

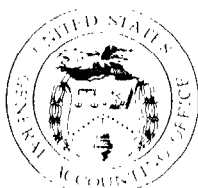
GAO

Report to the Commissioner, Internal
Revenue Service

August 1990

TAX
ADMINISTRATION

IRS Preparer Penalty
Data Inaccurate and
Misleading



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General Government Division

B-239935

August 15, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner
Internal Revenue Service

Dear Mr. Commissioner:

At the request of the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service (IRS), Senate Committee on Finance, we reviewed IRS' administration of the return preparer penalty program to determine whether IRS imposed preparer penalties appropriately and consistently. We are preparing a report to the Subcommittee regarding our findings. During our review, we found that the Individual and Business Master File data on preparer penalties did not accurately reflect preparer penalty activity.¹ This report identifies the inaccuracies we found, discusses their causes, and makes recommendations to you for improving the quality of IRS' preparer penalty statistics.

Results in Brief

Currently, IRS is not able to accurately determine the number, amount, or type of preparer penalty assessments and abatements. As a result, its preparer penalty statistics do not accurately reflect preparer noncompliance with the tax laws. This is because

- IRS has recorded multiple penalties on the master files as a single penalty transaction. Thus, the master file data have understated the number of return preparer penalties.
- IRS has excluded some penalty actions from being recorded on the master files. Accordingly, the master file data have understated both the number and amount of return preparer penalties.
- IRS has aggregated the penalties for preparer negligence and willful understatement on the master file. Thus, IRS cannot use the master files to differentiate between penalties assessed for two different types of noncompliance.
- IRS has entered miscoded or erroneous assessment and abatement data to the master files. These errors significantly distorted fiscal year 1987 preparer penalty statistics.

¹The Individual and Business Master Files are comprehensive computerized files containing entity and account information on taxpayers. Entity information includes the taxpayer's name, address, and filing status. Account information shows the different transactions related to a taxpayer's filing and payment of any tax liability.

Statistical information on the number, type, and amount of preparer penalty assessments and abatements could be a valuable management tool for IRS if the information is accurate and not misleading. With such data, IRS could make judgments on the extent of preparer noncompliance with the tax laws and on the level of enforcement efforts needed to deal with the preparer noncompliance.

Background

The Tax Reform Act of 1976 established two different preparer penalties in section 6694 of the Internal Revenue Code—a \$100 penalty for negligent or intentional disregard of IRS rules and regulations, section 6694(a), and a \$500 penalty for a willful attempt to understate a taxpayer's liability, section 6694(b). These penalties were designed to enable IRS to effectively deal with negligent and/or fraudulent preparers. When a preparer's conduct as proscribed by section 6694 causes an understatement of a taxpayer's liability, IRS is to assess a preparer penalty. According to IRS, 3,474 civil preparer penalties were assessed against 1,371 preparers during fiscal year 1987, and 2,179 penalties were assessed against 1,150 preparers during fiscal year 1988.

In November 1989, the Improved Penalty Administration and Compliance Tax Act was enacted as part of the Omnibus Budget Reconciliation Act of 1989. The new law, which is applicable to returns prepared after December 31, 1989, revised the definitions and the dollar amounts of the penalties. The \$100 penalty has been increased to \$250 and applies to returns with an understatement of tax liability where the preparer knew or reasonably should have known that a position taken did not have a realistic possibility of being sustained on its merits and such position was not disclosed or was frivolous. The \$500 penalty for willful understatement has been increased to \$1,000 and expanded to include cases of reckless or intentional disregard of rules and regulations by a preparer.

To assess these penalties, IRS enters an assessment transaction to the preparer's account on the appropriate master file—either the Business or Individual Master File—charging the preparer for the amount of the penalty. A separate civil penalties module is set up as part of the preparer's individual tax account to reflect nonreturn civil penalty transactions for each tax period involved. For example, a preparer who has received three preparer penalties for returns related to 3 different tax years has one account, but three modules—one for each year and each containing one penalty assessment transaction. On the other hand, a preparer who has received three preparer penalties for returns related

to the same tax year would have one module containing three penalty assessment transactions. Subsequent penalties assessed against those preparers would be added, as separate transactions, to the appropriate tax year module.

If, after a preparer penalty has been assessed, IRS or a U.S. district court determines that a penalty is not warranted, the penalty will be cancelled (abated). An abatement transaction is entered into the preparer's module cancelling the assessed penalty.

Objective, Scope, and Methodology

The Subcommittee on Private Retirement Plans and Oversight of IRS requested that we review IRS' administration of preparer penalties to determine whether IRS imposed preparer penalties appropriately and consistently. During that review, we found that the Individual and Business Master File data on preparer penalties did not accurately reflect preparer penalty activity.

To determine the extent of the problems identified, we reviewed IRS' procedures for recording preparer penalty assessments and abatements on the master files. We also reviewed all available information related to fiscal year 1987 assessment and abatement transactions from five districts² —Baltimore, Denver, Ft. Lauderdale, St. Louis, and San Francisco—to determine if the master file data accurately reflected the information on the source documents.³ We selected these districts because they were geographically dispersed and had a level of preparer penalty activity that would allow us to review 100 percent of the case files. We also reviewed all available information pertaining to fiscal year 1987 abatement transactions and their related assessment transactions for the Phoenix District to determine if the master file data accurately reflected the information. We added the Phoenix District because it accounted for over two-thirds of the total dollar amount of abatements nationwide. In total, we reviewed 474 assessment transactions and 103 abatement transactions from the 6 districts.

In addition, we identified two districts—Dallas and Manhattan—with Non-Master File (NMF) assessments.⁴ Because these assessments are not

²Fiscal year 1987 data were the latest available at the time of our review.

³We originally selected these districts as part of a review of whether IRS imposed preparer penalties appropriately and consistently.

⁴IRS' NMF is the manual system used to record transactions not recorded on IRS' computerized master files.

reflected in IRS statistics, we reviewed the information related to these assessments to determine the extent to which these assessments affected the accuracy of the preparer penalty activity reported by IRS.

We did our work between February and March 1990 in accordance with generally accepted government auditing standards.

Reported Statistics Do Not Accurately Reflect Preparer Noncompliance

We identified four factors that contribute to IRS' preparer penalty statistics not accurately reflecting preparer noncompliance. The four factors were (1) multiple penalties in one transaction, (2) omission of NMF assessments, (3) no differentiating between penalties, and (4) miscoded or erroneous data entered into master files.

Multiple Penalties in One Transaction

IRS procedures require that examiners consolidate multiple penalty assessments into one transaction, whenever possible, to prevent multiple notices being sent to the preparer. IRS procedures also allow multiple penalties to be abated in one transaction.

However, when multiple penalty actions are included in one transaction, the master file does not indicate the number of penalties assessed or abated and reflects the transaction as one penalty action. Therefore, although the amount assessed or abated is correct, the number of penalties assessed or abated is understated. For example, when 10 preparer negligence penalties are assessed in one \$1,000 transaction, the master file data reflects this as an assessment of 1 penalty, rather than as an assessment of 10 penalties. Because IRS cannot identify the number of penalties in each transaction, the number of preparer penalties is understated. Specifically, for fiscal year 1987, IRS reported 590 penalties assessed and 107 abated for the 6 districts where we reviewed penalty activity recorded on the master files. Multiple penalties in a single transaction caused these statistics to understate the total number assessed and abated by 576 (49 percent) and 132 (55 percent), respectively.

To ensure that the master file data more accurately reflect preparer penalty activity, IRS needs to create a master file indicator by which IRS can identify the actual number of penalties in each assessment and abatement transaction.

**Non-Master File
Assessments Omitted**

Another factor that causes IRS to understate the number and amount of penalties assessed is the omission of NMF assessments from master file data. A module on the master files can accept a limited number of transactions. When a module on the master files reaches capacity, all subsequent assessments are recorded on NMF and are not reflected in the master file data.

In our review of NMF preparer penalty activity in two districts, we found three preparer accounts that had been transferred to the NMF. These NMF accounts included 227 assessments, totaling \$116,400, that were not reflected in the fiscal year 1987 master file data or in IRS penalty statistics. For these two districts, IRS had reported 361 penalties assessed, totaling \$68,425, for fiscal year 1987. The omission of the NMF assessments caused these statistics to understate the number and amount of penalties assessed by 39 percent and 63 percent, respectively. These penalty assessments should be included in preparer penalty statistics to accurately reflect preparer penalty activity.

**No Differentiating
Between Penalties**

From the master file data, IRS cannot determine the number of negligent or intentional disregard, section 6694(a), and willful understatement penalties, section 6694(b), assessed and abated because one penalty cannot be differentiated from another. Although specific codes are assigned to penalty transactions in the master files to identify the type of penalty, these two penalties are assigned the same code. Therefore, the code cannot be used to differentiate between section 6694(a) and section 6694(b) penalty actions.

Additionally, the amount of a transaction may not indicate the penalty type because, as indicated above, multiple penalty actions might be included in one transaction. For example, a \$500 transaction may represent five section 6694(a) penalties or one section 6694(b) penalty. Until IRS establishes a means to differentiate between the two penalties on the master files, IRS management will not have information about the type of preparer noncompliance experienced.

**Miscoded or Erroneous
Data Entered Into Master
Files**

In addition to the factors discussed above, we found inaccuracies in the fiscal year 1987 data that resulted from input errors. These errors included miscoded penalties, erroneous assessments, and erroneous abatements.

According to IRS statistics for the 6 districts we reviewed, 590 penalties had been assessed for \$2,490,675 during fiscal year 1987. We found that four nonpreparer penalties that were miscoded as preparer penalties caused the amount of penalties assessed to be overstated by \$2,039,175. We also found 29 penalties, totaling \$3,600, that were erroneously assessed. These included duplicate assessments, assessments resulting from incorrect information on the assessment form, assessments resulting from data being entered incorrectly into the master file, and assessments entered to bring the interest due up to date. Our review showed that these input errors caused the reported statistics to overstate the number and amount of penalties assessed by 6 percent and 556 percent, respectively.

IRS also reported that during fiscal year 1987, 107 penalties totaling \$179,500 were abated by the districts we reviewed. We found two abatements, totaling \$16,000, that were inadvertently entered into the master file, although no decision to abate had been made. These erroneous abatements caused an overstatement of 2 percent in the number of penalties abated and 10 percent in the amount abated.

Although the number of input errors was not substantial, the \$2,042,775 in miscoded and erroneous assessments significantly overstated the dollars assessed for fiscal year 1987. We do not know whether the input errors we identified will occur in the same magnitude in all years. Regardless, IRS should evaluate the feasibility of developing methods to identify, correct, and exclude instances where miscoded or erroneously entered data are significantly overstating preparer penalty activity.

Master File Statistics Should Accurately Reflect Preparer Penalty Activity

Statistical information on the number, type, and amount of preparer penalty assessments and abatements could be a valuable management tool for IRS if the information is accurate and not misleading. With such data, IRS could make judgments about the extent of preparer noncompliance and the level of enforcement efforts needed to deal with the noncompliance. Given the current condition of the master file data, however, IRS has little or no indication of the extent to which preparers are not compliant with the tax laws. For example, recording multiple penalty assessments and abatements in a single transaction, as opposed to individual transactions, can cause the reported statistics to be misleading. If, during 1 year, IRS recorded 10 penalties in a single transaction, the reported statistics would indicate only 1 penalty assessment for the year. If, in another year, IRS recorded 10 penalties in separate transactions, the reported statistics would indicate 10 separate penalties.

Comparison of the statistics for the 2 years could imply that (1) IRS increased its efforts to identify and penalize noncompliant preparers and/or (2) preparer noncompliance increased. Either assumption could be misleading because, in fact, the number of preparer penalties did not change.

Conclusions

Preparer penalty statistics reported by IRS should accurately reflect preparer noncompliance. However, we found the reported data to be inaccurate because (1) multiple penalties in one transaction are reflected as one penalty action; (2) assessments recorded on the manual NMF system are omitted from reported penalty activity; (3) preparer negligence and the willful understatement penalties are assigned the same reference code; and (4) miscoded and erroneous assessment or abatement data are inadvertently input to the master files.

Recommendations

To ensure that master file statistics more accurately reflect preparer penalty activity, we recommend that the Commissioner of Internal Revenue

- create an indicator to identify the number of penalties included in each transaction;
- identify and establish a means to include assessments made on the manual system with the master file statistics;
- establish a means to differentiate between preparer penalty activity as defined in Internal Revenue Code sections 6694(a) and 6694(b); and
- evaluate the feasibility of developing methods to identify and correct miscoded or erroneously entered data, and exclude these assessments and abatements from IRS' reported statistics.

Agency Comments

In providing informal comments on this report, IRS officials generally agreed with the information contained in the report, the conclusion reached, and the recommendations.

We are sending copies of this report to the Joint Committee on Taxation; the Subcommittee on Private Retirement Plans and Oversight of IRS; Senate Committee on Finance; Subcommittee on Oversight, House Committee on Ways and Means; and other interested parties. We will also make copies available to others on request.

Major contributors to this report are listed in the appendix. Please contact me on 272-7904 if you have any questions concerning the report.

Sincerely yours,



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