocate wrote that before serious penalty reform can occur, better data about whether and how penalties promote voluntary compliance is needed.¹²

However, OSP generally does not fulfill the responsibilities specified in IRS policy or as envisioned by the 1989 IRS Task Force report, Congress, or the National Taxpayer Advocate. Rather, OSP analysts focus most of their efforts on addressing short-term issues, such as sudden spikes in assessments or abatements. These analyses are useful and should continue, as they could identify emerging problems with how penalties are being administered, but they do not constitute a comprehensive assessment of penalty administration.

OSP officials said that they have not done more to evaluate the administration of penalties and their effect on voluntary compliance primarily because of resource constraints both within OSP and IRS's various research units, methodological barriers that impede their ability to research the effect of penalties on voluntary compliance, and limitations in available databases.

¹² National Taxpayer Advocate, *2008 Annual Report to Congress*, vol. 2 (Washington, D.C.: Dec. 31, 2008).

A Plan Could Help Identify Needed Resources and Support Resource Requests

OSP does not have a plan for fulfilling its responsibilities. The Government Performance and Results Act of 1993¹³ may be a useful resource in developing such a plan as it provides several key management principles needed to effectively guide, monitor, and assess program implementation. These principles include (1) general and long-term goals and objectives, (2) a description of actions to support goals and objectives, (3) performance measures to evaluate specific actions, (4) schedules and milestones for meeting deadlines, (5) identification of resources needed, and (6) evaluation of the program with processes to allow for adjustments and changes. This approach is intended to ensure that agencies have thought through how the activities and initiatives they are undertaking are likely to add up to the meaningful result that their programs are intended to accomplish.

A plan would help to identify resource requirements and support resource requests. In developing a plan, OSP would need to identify the key penalty issues on which to focus its efforts, the types of analyses that would best address those key issues, and the type and amount of resources—whether within OSP or elsewhere in IRS—needed to execute the plan. Thus, by focusing on what it is attempting to accomplish by developing a plan, OSP would be better positioned to determine what resources within IRS are available to assist it. Further, a well-developed plan can provide policymakers within the executive branch and Congress a better basis for determining the appropriate level of resources for a program.

A Plan Could Lay Out Feasible Research for Evaluating the Effect of Penalties on Voluntary Compliance

Although OSP officials' concerns about methodological barriers to determining the effect of penalties on voluntary compliance are valid, relevant analyses likely could be performed. Developing a plan would help OSP officials determine which analyses could be useful for this purpose and possible strategies for furthering the state of knowledge on the effect of penalties on compliance.

OSP officials pointed to several examples of the methodological barriers to determining the effect of penalties on voluntary compliance. For example, increases in penalty amounts might be accompanied by other changes in enforcement activities, such as a higher audit rate, and separating the effect of these factors on voluntary compliance is difficult. In addition, a number of issues other than IRS enforcement activities

¹³ Pub. L. No. 103-62 (1993).

affect a taxpayer's behavior, including income, tax rates, demographics and social factors, and the influence of tax practitioners. Another complication is that a penalty set at a certain amount may effectively encourage voluntary compliance for one type of taxpayer, such as individuals, but not for another type of taxpayer, such as businesses.

Our discussions with state officials and review of academic studies raised similar concerns about the methodological barriers. None of the 25 states we contacted evaluate the impact of penalties on voluntary compliance, and FTA was unaware of any states currently doing such evaluations. State officials added that limited resources, political disinterest, and technological barriers further constrain their penalty analysis capacities. Some state officials said that they rely on IRS information and research to establish state enforcement priorities and similarly would look to IRS for penalty research. The academic studies we reviewed concluded, consistent with OSP's view, that measuring the impact of penalties on voluntary compliance is difficult because numerous variables go into determining a taxpayer's decision to voluntarily comply with tax laws. These variables include how risk averse a person is and how likely he or she is to attempt to "get away" with not complying.

Nevertheless, some analyses likely would be useful for better understanding the effect of IRS penalties on taxpayers' voluntary compliance. For example, it is widely believed that taxpayers are more likely to comply voluntarily if they believe that the tax code is implemented fairly and consistently across taxpayers. The 1989 IRS Task Force noted that better knowledge of both penalty applications and the perceptions of taxpayers that have been penalized were important in ensuring that taxpayers feel they are being treated fairly. Thus, analyses that determine whether penalties are being consistently applied across IRS so that similarly situated taxpayers receive the same penalties could provide pertinent information.

Penalties are also unlikely to have much effect on voluntary compliance if they are not used. Treasury noted the importance of better understanding the relationship between penalty administration and voluntary compliance in its strategic plan for reducing the tax gap.¹⁴ The plan states that Treasury wants penalties to be set at more appropriate levels because

¹⁴ Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (Washington, D.C.: Sept. 26, 2006).

some penalties may be too low to change behavior but others may be so high that examiners are reluctant to assess them.

The penalties for failure to provide appropriate information returns are an example of penalties that do not appear to be properly calibrated to influence compliance. The instructions for certain information returns¹⁵ require that taxpayers submit the form printed with special ink.¹⁶ Those that fail to do so are subject to a \$50 penalty. IRS officials said that this penalty and other format-related penalties are not assessed because the cost of developing and asserting the penalty was not worth it. Instead, IRS officials correct the forms manually. IRS officials said that the penalty would have to be raised substantially to make it worthwhile to assess. The decision to not assess penalties for this error based only on the revenue received from those penalized may have actually undermined voluntary compliance. A version of a popular tax preparation software package informs taxpayers that IRS has accepted forms that are not printed with the special ink.

In addition, IRS may be able to do certain longitudinal analyses of whether taxpayers assessed a penalty in one year become more compliant in future years. For example, IRS may be able to determine whether taxpayers that were assessed an underpayment penalty one year were assessed the same penalty in years that followed. Although multiple factors would influence the result, the data might help IRS better understand whether the penalty may have any effect on future compliance.

Currently, SB/SE's Research group is working on a project reviewing the First Time Abate policy that may provide some information related to certain penalties' effect on compliance.¹⁷ IRS did not know some information about the results of the policy, including the number of penalties abated under the policy, the amount of money involved, and the number of taxpayers qualifying for the abatement but not receiving it.

¹⁵ Examples include Form 1096, Annual Summary and Transmittal of U.S. Information Returns, and Form 1099, Miscellaneous Income.

¹⁶ The special ink is a red drop-out ink. It is colored in such a way as to be invisible to optical scanning devices, increasing the efficiency of data processing by allowing the scanner to skip nonessential information.

¹⁷ The First Time Abate policy is an exam program that grants relief to certain taxpayers who receive a failure to file, pay, or deposit penalty. Taxpayers with a clean history for the 3 years prior to receiving the penalty may have it abated. No reason is required. The only caveat is that they must contact IRS regarding the penalty.

Additionally, other questions have surfaced, including whether the policy is fair, whether taxpayers receiving the abatement “game” the system by complying for 3 years and then getting the abatement again, and, ultimately, whether the policy should be continued. Results of the project are expected in the summer of 2010.

In addition to analyses related to voluntary compliance that could be done internally, by developing a plan, OSP may be able to identify other means of developing information useful to gauging penalties’ effect on voluntary compliance. Taxpayer surveys or focus groups, for instance, could provide information on taxpayers’ perceptions about the fairness of penalties.

IRS could also explore other avenues for supporting research of penalty effectiveness, such as encouraging others to examine the relationship between penalties and voluntary compliance. For example, IRS hosts an annual research conference and 6 forums across the country used to discuss tax administration issues with experts and practitioners. These conferences and forums have been used to discuss compliance issues. At the 2008 IRS Research Conference, papers on measuring or improving tax compliance were presented. These types of studies, done independently, can potentially add valuable thoughts and information to the discussion on how best to encourage and increase taxpayer compliance with tax laws.

Data Limitations Could Be Addressed in a Plan

Finally, in developing a plan, OSP could assess options for overcoming the limitations in available data that officials say impede its ability to both assess the effect of penalties on voluntary compliance and perform more sophisticated reviews of IRS’s administration of penalties. The 1989 IRS Task Force report said IRS needed to develop an interactive database available for all management levels to perform ad hoc analysis of penalty administration and voluntary compliance. One of the task force’s recommendations was to develop a database that captured the maximum amount of data in order to avoid the expense and delay for special master file extracts. With this database, IRS would evaluate the equitable treatment of taxpayers with respect to all aspects of penalties (e.g., penalty waivers and taxpayer demographic information, such as income).

The Enforcement Revenue Information System (ERIS) contains substantial data on all IRS enforcement activities, including penalties. However, ERIS does not meet several of the task force’s recommendations. For example, ERIS does not include readily usable information related to taxpayer income or practitioner representation that could be used to determine equitable treatment, develop employee

training, or provide taxpayer education outreach. ERIS is not available at all management levels. While the system is used to develop many standard reports, officials say a lack of resources has prevented it from producing additional reports that could increase understanding of penalties. For example, the First Time Abate policy research project is using master file extracts instead of ERIS.

In addition, IRS does not routinely use existing penalty data to evaluate the administration of penalties. For example, IRS does not identify

- penalties with low or high assessment and abatement rates,
- whether significant differences exist in the abatement rate for high-income taxpayers relative to lower-income taxpayers,
- whether significant differences exist in penalty size between taxpayers that negotiate an installment agreement relative to those who pay cash,
- whether returns prepared by a paid preparer are more or less likely to have penalties abated,
- whether penalties are assessed or abated at different rates based on the geographic location where the case is worked,
- whether individual taxpayers receive more or fewer abatements than businesses for the same penalties, and
- whether the rate of erroneous penalty assessments is increasing or decreasing.

Analyses of trends in penalty data could help IRS identify areas that need further investigation and when penalties may not be applied consistently and fairly. For example, a low assessment rate could indicate that a penalty is effectively deterring noncompliance and that the infrequency of its assessment is appropriate. However, a low assessment rate might also indicate that a penalty has become outdated or is deemed too burdensome to assess. Similarly, a high abatement rate could indicate that IRS officials are hesitant to sustain a penalty because they deem it too harsh for the infraction.

IRS changed the process it follows to assess the penalty for an employer's failure to deposit the correct amount of taxes for employees, known as the Failure to Deposit (FTD) penalty,¹⁸ based on a trend analysis done by others. The Taxpayer Advocate Service (TAS) noted in its 2003 report¹⁹

¹⁸ 26 U.S.C. § 6656.

¹⁹ Taxpayer Advocate Service, *National Taxpayer Advocate 2003 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2003).

that IRS abated a substantial number of FTD penalties and that the higher the penalty, the more likely the penalty was to be abated. According to IRS, 24 percent of FTD penalties had been abated in 2002 accounting for 62 percent of the assessed dollars. Based in part on TAS's data analysis, IRS changed the procedures it follows to assess the FTD penalty by sending a notice to taxpayers warning them of possible assessment if they did not deposit what they owed. According to a report by the Treasury Inspector General for Tax Administration,²⁰ this procedural change helped lead to a decrease in penalty assessments and abatements.

Reportable Transaction Guidance Was Timely Issued, but Could Be More Useful to Affected Parties

IRS issued guidance to implement a new penalty for taxpayers that fail to disclose a reportable transaction in a timely manner and began assessing penalties after audits had been conducted. The reportable transaction penalty was effective immediately after its passage in October 2004,²¹ making the development of guidance on how IRS would interpret and implement the law important. Within 3 months, in January 2005, IRS issued interim guidance to alert taxpayers and practitioners to the reportable transaction penalty and how IRS planned to implement it.²² For example, the interim guidance explains the conditions under which IRS would impose the penalty and how it would use the authority to abate the penalty. Officials in the Office of Chief Counsel told us that their criterion for issuing guidance successfully is whether it was released in time to meet their customers' needs. The practitioners we spoke with from two leading practitioner organizations said that issuing the interim guidance in only 3 months was quick and the guidance included the information they needed to understand how IRS would implement the penalty.

Those same practitioners were concerned that other practitioners may lack an understanding of all of the requirements for disclosing reportable transactions and suggested that more targeted outreach regarding the reportable transaction penalty was needed, since the penalty is large and the process to get the penalty abated is difficult. As mentioned earlier, the Commissioner of Internal Revenue, or the Commissioner's delegate, can abate the penalty for most types of reportable transactions, but if a

²⁰ Treasury Inspector General for Tax Administration, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments*, Reference Number 2005-30-136 (Washington, D.C.: September 2005).

²¹ Pub. L. No. 108-357 (2004).

²² Notice 2005-11.

taxpayer is penalized for a listed transaction there is no abatement option. These practitioners said that it would be easy to inadvertently violate the provision because taxpayers and practitioners may not realize that transactions that seem reasonable to them and have resulted in no net gain are considered reportable. They noted that if some practitioners or taxpayers are associating this penalty only with abusive tax shelters, they may not realize all of the situations where the requirement to disclose a transaction applies. They added that in the current economic climate there are likely to be many transactions that result in a loss that do not get disclosed on the required form.²³ The practitioners said that they were concerned because taxpayers and other practitioners may not have been in such situations before, and it is likely that IRS will see a significant increase in undisclosed transactions of this nature.

In the 2008 Annual Report,²⁴ TAS also expressed concerns that the reportable transaction penalty is being assessed against taxpayers for which it was not intended and that the penalty is unfairly harsh. According to TAS, the purpose of the penalty is to combat tax shelters by penalizing taxpayers that failed to disclose that they have entered into transactions deemed aggressive by IRS. Because the reportable transaction penalty applies without exception to the failure to include disclosure on a return when required, an improper tax benefit is not required as long as the tax return reflects tax consequences or a tax strategy described in public guidance.

IRS officials said they conducted standard educational outreach to the practitioner community regarding the specifics of the reportable transaction penalty. This included sending updates to e-mail groups regarding notices and revenue procedures implementing the new penalty requirements, postings of the latest news to IRS's Web site, and requesting comments on proposed regulations. In addition, officials in OTSA said that they had presented information on the penalty to practitioner groups as

²³ Specifically, these transactions are loss transactions resulting in a claim for a loss under I.R.C. § 165 of at least \$10 million in any single taxable year or \$20 million in any combination of taxable years for corporations or partnerships that have only corporations as partners; \$2 million in any single taxable year or \$4 million in any combination of taxable years for all other partnerships and individuals, S corporations, or trusts; and \$50,000 in any single taxable year for individuals or trusts if the loss arises with respect to I.R.C. § 988 relating to foreign currency transactions.

²⁴ Taxpayer Advocate Service, *National Taxpayer Advocate 2008 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2008).

part of larger presentations on civil penalties. However, some of the practitioners we spoke with said that in the current substantially altered economic climate, some taxpayers may be caught unaware of the need to disclose a reportable loss transaction and be penalized without a ready avenue for relief. Further, there is little basis to reliably predict which taxpayers might be caught in this situation.

IRS officials recognize the need to further raise awareness with taxpayers. They plan to use the National Tax Forums²⁵ during the summer of 2009 to hold focus groups regarding the reportable transaction penalty. The goal of the focus groups is to reach out to practitioners who may not understand the disclosure requirements and get the thoughts of those who have had experience with the reportable transaction penalty. However, at best, IRS would only reach a small portion of the tax return preparer community in this fashion even though many preparers may end up with clients susceptible to the penalty. Using its standard, low-cost outreach methods to again focus tax preparers and the public's awareness on the disclosure requirements for the reportable loss transaction could reach a wider audience.

IRS officials said that the majority of tax returns eligible for assessment of the penalty were not filed until fall 2005, well after the interim guidance had been released, and would not have been audited until 2006. IRS officials said that development of these cases takes time and that IRS could not assess the penalty until there was sufficient basis to believe that a taxpayer had participated in a reportable transaction during a specific taxable year, had a disclosure requirement, and failed to complete the required form. IRS receives the required forms at its Ogden facility but does not assess penalties until after referring cases to an examiner. A penalty is only assessed after an examiner reviews the case because examiners develop related issues that may not be apparent from the face of the form itself. If a taxpayer failed to report participation in a reportable transaction, IRS would not know of the taxpayer's participation until it examined the tax return or investigated the promoter of the transaction. Therefore, the majority of cases for which a penalty may have been appropriate would not have been identified until late 2006 and 2007. According to IRS officials, as of January 2009, IRS had assessed 98 of the

²⁵ The National Tax Forums are held annually in multiple locations across the United States. Many groups, including the AICPA, the ABA, the NAEA, the National Association of Tax Professionals, the National Society of Accountants, and the National Society of Tax Professionals participate in the forums.

penalties for \$13.7 million and collected \$2.7 million. In addition, 1,188 returns had been assigned to field groups and 50 returns were being reviewed by IRS's Appeals Division.

Conclusions

Civil tax penalties play an important role in helping ensure that taxpayers make an honest effort to pay the taxes that they owe. Twenty years after Congress and an IRS Task Force said that IRS needs to conduct more continuous and comprehensive analyses of the penalties it administers and their effect on voluntary compliance, and after having designated an office with those responsibilities, IRS is not meeting this expectation. IRS does not have a plan that identifies how it will carry out these responsibilities and address the resource, methodological, and data limitations that officials say impede its progress. IRS should develop and execute such a plan to better focus its efforts and ensure that penalties are being administered efficiently, effectively, fairly, and consistent with encouraging taxpayers' voluntary compliance.

IRS issued guidance for the reportable transaction penalty in a timely manner following its passage in 2004. However, in the current economic climate certain transactions involving losses may subject many unsuspecting taxpayers to a harsh penalty. They may be unaware of reporting requirements because they have never been in such situations before. IRS's planned additional outreach on this penalty is not sufficient. IRS should use its standard, low-cost outreach methods to alert as many tax return preparers and taxpayers as possible about the need to properly report loss transactions to avoid penalties.

Recommendations for Executive Action

In order to ensure the most efficient, fair, and consistent administration of civil tax penalties, and that penalties are achieving their purpose of encouraging voluntary compliance, the Commissioner of Internal Revenue should direct OSP to evaluate penalty administration and penalties' effect on voluntary compliance. The Commissioner also should direct OSP to develop and implement a plan to collect and analyze penalty-related data. The plan should address the constraints officials have identified as impeding progress in analyzing penalties.

In addition, the Commissioner of Internal Revenue should use IRS's standard, low-cost methods of outreach to again alert as many tax return preparers and taxpayers as possible about the need to properly report loss transactions to avoid penalties.

Agency Comments and Our Evaluation

The Deputy Commissioner for Services and Enforcement provided written comments in a May 26, 2009, letter, which is reprinted in appendix I. IRS staff also provided technical comments that we incorporated as appropriate.

IRS agreed that OSP will develop a plan to comprehensively evaluate penalty administration and the impact of penalties on voluntary compliance. IRS said that such a plan was important in understanding the relationship between penalty administration and voluntary compliance and in identifying priorities and potential resource needs. Developing a comprehensive plan may take time. In the interim, we believe that the data IRS currently collects can be used to begin useful penalty analyses. For example, IRS could evaluate whether penalties are assessed or abated at different rates based on the geographic location of the office responsible for the case or whether significant differences exist in the abatement rate for high-income taxpayers relative to lower-income taxpayers. Such analyses could be done now and help IRS determine whether penalties are being applied consistently.

IRS also agreed to undertake outreach to ensure that taxpayers are again alerted to the situations where disclosure of reportable transactions is needed.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. This report also 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 on (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix II.



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

May 26, 2009

Mr. Michael Brostek
Director, Strategic Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled "Tax Administration – IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts (Job Code GAO-09-567)."

We recognize that civil tax penalties are an important tool for encouraging compliance with tax laws. Effective administration of penalty application is critical in ensuring fair and equitable treatment of taxpayers and ensuring voluntary compliance.

The Office of Servicewide Penalties (OSP) has overall responsibility for the Internal Revenue Service's (IRS) civil penalty program. We concur that an OSP comprehensive plan to evaluate the administration of civil tax penalties to understand the relationship between penalty administration and voluntary compliance is important. Additionally, such a plan will be useful in identifying priorities and in determining additional potential resource needs. We agree that this analysis would likely result in a better understanding of the effect of IRS penalties on taxpayers' voluntary compliance.

Your report also stresses the importance of collecting information to evaluate penalty administration. OSP is in agreement and has already commissioned IRS Research to conduct an analysis using Masterfile data on its behalf. For example, OSP requested that IRS Research complete a project on the First Time Abatement policy for Failure to File, Failure to Pay, and Failure to Deposit penalties.

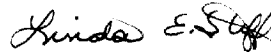
We appreciate the suggestions that you provided in your report and will carefully consider the findings as we develop the OSP plan.

2

The enclosed response addresses each recommendation separately.

If you have any questions, please contact Christopher Wagner, Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,



Linda E. Stiff

Enclosure

Enclosure

RECOMMENDATION

In order to ensure the most efficient, fair, and consistent administration of civil tax penalties, and that penalties are achieving their purpose of encouraging voluntary compliance, the Commissioner of Internal Revenue should direct OSP to evaluate penalty administration and penalties effect on voluntary compliance. The Commissioner also should direct OSP to develop and implement a plan to collect and analyze penalty related data. The plan should address the constraints officials have identified as impeding progress in analyzing penalties.

COMMENT

IRS's OSP will develop a plan to comprehensively evaluate penalty administration and the impact of penalties on voluntary compliance. Such a plan will be useful in identifying priorities and in determining additional potential resource needs.

RECOMMENDATION

In addition, the Commissioner of Internal Revenue should use IRS's standard, low cost methods of outreach to again alert as many tax return preparers and taxpayers as possible about the need to properly report loss transactions to avoid penalties.

COMMENT

We will work with our Communications staff to use the standard outreach methods to again alert taxpayers of the situations where disclosure is needed.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Jonda R. Van Pelt, Assistant Director; Julia T. Coulter; Benjamin C. Crawford; Alison Hoenk; Ellen M. Rominger; Elwood D. White; and John M. Zombro made key contributions to this report.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

