Report to The Congress on

PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE

Department of the Treasury
Office of Tax Policy

October 1999

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OCT [illegible] 1999

The Honorable William Roth
Chairman
Committee on Finance
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

Section 3801 of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 782 (July 22, 1998), requires the Treasury Department to conduct a study reviewing the administration and implementation by the Internal Revenue Service of the interest and penalty provisions of the Internal Revenue Code of 1986 ("Code"). Enclosed is our report of that study.

As directed by Congress, the issues discussed include: (1) whether the penalty and interest provisions encourage voluntary compliance; (2) whether the provisions operate fairly; (3) whether the provisions are effective deterrents to undesired behavior; and (4) whether the provisions are designed in a manner that promotes efficient and effective administration by the Internal Revenue Service. This report makes a number of recommendations regarding the penalty and interest provisions designed to foster compliance without undue burden or complexity. The Treasury Department's report on corporate tax shelters issued on July 1, 1999 contains a discussion and recommendations with respect to penalty provisions pertaining to corporate tax shelters.

I am sending a similar letter to Senator Moynihan

Sincerely,

Jonathan Talisman
Deputy Assistant Secretary (Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OCT 1999

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

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INTRODUCTION

This study was conducted by the Treasury Department with respect to the penalty and interest provisions of the Internal Revenue Code of 1986,[1] pursuant to section 3801 of the IRS Restructuring and Reform Act of 1998 ("RRA 1998").[2] The first part of this report contains an executive summary, setting forth the Treasury Department's key recommendations with respect to the penalty and interest provisions of the Code. The executive summary is followed by the text of the report. The text delineates (1) the scope of the study; (2) the historical context of the present-law penalty and interest provisions; (3) the criteria relevant to evaluation of the penalty and interest provisions; (4) data on taxes, penalties and interest; (5) analysis and recommendations with respect to specific penalty and interest provisions; and (6) analysis and recommendations with respect to penalty and interest abatement provisions. Attached as appendices are (1) a compendium of the penalty and interest provisions of the Code (Appendix A); and (2) a summary of state income tax penalty and interest provisions for a sample of states (Appendix B).

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[1] Unless otherwise specified, references in this report to the "Code" refer to the Internal Revenue Code of 1986, as amended.
[2] Pub. L. No. 105-206, 112 Stat. 782 (1998).

EXECUTIVE SUMMARY

I. Purpose

Section 3801 of the IRS Restructuring and Reform Act of 1998 ("RRA 1998") directs the Secretary of the Treasury to undertake a study of the penalty and interest provisions of the Code. The study is to review the administration and implementation of those provisions and make any legislative and administrative recommendations deemed appropriate to simplify penalty or interest administration and reduce taxpayer burden. The Treasury Department, in consultation with the IRS and interested parties, has conducted its study and this report presents its analysis and recommendations.

II. Legislative Recommendations

Difficult balances must be struck to achieve a fair and effective system of sanctions involving different taxpayers and diverse causes for noncompliance. The overarching objectives are to foster and maintain a high degree of voluntary compliance, encourage taxpayers to promptly resolve noncompliance problems with the IRS, and impose a system of sanctions that is sufficient to discourage intentional noncompliance without imposing undue burden and complexity on taxpayers whose noncompliance is due to other factors. The penalty and interest regime also cannot be evaluated in isolation; it is one important facet of a complex and interactive system of tax collection mechanisms. The study also addresses the important distinction between penalties as sanctions and interest as compensation for the use of money, a distinction that presents difficult analytical issues and administrative considerations. Treasury also was mindful that the behavioral impact of significant changes in the penalty and interest regime cannot be predicted with precision and believes that caution is appropriate in making recommendations for change. Accordingly, Treasury makes the following legislative recommendations with respect to the penalty and interest provisions of the Code:[3]

[3] Proposed effective dates are not provided with these recommendations, and would be contingent on IRS implementation and other considerations.

Penalties for Failure to File Returns and Failure to Pay

Treasury recommends that the failure to file and failure to pay penalties be restructured to eliminate the frontloading of the failure to file penalty and to impose a higher failure to pay penalty than under current law. The frontloading of the failure to file penalty under current law in the first five months of a filing delinquency does not provide a continuing incentive to correct filing failures and imposes additional financial burden on taxpayers whose filing lapse may be coupled with payment difficulties so as to impede compliance. The filing obligation is of paramount importance to the tax system, but imposition of a severe penalty in the first five months of a filing delinquency appears incongruent with the availability of automatic extensions of time to file. Treasury proposes, accordingly, that the failure to file penalty be restructured to impose a lower penalty rate over a longer period of time, up to the current-law maximum amount. The current-law higher penalty for fraudulent failures to file, however, would be maintained. This proposal would maintain a failure to file penalty to encourage timely filing, but not impose as significant a financial burden as under current law for a filing lapse of short duration, while providing a continuing incentive for delinquent filers to correct a filing lapse of longer duration.

The failure to pay penalty should provide appropriate incentives to taxpayers to correct a payment delinquency and, if necessary, arrange for payment under various payment programs that the IRS makes available. A taxpayer who fails to make such arrangements in a timely manner should be subject to a higher penalty rate than that provided under current law. Treasury proposes, accordingly, that the failure to pay penalty be restructured to accomplish these purposes by imposing a penalty at the current rate of 0.5 percent per month for the first six months of a payment delinquency. The penalty rate would be raised to one percent per month for continuing payment delinquencies after the sixth month to provide an additional incentive to pay an outstanding tax liability. As under current law, the maximum penalty would be 25 percent. These penalty rates would be reduced if taxpayers make, and adhere to, arrangements with the IRS for payment. The failure to pay penalty would not be coordinated, as under current law, with the failure to file penalty to recognize that each form of delinquency is a separate act of noncompliance. More specifically, these recommendations would:

(1) Restructure the failure to file penalty to impose a penalty of 0.5 percent per month of the net amount due for the first six months of a delinquency in filing tax returns, which penalty rate will be increased to one percent per month thereafter, up to a maximum 25 percent. This restructured penalty would eliminate the current-law frontloading of the penalty into the first five months of a filing delinquency, providing a continuing incentive for delinquent filers to correct their filing delinquency over longer periods of time. The maximum penalty of 25 percent is the same as under current law. As under current law, fraudulent failures to file would be penalized at a higher penalty rate of 15 percent per month, up to a maximum of 75 percent.

(2) Restructure the failure to pay penalty to impose a penalty of 0.5 percent per month of the net amount due for the first six months of a payment delinquency, which rate would be increased to one percent per month thereafter, up to a maximum 25 percent. The penalty rate would be decreased from 0.5 percent to 0.25 percent per month if the taxpayer, within six months, enters into a payment arrangement with the IRS to which the taxpayer adheres. Likewise, the one-percent penalty rate would be reduced to 0.5 percent if the taxpayer, after the lapse of six months, enters into a payment arrangement with the IRS to which the taxpayer adheres.

Treasury also recommends that consideration be given to charging a fee, in the nature of a service charge, for late filing of “refund due” or “zero balance” returns. Presently, the failure to file penalty is imposed if a balance is due with the return but is not imposed if tax is not owed as a result, for example, of overwithholding. The importance of the filing obligation and the IRS administrative costs associated with nonfiling may warrant imposition of a fee for late-filed returns to encourage timely filing even if no balance is due with the return.

Penalties for Failure to Pay Estimated Tax

Treasury recommends that the current-law addition to tax for failure to pay estimated tax remain treated as a penalty. Treasury recognizes that the current sanction has attributes of interest and of a penalty. The ancillary effects, however, of converting the sanction to an interest charge do not warrant such a change. Conversion to an interest charge may mean that existing statutory waiver provisions are inappropriate. Conversion to interest also would permit corporations to deduct the payment of such sanction.

In recognition, however, of the potentially cumbersome nature of complying with the estimated tax payment requirements, the following simplifying changes are recommended for consideration:

(1) Individuals should not be subject to estimated tax penalties if the balance due with their returns is less than $1,000. Thus, estimated tax payments should be included in the calculation of the $1,000 threshold, but Treasury recommends this change under a simplified averaging method that would preclude taxpayers from satisfying the threshold by concentrating estimated tax payments in later installments.

(2) A reasonable cause waiver from penalty should be permitted for individuals who are first-time estimated taxpayers, provided the balance due on the tax return is below a threshold amount and is paid with a timely filed return.

(3) Penalty waiver should be provided for individual estimated tax penalties below a de minimis amount, in the range of $10 to $20.

Penalty for Failure to Deposit

Treasury recommends that few immediate changes be made to the deposit rules or penalties at this time to provide a sufficient period of time for changes to the deposit rules enacted by RRA 1998 to take effect. However, the penalty for failure to use the correct deposit method should be reduced from 10 percent to 2 percent. The current-law 10-percent penalty is too severe for this type of error.

Treasury also recommends that, in cases where depositors miss a deposit deadline by only one banking day, consideration be given to a reduction in the current penalty rate of two percent to a lower amount, but above an interest charge for a one-day delay.

Accuracy-Related and Preparer Penalties

The minimum accuracy standards, for disclosed and nondisclosed tax return positions, should be modified to impose the same standards on taxpayers and tax return preparers. A significant proportion of taxpayers rely on paid preparers. Such professionals have dual responsibilities to their client/taxpayers and to the integrity of the tax system and should be expected to be knowledgeable and diligent in applying the Federal tax laws.

The minimum accuracy standards should be raised to require a "realistic possibility of success on the merits" for a disclosed tax return position and "substantial authority" for an undisclosed return position The standards for tax shelter items of noncorporate taxpayers should be higher. In the case of disclosed positions, substantial authority and a reasonable and good faith belief that the position had a "more likely than not" chance of success should be required. For undisclosed positions, substantial authority should be accompanied by a reasonable and good faith belief that the position "should" prevail if challenged on the merits. A "should" standard is commonly understood to impose a significantly higher standard of accuracy than a "more likely than not" chance of success standard. The proposed changes in the accuracy standards would reduce the number of accuracy standards, impose minimum standards that are higher than current law litigating standards to discourage aggressive tax reporting, and eliminate divergence between the standards applicable to taxpayers and tax preparers.

Treasury also recommends that the "substantiality" requirement be modified as proposed in the Administration's FY 2000 Budget proposals such that, for corporate taxpayers, an understatement would be "substantial" if the understatement was the lesser of $10 million dollars or 10 percent of the tax required to be shown on the return. This report also incorporates, by reference, the recommendations made with respect to penalties applicable to corporate tax shelters in the Administration's FY 2000 Budget as modified by Treasury's White Paper on corporate tax shelters issued on July 1, 1999.

Treasury further recommends consideration of better harmonization of the substantial understatement and negligence penalties. In many cases, the standards applicable to the substantial understatement penalty may subsume the negligence standards. It may be appropriate to consider whether the negligence penalty should relate only to understatements that do not satisfy the "substantiality" requirement.

In determining the amount of the preparer penalty, consideration should be given to a fee-based or other approach to more closely correlate the preparer penalty to the amount of the underlying understatement of tax, rather than the current-law flat dollar penalty amount.

Penalty for Filing a Frivolous Return

The current-law penalty for filing a frivolous tax return should be raised from $500 to $1,500, but the IRS should abate the penalty for a first-time occurrence if a nonfrivolous return is filed within a reasonable period of time. This penalty amount was last raised in 1982 and significant numbers of such penalties are assessed. This approach will help bring taxpayers who file frivolous returns into better compliance.

Failures to File Certain Information Returns With Respect to Employee Benefit Plans

Several penalties currently apply to a qualified retirement plan's failure to file IRS Form 5500. These penalties should be consolidated into a single penalty not in excess of a monetary amount per day and not to exceed a monetary cap per return. This penalty would be waived upon a showing of reasonable cause. Welfare and fringe benefit plans should be subject to a similar single penalty.

Penalty and Interest Abatement

Interest Abatement

Abatement of interest in situations where taxpayers have reasonably relied on erroneous written advice of IRS personnel should be available. Treasury does not recommend further legislative expansion of the provisions permitting abatement of interest. A distinction exists between the imposition of interest as a charge for the use of money and penalties as sanctions for noncompliance. Because of this distinction, abatement of interest should be allowed in more limited circumstances than for penalties and generally restricted to circumstances where the IRS may be at fault or where serious circumstances outside the taxpayer's control result in payment delays. Current law provisions permitting abatement in circumstances of unreasonable IRS error or delay and in certain other prescribed circumstances provide sufficient scope for interest abatement at this time. In addition, taxpayers have recourse to other mechanisms for mitigation of interest and penalties, such as the offer-in-compromise program, which are in the early stages of implementing changes after enactment by RRA 1998.

Consideration of any modification of the current law monetary limitation on mandatory interest abatement in cases of erroneous refunds should be coupled with consideration of whether the IRS has adequate means under current law to recover erroneous refunds. Procedural impediments exist with regard to the recovery of erroneous refunds by assessment in all cases and litigation is required in some circumstances.

Penalty Abatement

Other than as described above, Treasury recommends that the IRS implement administrative improvements to ensure greater consistency in the application of penalty abatement criteria and enhanced quality review of penalty abatement decisions, as described below.

Interest Provisions

The underpayment interest rate (other than the "hot interest" rate) should be a uniform rate determined by appropriate market rates of interest. Treasury recognizes that no single rate is the appropriate market rate for all taxpayers but concludes that, for reasons of fairness and administrability, a single rate generally should apply to underpayments of tax. The appropriate rate should be in the range of the Applicable Federal Rate (AFR) plus two to five percentage points to reflect an average market rate for unsecured loans.

The existing rate differential between the underpayment and overpayment rates for large corporate underpayments and overpayments, including the “hot interest” rate on large corporate underpayments, should be retained. Because of the recent enactment of global interest netting rules, it is premature to eliminate existing rate differentials.

Treasury does not support an exclusion from income for overpayment interest paid to individuals. The legislative policy precluding deductions of consumer interest does not warrant such a change.

III. Administrative Recommendations

1. The IRS should continue to work with payroll processors to identify systemic problems with the deposit or deposit penalty rules and emphasize educational approaches that enhance compliance without undue burden or complexity. Treasury and the IRS should work with payroll processers to develop some type of “proxy” penalty that would not require the IRS to deal with large numbers of customers of a payroll processor when occasional or inadvertent deposit errors occur.

2. Administrative improvements in the penalty abatement process should be implemented to improve quality review of penalty abatements and refine the recordation and monitoring of the reasons for penalty abatements. Various programs of the IRS currently being developed to enhance the penalty abatement process should be implemented when administratively practicable.

3. On an ongoing basis, the IRS should improve the quality of its notices and communications to taxpayers regarding the basis for penalty and interest assessments and procedures for penalty and interest abatement.[4] Procedures to reduce the burden on the

[4] Section 3306 of RRA 1998 requires the IRS to include with each notice of penalty information that informs a taxpayer of the nature of the penalty and a computation of the penalty. Section

IRS and on taxpayers of abating penalties and interest should be instituted where and when administratively feasible.

4. On an ongoing basis, the IRS should undertake review of cases involving awards of attorneys' fees or cases where penalties have not been judicially sustained to enhance quality review of the administrative process, including, in particular, the accuracy-related penalties.

3308 of RRA 1998 requires that similar information be provided with respect to a notice that includes an amount of interest required to be paid.

I. SCOPE OF STUDY

A. Legislative Mandate

Section 3801 of RRA 1998 directed the Secretary of the Treasury and the Joint Committee on Taxation to conduct separate studies of the penalty and interest provisions of the Code. These studies were to review "the administration and implementation by the Internal Revenue Service of the interest and penalty provisions of the Internal Revenue Code of 1986 (including the penalty reform provisions of the Omnibus Budget Reconciliation Act of 1989)" and to make "any legislative and administrative recommendations the Committee or the Secretary deems appropriate to simplify penalty or interest administration and reduce taxpayer burden." The legislative history of RRA 1998 sets forth the legislative expectation that the Committee and the Secretary examine whether the current penalty and interest provisions encourage voluntary compliance, whether the provisions operate fairly, whether they are effective deterrents to undesired behavior, and whether they are designed in a manner that promotes efficient and effective administration of the provisions by the Internal Revenue Service.[5]

B. Solicitation of Public Comments

As part of its study, in January 1999, the Treasury Department issued a notice[6] soliciting public comments on the penalty and interest provisions of the Code. The notice invited public comments on the following issues:

1. whether the penalty and interest provisions of the Code encourage voluntary compliance (i.e., whether they are effective deterrents to noncompliance, tax avoidance, and fraud);
2. whether administration of these provisions by the Service encourages voluntary compliance;
3. whether the penalty and interest provisions are designed in a manner that promotes efficient and effective administration by the Service;
4. whether and how the Service's penalty and interest administration should be simplified or the burden modified on taxpayers and other third parties such as tax return preparers;

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[5] H.R. (Conf. Comm.) Rep. No. 599, 105th Cong., 2d Sess. 323 (June 24, 1998).
[6] Notice 99-4, 1999-3 I.R.B. 9. The Joint Committee on Taxation issued a similar notice in December 1998 (JCT Press Release 98-02).

5. whether the penalty and interest provisions are designed to operate, and are administered by the Service, fairly such that similarly situated taxpayers are treated alike;
6. whether the current penalty and interest provisions allow taxpayers to generate overpayments or underpayments in order to take advantage of disparities between commercial borrowing rates and the rates imposed by section 6621;
7. whether communications from the Service to taxpayers provide an adequate explanation of why penalties and interest were imposed so that taxpayers can avoid penalties and interest in the future;
8. the sources and scope of the Commissioner's authority to waive or not enforce penalties, and whether such authority should be modified;
9. whether the Commissioner's authority to abate interest under section 6404 should be modified;
10. whether the Service's administration of its penalty waiver and interest abatement authority is accomplished uniformly and fairly and the effect of the Service's administration of its penalty waiver and interest abatement authority (including the effect on compliance);
11. whether certain provisions of the Code should be clarified to identify whether they impose a penalty or tax (given that the characterization may affect the determination of when interest accrues thereon);
12. whether and how the penalty and interest regimes of voluntary tax systems of other countries compare to the U.S. federal tax penalty and interest regime; and
13. whether different entities should be subject to different penalty regimes, and whether penalty regimes should align with the four operating units of the Service's future structure.

In response to the notice for public comment, written submissions were received from a number of organizations and individuals. The comments of interested parties have been carefully taken into account in this study and in the preparation of this report. Treasury wishes to thank all those who submitted comments in connection with this study. The comments have assisted us in examining the policy, legal, and administrative issues related to the penalty and interest provisions of the internal revenue laws.

C. Methodology of Study

In addition to solicitation of public comments, the Treasury Department assembled a task force comprised of representatives of the Treasury Department's Office of Tax Policy, representatives of the IRS Office of Chief Counsel, Office of Specialty Taxes, and Research and Statistics of Income Division, and representatives of the Department of Justice. The task force reviewed and considered the public comments, reports of prior IRS task forces or working groups on penalty and interest issues, and other available reports and studies in analyzing the present-law penalty and interest provisions. Other personnel within the IRS were consulted. Available data on penalty and interest assessments and abatements were considered. The Treasury Department also had the benefit of discussions with the staff of the Joint Committee on Taxation, which shared with Treasury a review of abatement statistics and administrative processes conducted at the request of the Committee staff by the General Accounting Office.

As a result of the foregoing, the Treasury Department determined to concentrate its study and this report on the principal civil penalty and interest provisions of the Code. Specifically, the penalties given primary consideration are the: (1) failure to file penalty (Code section 6651(a)(1)); (2) failure to pay penalty (Code section 6651(a)(2), (3)); (3) estimated tax penalties (Code sections 6654 and 6655); (4) deposit penalties (Code section 6656); and (5) accuracy-related and preparer penalties (Code sections 6662, 6694 and 6695). In addition and pursuant to the legislative mandate, the study focuses on the interest provisions of the Code, their relationship to certain of the penalty provisions, and penalty and interest abatement issues. Several factors were influential in determining the focus for the Treasury's study and this report.

A threshold issue was the definition of a "penalty" that would be used in defining the scope of Treasury's study. In its broadest sense, a penalty can be defined to encompass any adverse consequence of a failure to comply with the internal revenue laws. On the other hand, the Code denominates certain provisions as additions to tax or penalties (civil and criminal); and these are principally found in Code sections 6651 through 6724 (additions to tax and civil penalties) and sections 7201 through 7275 (criminal penalties). A broad definition potentially encompasses adverse consequences that are not statutorily denominated as penalties but that, in certain contexts, may be considered to function as such. For example, the denial of a tax deduction or credit for failure to meet certain requirements of the Code (e.g., failure to maintain the proper documentation to support a deduction or credit) might be viewed as a sanction. The denial of an opportunity for administrative or judicial review of the merits of a taxpayer's position on an issue of substantive tax law due to the taxpayer's failure to comply with applicable periods of limitation or exhaustion of administrative remedies also can be viewed as a sanction. If any adverse consequence is considered a penalty, however, the study necessarily would subsume numerous provisions of the Code that are not traditionally denominated as penalties and require consideration of different concepts and issues. For example, the civil penalty provisions of the Code generally can be abated if the taxpayer demonstrates reasonable cause and not willful neglect, and such penalties generally also are subject to certain rules regarding their imposition and the procedural rights of taxpayers in disputing such penalties. These rules are not necessarily applicable, or may apply differently, to other types of situations involving a failure to comply with the internal revenue laws. On the other hand, certain types of sanctions, for example, excise taxes on greenmail, golden parachute payments, or on prohibited transactions in the context of tax exempt organizations, are not traditionally denominated as penalties, but more closely function as such in the sense that they not only deprive a taxpayer of a particular tax result but impose an additional cost on the parties treated as responsible for the undesired conduct. On balance, Treasury concluded that its study and this report should focus on those penalties and additions to tax that are denominated as such in the Code, were the focus of public comment, and account for the majority of penalty assessments.

As stated, the primary focus is on those penalties that relate to a taxpayer's basic tax obligations and which comprise the vast majority of penalties assessed and abated -- the penalties for failure to file, to pay, or to "pay-as-you-go" through withholding or estimated tax payments. In addition, the study focuses on the accuracy-related and preparer penalties which, although not assessed in comparable numbers, are an important component of the penalty structure in the context of disputes between the IRS and taxpayers regarding the correctness of a reported tax liability. The report does not include discussion of penalties relating to corporate tax shelters because those penalties were already discussed in detail by the Treasury Department in its White Paper on corporate tax shelters.[7] That study includes specific analyses and recommendations pertaining to those penalties most germane to corporate tax shelters, and such penalties are more appropriately considered in the larger context of the corporate shelter-related substantive

[7] Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals (July 1, 1999) (hereinafter, "Treasury Corporate Tax Shelter White Paper").

provisions of the tax laws. The analyses and recommendations of that report are included herein by reference.

In addition, although an important feature of the tax reporting and penalty regime, Treasury treated the information reporting rules and attendant penalties as generally outside the scope of the study. There are presently over fifty provisions in the Code (Code sections 6031 through 6060) that impose information reporting on different types of persons and transactions. The issues that arise with respect to information reporting rules, related withholding rules, and penalties are distinct in a number of respects from those that arise with respect to the more routine civil penalties. Treasury will give careful consideration, however, to public comments received in connection with information reporting penalties and work with the Congress on any legislative changes that may be appropriate. The Administration's FY 2000 Budget proposals also made recommendations with respect to information return penalties.[8]

The report focuses on civil tax penalties and not on the criminal tax penalties contained in the Code. Criminal penalties are the most serious sanction for conduct violative of the tax laws, but consideration of those penalties involves different conceptual issues of procedural protections, administrative and judicial process and other issues not present in the context of civil penalties.[9] Although criminal tax penalties are investigated by IRS agents, they also are investigated by other Federal agencies and many prosecution policies are determined by a different Federal agency -- the Department of Justice. Moreover, civil penalties comprise roughly three-fourths of the penalty provisions in the Code and are imposed with greater frequency than criminal penalties. Thus, this report focuses on the civil penalties that affect a greater proportion of the taxpaying public, were the focus of public comment and concern, and do not raise the types of conceptual issues inherent in a study of criminal penalties.

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[8] See Department of the Treasury, General Explanations of the Administration's Revenue Proposals 187 (Feb. 1999). To encourage timely and accurate reporting in cases of large volumes of information returns or reporting of significant payments, the Administration proposes an increase in the penalty for failure to file or accurately report, subject to certain limitations.
[9] See, e.g., United States v. Grunewald, 987 F.2d 531, 534 (8^{th} Cir. 1993)("Significantly different rights, responsibilities, and expectations apply to civil audits and criminal tax investigations.").

D. General Policy Considerations

The Treasury Department believes that any reconsideration of present-law penalty or interest provisions of the Code should be accorded careful scrutiny. The last major legislative reconsideration of the penalty provisions occurred in connection with the Omnibus Budget Reconciliation Act of 1989. That legislative reconsideration was preceded by a major IRS study of the penalty and interest provisions.[10] Since that time, Congress has amended the penalty and interest provisions numerous times, most recently in RRA 1998. A number of those legislative changes are relatively recent and their impact cannot yet be gauged.

RRA 1998, in particular, contains a number of provisions affecting the civil penalty and interest provisions of the Code. Most notably, with respect to interest, the interest rate on overpayments and underpayments for individual taxpayers was equalized and global interest netting was enacted for all taxpayers. RRA 1998 also provided for the suspension of interest if the IRS fails to notify a taxpayer of his or her liability for tax within certain specified time periods. New requirements were added to require better notification to taxpayers of penalty and interest liabilities and underlying computations. In addition, important modifications were made to the deposit rules to ameliorate identified deposit timing problems and to certain penalty provisions and related procedural rules (e.g., mitigation of the failure to pay penalty for taxpayers paying through installment agreements) to address particular concerns. This legislation also contained provisions affecting a number of IRS programs that enable taxpayers to arrange payment of outstanding liabilities, including the installment agreement and offer in compromise programs, and provided new taxpayer rights with respect to IRS collection procedures. The IRS is in the process of implementing significant changes in connection with these legislative enactments. In the future, these legislative changes and administrative actions should have an important impact, among others, on the penalty and interest regime.

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[10] Internal Revenue Service, Report on Civil Tax Penalties by Executive Task Force, Commissioner's Penalty Study (February 1989) (hereinafter "1989 Task Force Report").

More generally, any reconsideration of existing law should be cognizant of the ongoing reorganization of the IRS, a process which, as the Commissioner has testified on several occasions, will require several years to implement and will include a major functional reorganization of the IRS, significant computer modernization, deployment of interactive technology, enhanced employee training and other efforts designed to enhance service to taxpayers. As has been described on numerous occasions, historically the IRS has been organized along geographic lines, which has involved duplication and dispersal of functions. Concerns expressed regarding the burden imposed on taxpayers by the penalty and interest provisions of the Code may, in part, reflect underlying deficiencies in the IRS's ability to detect and resolve disputes quickly with taxpayers. These concerns should be mitigated in the future as the reorganization proceeds and the IRS is able to interact more efficiently and effectively with taxpayers. In this environment, changes to the penalty and interest provisions should not engender undue administrative complexity that would impede the ongoing reorganization. Implementation of the recommendations in this study are contingent on the ability of the IRS to make the necessary administrative changes.

Another important policy consideration is the status of the government as an involuntary creditor. Commercial institutions, in contrast to government, compete in the marketplace for customers and have different means of managing the risks associated with borrowing and lending. Comparisons of the behavior of government and commercial institutions arise in connection with the interest provisions of the Code and certain penalties that have features of an interest charge. Conceptually, however, there may be important distinctions between government and the private sector that influence the approach of the internal revenue laws to the imposition of penalties and interest.[11]

Finally, the compliance and burden considerations articulated by the legislative mandate subsume a number of different issues that inherently reflect competing concerns. The theoretical

[11] The Treasury Department's report to Congress on netting of interest overpayments and underpayments, Report to the Congress on Netting of Interest on Tax Overpayments and Underpayments (April 1997) at 16-20 contains a discussion of the different approaches the interest provisions reflect with respect to treating the government as akin to a commercial borrower and lender (hereinafter "Treasury Global Interest Netting Report").

literature and available empirical evidence generally provide qualitative insights without reconciliation of these competing issues. When the theoretical and empirical issues are analyzed, difficult choices among alternatives often remain. The fundamental objective should be to foster and enhance the high degree of voluntary compliance that presently exists among the taxpaying public without undue burden or complexity. Relatedly, where taxpayers have genuine difficulty in meeting their tax obligations, the penalty and interest provisions should encourage timely resolution of taxpayer noncompliance without undue administrative complexity and in a manner that does not impair voluntary compliance.

II. Overview of Major Penalty and Interest Provisions

To analyze the present-law penalty and interest provisions, it is useful first to consider briefly their historical development.[12] A historical perspective provides a useful context for an understanding of the current-law penalty and interest regime. The following summary does not describe every change in the penalty and interest provisions that has occurred over time, but is intended to capture the main components of those changes since 1954.[13]

Our Federal income tax system is a "self assessment" system and, concomitantly, the internal revenue tax laws impose three principal obligations upon taxpayers – to file timely returns, to report the correct tax owed, and to pay timely the amount due and owing. Since World War II, this system has been operated as a "pay-as-you-go" system supported by withholding on wages and comparable obligations for non-wage income. Over time, this regime has been supplemented with reporting requirements on third party payors and penalties for information reporting noncompliance directed toward more accurate reporting of certain types of income and expenses. The system of sanctions has evolved in tandem with the underlying system for collecting tax revenues.

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[12] Portions of the ensuing discussion are reprised from the 1989 Task Force Report, supra note 10, at Chapter 5.

[13] In this regard, the 1989 Task Force Report contains a description of the significant changes in the penalty provisions enacted between 1954 and 1988. That report is relied on in this discussion for this period, but is supplemented by a discussion of changes in the penalty provisions subsequent to 1988 and in the interest provisions, both of which were not within the scope of that report.

A. Penalties

Penalties for violations of Federal tax laws have been a component of such laws since the Civil War period. The earliest penalty provision enacted for an income tax was a criminal sanction designed to effectuate the collection of tax.[14] Another early penalty provision was enacted in 1862, imposing a 5-percent penalty for default in payment where such default extended beyond 30 days. The major civil tax penalties, however, were not enacted until 1918, when the 1918 Revenue Act provided for a 5-percent penalty for negligence and a 25-percent penalty for a false or fraudulent return. By the time the Internal Revenue Code of 1954 (hereinafter, the "1954 Code") was enacted, civil penalties were still few in number and constituted a relatively insignificant aspect of tax administration. By contrast, the Internal Revenue Code of 1986 presently contains over 100 civil and criminal penalties, approximately three quarters of which are civil penalties that provide for monetary sanctions. In further elaborating on this development, it is useful to begin with the 1954 Code and divide the period to the present into five major periods: (1) 1954, (2) 1955-1974, (3) 1975-1988, (4) 1989, and (5) 1990 to the present.

1. 1954

The 1954 Code contained 13 civil penalties. The major civil penalties were comprised of two basic types – penalties for breaches of the basic filing and "pay-as-you-go" obligations and penalties applicable to understatements of tax. Penalties of the first type were imposed for failure to file a return,[15] failure to pay estimated tax,[16] and failure to use the federal depository system.[17] Two penalties existed in relation to understatements of tax: the negligence and fraud penalties.[18] There was no separate penalty, as now, for failure to pay the tax shown on a return to be due or for failure to pay the correct amount of tax, i.e., the amount of tax that should have

[14] Act of August 5, 1861 sec. 51, 12 Stat. 292.
[15] Code section 6651 (1954 Code).
[16] Code sections 6654 (individuals) and 6655 (corporations) (1954 Code).
[17] Code section 6656 (failure to deposit) and 6672 (failure to pay over trust fund taxes) (1954 Code).
[18] Code section 6653(a) (negligence) and 6653(b) (fraud) (1954 Code).

been reported on the return. Limited information reporting also was required and failure to comply with such requirements was penalized.[19]

The penalties were relatively simple in design. The failure to file penalty originally was a flat 25 percent of the tax due on the return regardless of how late the return was filed.[20] Subsequently, to encourage early correction of filing delinquencies, Congress amended the penalty to 5 percent per month, up to a maximum of 25 percent.[21] The penalty could be waived if the failure was due to reasonable cause and not to willful neglect.

An estimated tax penalty was imposed if the tax paid was less than 70 percent of the final tax liability shown on the return.[22] The penalty was imposed at a rate of 6 percent annually on the shortfall. Realizing the difficulty for some taxpayers in making accurate estimates, a safe harbor was enacted based on a taxpayer's tax liability for the preceding year.[23] The penalty could not be waived for reasonable cause. Depositors also were penalized for failure to deposit taxes paid into an authorized governmental depository. As enacted in the 1954 Code, the deposit penalty was time sensitive. The penalty was one percent per month (plus one percent for each additional month (or fraction thereof)) during which the failure existed, not to exceed 6 percent in total. The penalty could be waived if the failure was due to reasonable cause and not willful neglect.

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[19] Code section 6652 (1954 Code). The other civil penalties in the 1954 Code related to the failure to pay stamp tax (section 6653(e)), bad checks (section 6657), jeopardy situations (section 6658), damages for instituting Tax Court proceedings for reasons of delay (section 6673), and furnishing fraudulent statements (or failing to furnish required statements) to employees (section 6674).

[20] The penalty originally was enacted in this form in the Revenue Act of 1928.

[21] Enacted in the Revenue Act of 1936.

[22] Code sections 6654(b) and 6655(b) (1954 Code).

[23] The estimated tax penalty originally was enacted in the Current Tax Payment Act of 1943; the safe harbor based on the prior year tax liability was enacted shortly thereafter in the Revenue Act of 1943. Corporations were brought into the estimated payment regime with adoption of the 1954 Code.

The negligence penalty was imposed at a rate of 5 percent of an underpayment if any part of the underpayment was due to negligence or intentional disregard of rules or regulations.[24] If due to fraud, the penalty was increased to 50 percent of the underpayment.[25] These penalties could be waived upon a showing of reasonable cause.

2. 1955-1974

Between 1955 and 1974, "most changes to penalties and their administration occurred either in response to key compliance concerns or in connection with the computerization of the IRS."[26] Briefly summarized, the compliance issues addressed by penalties during this period "took the form either of a violation of existing law for which the remedy seemed inadequate or the addition of a new statutory rule that required the support of a sanction."[27] The principal example of the former category was the enactment in the Tax Reform Act of 1969[28] of the failure to pay penalty. This penalty was enacted essentially as an interest surcharge because the interest rate charged was perceived to be too low to adequately discourage taxpayers from using the government as a low-cost source of funds.[29] With respect to the latter category, a number of information return penalties were added in relation to new reporting requirements in the international tax context.[30] Expanded information return reporting of interest and dividends was adopted in response to perceived underreporting of such income, with concomitant penalties for failure to provide correct payee identification numbers or to file required statements.[31] New

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[24] Code section 6653(a) (1954 Code).
[25] Code section 6654(b) (1954 Code).
[26] 1989 Task Force Report, supra note 10, at V-5. That report contains (at V-5 through V-10) a more detailed description of the changes enacted to the penalty structure between 1955 and 1974. Only the salient highlights are summarized in the text above.
[27] Id. at V-6.
[28] Pub. L. No. 91-172, sec. 943(a), 83 Stat. 727 (1969).
[29] See S. Rep. No. 552, 91st Cong., 1st Sess. 297-98 (Nov. 21, 1969)("Since the current cost of borrowing money is substantially in excess of the 6 percent interest rate provided by the Code, it is to the advantage of taxpayers in many cases to file a return on the due date but not to pay the tax shown as owing on the return.").
[30] 1989 Task Force Report, supra note 10, at V-6.
[31] Id. at V-7 – V-8.

rules and sanctions were enacted with respect to exempt organizations and employee plans.[32] Each of these measures addressed particular compliance concerns in relatively discrete areas.

3. 1975-1988

Beginning in 1976, "[b]roader compliance issues were attacked legislatively, and the pace of tax legislation picked up considerably."[33] During this period, the principal focus of legislation was the rules and sanctions affecting tax preparers and tax shelters.

On the basis of estimates that a substantial proportion of taxpayers relied upon the assistance of paid preparers, the IRS began to examine the conduct of such preparers and, in a series of reports to Congress,[34] determined that substantial numbers were engaging in abusive practices. Although consideration was given to regulating preparers, the approach selected was the imposition of penalties on preparers for engaging in certain types of conduct. These penalties were enacted as part of the Tax Reform Act of 1976,[35] and included the power to penalize tax preparers who failed to enter their TIN on a return, who cashed refund checks, or who negligently or intentionally disregarded the law when preparing a tax return.[36] Congress also provided the Secretary with authority to seek injunctive relief against preparers who engaged in certain types of abusive conduct.[37] These penalties remained relatively unchanged through 1988.[38]

The other major thrust of Congressional action occurred in response to the widespread problem of individual tax shelters. The Treasury Department's Corporate Tax Shelter White

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[32] Id. at V-8 – V-10.
[33] Id. at V-19. See pages V-19 through V-40 for a more detailed description.
[34] Id. at V-20 – V-21.
[35] Pub. L. No. 94-455, sec. 1203 (1976).
[36] See sections 6107 (requiring that a copy of the return be provided to the taxpayer); 6109(a)(4) (requiring preparer to enter his or her TIN on the return); 6694 (penalty for understatement of taxpayer's liability by preparer); 6695 (other assessable penalties applicable to preparers)
[37] Code section 7407. As originally enacted, the preparer could forestall an injunction by providing a bond as surety for the payment of penalties under sections 6694 and 6695. This mechanism was repealed in 1989.

Paper describes this history in greater detail, but the salient features of the approach taken to penalties in this context are as follows.[39] Prior to 1982, Congress responded to the widespread syndication of tax shelters by tightening and modifying a number of existing penalties.[40] The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made a number of contributions to the battle against tax shelters, including a penalty for substantial understatements of tax.[41] This penalty imposed a different standard of conduct than the standard underlying the negligence and fraud penalties. It was not as dependent on the acts or omissions of the taxpayer but, instead, on the strength of the position reported on the return and whether the position was disclosed. This shift in approach was the result of concern that the negligence and fraud penalties did not adequately deter aggressive tax reporting or reliance on the "audit lottery." As enacted, the penalty focused on the persuasiveness of the taxpayer's position and was avoidable through the existence of substantial authority for the return reporting position. In the absence of substantial authority, the penalty was only avoidable if the position was not frivolous and the relevant facts were disclosed on the tax return.

If the issue involved a tax shelter, the standards imposed were more stringent. A "tax shelter" was defined for this purpose as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if the principal purpose of such [arrangement] is the avoidance or evasion of Federal income tax."[42] For tax shelter items, in addition to the substantial authority standard, a second requirement was imposed that the taxpayer reasonably believed that the tax treatment was "more likely than not" the proper treatment. The penalty could be waived by the Secretary on a showing of reasonable cause for the understatement and

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[38] The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 6242 (1988), enacted an additional preparer penalty (section 6712, redesignated by the Omnibus Budget Reconciliation Act of 1989 as section 6713) relating to disclosure of a client's tax affairs.
[39] See Treasury Department Corporate Tax Shelter White Paper, supra note 7, at 59 - 71.
[40] For example, the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, strengthened rules regarding tax straddles, and imposed a penalty for valuation overstatements. New reporting rules applied with respect to straddles and failure to comply was presumed negligent and penalized by the negligence penalty amount and, in addition, an amount equal to 50 percent of the interest thereon. See 1989 Task Force Report, supra note 10, at V-25 – V-26.
[41] Code section 6661, as enacted by Pub. L. No. 97-248, sec. 323 (1982).
[42] Code section 6661(b)(2)(C)(ii) (as enacted).

good faith.[43] As originally enacted, the substantial understatement penalty was 10 percent of the underpayment, but this rate was raised in 1986 to 25 percent.[44]

In addition to the substantial understatement penalty, civil penalties were enacted with respect to the promotion of abusive tax shelters and aiding and abetting the understatement of tax.[45] The IRS also was provided with statutory authority to seek injunctions against tax shelter promoters.[46] In 1984, tax shelter promoters were required to register shelters with the IRS and maintain lists of investors.[47] Penalties were imposed for failure to comply with these requirements.[48] The registration requirements enabled the IRS to prescreen shelters and take appropriate action including, where warranted, injunctive relief or pre-notification letters advising investors that the shelter was considered abusive and that claimed tax benefits, if reported on an investor's tax return, would be disallowed. Further toughening of penalties occurred in the Tax Reform Act of 1984[49] and the Tax Reform Act of 1986.[50]

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[43] Code section 6661(c) (as enacted).

[44] The penalty rate was raised to 20 percent by the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1504 (1986), but was almost immediately raised to 25 percent by the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, sec. 8002 (1986).

[45] Code sections 6700 and 6701. These penalties were enacted based on the perception that "the promoter, professional advisor or salesman of a tax shelter generally is more culpable than the purchaser who may have relied on their representations as to the tax consequences of the investment." Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 210-11 (Dec. 31, 1982). The accountability imposed on promoters and organizers of tax shelters recognized the role of such persons in inducing taxpayers to invest in, and in making representations regarding the legal sufficiency of, such arrangements.

[46] Code section 7408.

[47] Code sections 6111 and 6112, enacted as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. These provisions reflected legislative concern that "promoters of and investors in syndicated investments and tax shelters [were] profiting from the inability of the Treasury Department to examine every return." S. Rep. No. 169, 98th Cong., 2d Sess. 425 (Apr. 2, 1984). See Treasury Department Corporate Tax Shelter White Paper, supra note 7, at 61-65.

[48] Code sections 6707 and 6708.

[49] The interest rate for tax-motivated transactions was raised to 120 percent of the otherwise applicable rate (section 6621(d)), and the valuation penalty was broadened through the addition of section 6660. The penalty for promotion of an abusive tax shelter was increased from 10 percent to 20 percent.

[50] The fraud penalty was increased to 75 percent and the overvaluation penalties were broadened to encompass pension matters with the addition of section 6659A. The negligence penalty was

Notwithstanding these primary compliance concerns, Congress also made a series of changes or additions to the penalty structure reflecting more discrete concerns. TEFRA enacted a penalty for filing a frivolous return.[51] The Omnibus Budget Reconciliation Act of 1986 raised the deposit penalty from 5 percent to 10 percent.[52] The failure to pay penalty was increased from one-half to one percent per month after a taxpayer was notified of the IRS's intent to levy. The Technical and Miscellaneous Revenue Act of 1988[53] modified the negligence and fraud penalties by eliminating their interest component. Instead, the penalties were to bear interest from the due date of the return rather than from the date of notice and demand for payment.[54] The fraud penalty was redesigned to apply only to the portion of the underpayment attributable to fraud; however, after fraud was proven, the penalty would apply to the entire underpayment unless the taxpayer established the portion not due to fraud.[55] Legislative focus continued on expansion of the information reporting rules.[56] Other penalties also were added or modified during this period, for example, to increase the penalty for false information on a withholding certificate and to provide a penalty for overstated claims of tax deposits.[57]

4. 1989

In 1989, the IRS issued a report on the penalty structure after a multi-year study of the then-current penalty provisions. Following issuance of this report, Congress undertook a major review of the penalty provisions. This review resulted in enactment of the Improved Penalty Administration and Compliance Tax Act (IMPACT), which was incorporated into the Omnibus Budget Reconciliation Act of 1989.[58]

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extended to all taxes and the definition of negligence was changed to include "any failure to make a reasonable attempt to comply with the provisions of the Code."

[51] Code section 6702.

[52] Pub. L. No. 99-509, sec. 8001 (1986). See 1989 Task Force Report, supra note 10, at V-32.

[53] Pub. L. No. 100-647, sec. 1015 (1988).

[54] The 1989 Task Force Report, supra note 10, at V-33, observed that this was "a radical departure from past practice whereby additions to tax were made only after notification to the taxpayer" and while this was still true for the penalty, it no longer was true for the interest on the penalty.

[55] Technical and Miscellaneous Revenue Act of 1988, supra note 53, sec. 1015.

[56] See 1989 Task Force Report, supra note 10, at V-34 through V-40.

[57] See id. at V-48 – V-51.

[58] Pub. L. No. 101-239, 103 Stat. 2106 (1989).

IMPACT streamlined and revamped the civil tax penalty provisions and made a number of administrative recommendations.[59] This legislation effectuated changes principally in the categories of document and information return penalties; accuracy-related penalties; preparer, promoter and frivolous return penalties; and penalties for failures to file or pay. With respect to information reporting penalties, the penalty for failure to file correct information reports[60] was modified to calibrate the penalty on the basis of when, if at all, the correct information return was filed. This change was made to encourage information return filers to provide correct information by reducing the penalties when a corrected return was filed. Other changes were made with respect to penalties for failure to furnish correct payee statements; other reporting requirements, waiver, definitions, and special rules; penalties for failure to report information with respect to certain foreign corporations; and uniform requirements for returns on magnetic media.[61]

The accuracy-related penalties to that point were separate, cumulative penalties (for negligence and fraud, substantial understatement, gross overvaluation, and estate or gift tax valuation understatement).[62] In IMPACT, this penalty structure was simplified and rationalized by separating the delinquency and accuracy-related penalties such that the accuracy penalties would apply only to filed returns.[63] To accomplish this, IMPACT repealed the existing penalties for negligence, substantial understatement, and valuation overstatements and understatements, and combined them into a single penalty under Code section 6662.[64] The penalty rate was made

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[59] Including, for example, development by the IRS of a penalty policy statement and handbook of penalty administration. These two recommendations were implemented by development of Policy Statement P-1-18 and the Penalty Handbook, I.R.M. 120.1 (Rev. Aug. 20, 1998).

[60] Code section 6721.

[61] Code sections 6722, 6723, 6724, 6038 and 6011(e). See H.R. Rep. No. 247, 101st Cong., 1st Sess. 1381-87 (Sept. 20, 1989).

[62] These penalties were found in Code sections 6653 (negligence and fraud), 6659 (valuation overstatement), 6659A (overstatement of pension liabilities), 6660 (estate and gift tax valuation understatement), and 6661 (substantial understatement).

[63] Prior to IMPACT, both the delinquency and accuracy penalties applied to failures to file and some courts had held that a failure to file without reasonable cause was per se negligent. After IMPACT, accuracy penalties only applied to returns filed by the taxpayer. See H.R. Rep. No. 247, supra note 61, at 1393-94.

[64] According to the legislative history, id. at 1389, the accuracy-related penalties were reorganized “into a new structure that operates to eliminate any stacking of the penalties.”

a uniform 20 percent. The fraud penalty was enacted as a separate penalty in Code section 6663. A reasonable cause waiver was provided in Code section 6664 that was applicable to all accuracy-related penalties.[65] In addition, prior to IMPACT, the negligence penalty applied to an entire underpayment if any part was due to such conduct. This was changed so that the negligence penalty only applied to the portion of the underpayment due to negligence.[66] The legislation retained the rules applicable to the fraud penalty so that the penalty applied to the portion of an underpayment attributable to fraud and, if fraud was determined, the entire underpayment was presumptively fraudulent unless the taxpayer established otherwise.[67] Among other changes, the authority upon which taxpayers could rely as "substantial authority" was expanded and a standardized definition of "underpayment" was provided to simplify and coordinate the prior-law definitions.[68]

A number of additions or changes were made with respect to the promoter, preparer and frivolous return penalties. The penalty for instituting frivolous suits in the Tax Court was increased from $5,000 to $25,000. The frivolous return penalty was modified by repealing the

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[65] Enactment of a standardized exception criterion was "designed to permit the courts to review the assertion of penalties under the same standards that apply in reviewing additional tax that the IRS asserts is due." It also was expected that "taxpayers will more easily understand the standard of behavior that is required" and that unified exception criteria would "simplify the administration of these penalties by the IRS." In enacting the reasonable cause exception under section 6664, the legislation repealed the section 6661(d) reasonable cause waiver because the courts had reviewed that waiver under an abuse of discretion standard and it was expected that the new reasonable cause criterion would "provide greater scope for judicial review." Id. at 1392-93.

[66] This change was intended to remove the inequity of the negligence penalty being equally applicable in situations where a small portion, or all, of the underpayment was due to negligence. Id. at 1389. This targeting with respect to the fraud penalty had occurred in 1988. The legislation also repealed the presumption of negligence applicable in cases of failure to report amounts shown on information returns.

[67] In establishing items not attributable to fraud, the burden of proof on the taxpayer was clarified to be a preponderance of the evidence. The burden of proof on the IRS to initially establish fraud remained the clear and convincing evidence standard.

[68] The rule that interest on these penalties commenced with the date the return was required to be filed was maintained. The legislative history, supra note 61, at 1394, states that "this rule is appropriate because the behavior being penalized is reflected on the return" and the rule "will reduce the incentives of taxpayers and their advisors to play the 'audit lottery.'"

provision that allowed the filing of a refund suit by prepayment of 15 percent of the penalty.[69] The preparer penalty was revised to replace the negligence standard with a standard that imposed a penalty for positions the preparer knew, or should have known, did not have a "realistic possibility of being sustained on the merits" and which were not disclosed or were frivolous.[70] Among other changes, because the fraud penalty was amended to apply only to filed returns, IMPACT enacted the fraudulent failure to file penalty to apply at a rate of 15 percent per month, up to a maximum 75 percent. IMPACT also established a four-tier deposit penalty structure to encourage earlier deposits prior to discovery by the IRS of the failure to make a timely deposit.[71]

5. 1990 to the present

Between 1990 and 1997, a number of legislative enactments tightened the accuracy-related penalties. A number of technical changes also were made to modify the estimated tax payment rules. Beginning with the Taxpayer Bill of Rights 2,[72] the legislative focus shifted to amelioration of penalties in certain circumstances. This process continued through RRA 1998, which made a more extensive series of changes to mitigate the effects of penalties in certain situations. During this period, penalties generally were only added to the Code in relation to new types of economic transactions, such as new types of savings accounts, or new information reporting requirements. The most important features of these legislative acts are described below.

Omnibus Budget Reconciliation Act of 1990:[73] This legislation modified the deposit rules relating to next banking day deposits for payrolls of $100,000 or more and modified the accuracy-related penalty with respect to Code section 482 adjustments.

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[69] This repeal was based on the view that taxpayers who contest this penalty should be positioned similarly to taxpayers who must pay the full amount of income tax before filing a refund suit. Id. at 1399.

[70] This standard was adopted "because it generally reflects the professional conduct standards applicable to lawyers and certified public accountants." Id. at 1396. The penalty amounts also were increased to their current-law levels.

[71] See generally H.R. Rep. No. 247, supra note 61, at 1402-04.

[72] Pub. L. No. 104-168, 110 Stat. 1452 (1996)

Emergency Unemployment Compensation Act of 1991:[74] This legislation made changes to the estimated tax provisions for individuals regarding the use of the preceding year's tax computation in calculating the current year's estimated tax payments.

Tax Extension Act of 1991:[75] This legislation also modified the estimated tax provisions, making changes for specified taxable years in the current year's tax applicable percentage for corporations that did not use the safe harbor of 100 percent of the prior year's tax computation.

Public Law No. 102-244:[76] This legislation made further temporary modifications to the current year's tax applicable percentages for corporate estimated tax payments.

Unemployment Compensation Amendments of 1992:[77] This legislation made further modifications to the current year's tax applicable percentage for corporate estimated tax payments. Apart from the temporary changes previously enacted (which were also modified), the applicable percentage for required installment amounts was raised from 90 percent to 91 percent of current year's tax.

Omnibus Budget Reconciliation Act of 1993:[78] This legislation enacted a number of modifications to the penalty provisions. Among other changes, additional amendments were made to the estimated tax payment rules, in particular to raise the current year's tax applicable percentage for corporations from 91 percent to 100 percent. In addition, the accuracy-related penalty was modified by changing the "not frivolous" disclosure standard to a "reasonable basis" standard.[79] The threshold amount for the transfer pricing adjustment that triggers a substantial

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[73] Pub. L. No. 101-508, 104 Stat. 1388 (1990).
[74] Pub. L. No. 102-164, 105 Stat. 1049 (1991).
[75] Pub. L. No. 102-227, 105 Stat. 1686 (1991).
[76] There is no formal title to this public law; it is an extension of the Emergency Unemployment Compensation Act of 1991.
[77] Pub. L. No. 102-318, 105 Stat. 290 (1992).
[78] Pub. L. No. 103-66, 107 Stat. 313 (1993).
[79] The stated reason was that the "not frivolous" standard "does not sufficiently discourage taxpayers and preparers from taking unreasonable return positions." H.R. Rep. No. 111, 103d

valuation misstatement penalty also was lowered and the reasonable cause/good faith exception was replaced with an exception contingent on the taxpayer's adherence to certain prescribed requirements.

Uruguay Round Agreements Act of 1994:[80] This legislation made an important modification to the accuracy-related penalty with respect to corporate tax shelters. It eliminated the exception to the substantial understatement penalty for items for which the taxpayer had substantial authority and reasonably believed its position was more likely than not to prevail. Thus, after this change, the penalty could be avoided only upon a showing of reasonable cause.[81] Amendments also were made to the estimated tax provisions relating to the treatment of subpart F and Code section 936 income.

Taxpayer Bill of Rights 2:[82] This legislation made a number of changes to the penalty provisions, the majority of which were intended to mitigate or rectify certain inequities. Among other changes, authority was provided to waive the deposit penalty for first-time depositors, i.e., if the failure to deposit occurred during the first quarter that employment tax deposits were required, providing certain other requirements were met.[83] The penalty also could be abated for first-time depositors if the deposit was inadvertently sent to the IRS rather than to the required government depository. The failure to pay penalty was applied to substitute returns in the same manner as for delinquent filers, that is, from the due date of the return.[84] The time period permitted for payment upon notice and demand was extended. Prior written notice was required

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Cong., 1st Sess. 754 (1993). As originally proposed, the heightened standard would have applied both to the accuracy penalties and the preparer penalty but, as enacted, applied only to the accuracy penalties. See H.R. Rep. No. 213, 103d Cong., 1st Sess. 669 (1993).

[80] Pub. L. No. 103-465, 108 Stat. 4809 (1994).

[81] See Treasury Corporate Tax Shelter White Paper, supra note 7, at 75.

[82] Pub. L. No. 104-168, supra note 72.

[83] The depositor also is required to satisfy the net worth requirements of section 7430 and to timely file the employment tax return.

[84] Under prior law, taxpayers who filed delinquent returns showing a balance due were assessed a failure to pay penalty under Code section 6651(a)(2) from the due date of the return, whereas if the IRS filed a substitute return for nonfilers under section 6020, the penalty was assessed under Code section 6651(a)(3) ten days after notice and demand for payment. This inequity between voluntarily-filed delinquent returns and substitute returns was rectified. H.R. Rep. No. 506, 104th Cong., 2d Sess. 53 (Mar. 28, 1996).

prior to imposition of the trust fund recovery penalty of Code section 6672. This change was accompanied by new disclosure rules and a right of contribution, allowing for recovery from other parties, where more than one person is liable for the penalty.[85]

Taxpayer Relief Act of 1997:[86] This legislation made certain modifications to the penalty provisions, in particular the accuracy-related penalty and registration requirements in the context of corporate tax shelters.[87] A reasonable cause exception also was added for certain penalties.[88] The de minimis threshold for individual estimated tax payments was raised from $500 to $1,000.[89]

IRS Restructuring and Reform Act of 1998: This legislation contained a number of penalty-related provisions. The general thrust of these provisions is to further mitigate penalties in certain circumstances. The failure to pay penalty is mitigated during the period that an installment agreement is in effect between a taxpayer and the IRS, provided the tax return was timely filed. The penalty is reduced by half, i.e., from 0.5 percent to 0.25 percent, for each month of the delinquency during the period of the agreement.

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[85] The legislative history states that a federal right of contribution was enacted because variations in such rights under state law "make it difficult or impossible to press successful suits in state courts to force a contribution from other responsible persons." Id. at 39-41. In addition, voluntary board members of tax-exempt organizations were exempted from trust fund recovery penalties under certain circumstances. Other changes with respect to tax exempt organizations included an increase in the penalty for failure to provide public inspection of returns for tax exempt organizations from $1,000 to $5,000 per return and an increase in the annual return penalty to $20 per return, with a cumulative limit of $10,000, and with higher penalty amounts imposed on organizations with gross receipts of over $1 million.

[86] Pub. L. No. 105-34, 111 Stat. 788 (1997).

[87] The definition of a tax shelter was broadened from an arrangement having the evasion or avoidance of Federal income tax as "the principal purpose" to one with evasion or avoidance as "a significant purpose." In addition, the reasonable basis exception was restricted in the case of multi-party financings and the registration requirements were extended to corporate tax shelters promoted under conditions of confidentiality. See Treasury Corporate Tax Shelter White Paper, supra note 7, at 74-76.

[88] See Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 393 (Dec. 17, 1997).

[89] See id. at 336.

The deposit penalty was amended to eliminate the effect of cascading penalties. Prior to RRA 1998, deposits of payroll taxes were allocated to the earliest period for which a deposit was due and, if a deposit was missed or was insufficient, later deposits were first applied to satisfy shortfalls for earlier periods. Cascading penalties would result as payments that would otherwise be sufficient to satisfy current liabilities were applied to earlier shortfalls. As enacted by RRA 1998, taxpayers can designate the period to which the payment will be applied and, for deposits made after December 31, 2001, deposits will automatically be applied to the most recent period unless the taxpayer designates otherwise.[90]

Also pursuant to RRA 1998, notices imposing a penalty must include certain information about the penalty, including a computation thereof, and supervisory approval is required for certain non-computer-generated penalties. In judicial proceedings where the imposition of a penalty is contested, the burden was placed on the IRS to come forward with evidence that imposition of the penalty is appropriate.

B. Interest

Until the 1970s, the interest provisions of the Code were relatively uncomplicated. The interest rates on tax underpayments and overpayments were identical at a statutorily prescribed 6-percent simple interest rate. No failure to pay penalty existed in addition to the interest charge on an unpaid liability. If a taxpayer was not subject to withholding and was required to pay estimated tax, an estimated tax penalty accrued at a 6-percent simple interest rate. Interest accrued on an unpaid tax liability from the date the liability was due and on penalties from the date of notice and demand (unless paid within 10 days). Overpayments did not accrue interest if refunded within 45 days after the return was due (or filed, if later), and accrual of interest could be terminated up to 30 days before a refund was made.

This structure continued in existence until 1969. That year, Congress enacted a penalty of one-half percent per month, up to a maximum 25 percent, for failure to timely pay tax. The

[90] The authority to waive a deposit penalty for inadvertent failures by first time depositors also was amended to permit such waiver when the failure relates to the first deposit a taxpayer is required to make after changing the frequency of deposits.

legislative history of this provision indicates Congressional concern that commercial interest rates at the time exceeded the statutory simple interest rate of 6 percent and Congressional intent to discourage taxpayers from effectively using the government as a low-cost borrowing source.[91] The failure to pay penalty as enacted thus appears intended to act effectively as an interest surcharge to better align government and commercial borrowing rates.

The next major change occurred in 1974 when the simple interest rate of 6 percent was replaced with an annually adjustable simple interest rate equal to 90 percent of the prime rate. Again, Congress expressed concern that high commercial interest rates encouraged taxpayers to delay paying their tax liabilities. To the extent that this change brought interest rates more in line with commercial rates, it diminished the rationale for the separate failure to pay penalty, but the penalty remained in existence.

In 1981, the interest rate was increased to 100 percent of the prime rate. Again, the rationale was that the interest rate was too low relative to commercial interest rates and was contributing to a growth in delinquent accounts. In 1982, Congress made further changes to the interest provisions. Deficiency interest was compounded daily as a better reflection of commercial practice. The frequency with which the rates were adjusted also was increased from yearly to semiannually.

While these changes were intended to address concerns over the growth in delinquent accounts, the stated view in making such changes was to bring interest rates in line with commercial rates and to discourage taxpayers from using the government as a low-cost source of funds. Beginning in 1984, however, interest rates began to be used for other compliance purposes. A special interest rate was imposed on deficiencies attributable to "tax-motivated transactions" that was computed as 120 percent of the normal deficiency interest rate. The beginning date for accrual of interest on accuracy-related penalties was changed from the date of notice and demand for payment to the due date of the tax return, reflecting the view that the sanctionable conduct occurred at the time the return was filed.

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[91] S. Rep. No. 552, 91st Cong., 1st Sess. 297-98 (Nov. 21, 1969).

Also, in 1986 for the first time, a differential was introduced between the rate charged on underpayments and the rate paid on overpayments of tax. Underpayments bore a rate of interest one percentage point higher than overpayments.[92] The underpinning for this differential again had as its focus the perceived disparate conduct of the government and commercial financial institutions. The stated rationale was that financial institutions lend funds at a rate of interest higher than they pay and that Treasury rates, being identical, did not conform to commercial practice, causing taxpayers "either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate."[93] In addition, interest on tax underpayments ceased to be deductible for individuals consistent with the Congressional determination that personal loans would not give rise to deductible interest. Concurrently, Congress enacted Code section 6404(e) to provide the IRS with discretion to waive interest that had accrued due to ministerial errors by the IRS.

In 1989, the higher interest rate imposed on deficiencies attributable to tax-motivated transactions was repealed as part of overall reform of the accuracy-related penalties.[94] In 1990, the one-percentage point differential between interest rates on underpayments and overpayments was increased to three percentage points for large corporate underpayments (in excess of $100,000), applied with respect to interest accruing 30 days after issuance of a first letter of proposed deficiency (30-day or 90-day letter). The effect of this change was to place corporate payments of interest to the IRS which, in contrast to payments by individuals, continued to be deductible, on a parity with individuals.[95] In 1994, the interest payable to corporations on overpayments equal or greater than $10,000 was reduced by one and one-half percentage points to one-half percentage point above the AFR. The stated reason for this change was that "distortions may result if the rates of interest in the Code differ appreciably from market rates.

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[92] In addition, the basis for determining the rate of interest was changed from the prime rate to the applicable short term Federal rate (AFR) and rates were adjusted quarterly rather than semiannually.
[93] S. Rep. No. 313, 99th Cong., 2d Sess. 184-85 (May 29, 1986).
[94] Pub. L. No. 101-239, 103 Stat. 2106.
[95] The Senate version of the Omnibus Budget Reconciliation Act of 1990 would have denied the deduction for corporate underpayment interest. In conference, deductibility was maintained, but the corporate underpayment interest rate was increased. See H.R. (Conf. Comm.) Rep. No. 964, 101st Cong., 1st Sess. 1100-01 (Oct. 27, 1990).

Reducing the overpayment rate for large corporation overpayments of taxes will reduce the possibility of distortions."[96] After enactment of the reduced overpayment rate, the potential differential between interest charged or paid on large corporate underpayments and overpayments, respectively, was 4.5 percentage points.

In 1996, the IRS was provided expanded authority to abate interest for managerial as well as ministerial acts, but in both circumstances only where the delay or error was unreasonable.[97] RRA 1998 made a number of significant alterations to the interest provisions, reflecting a degree of concern with the consequences of provisions previously enacted. First, the interest rate differential between underpayments and overpayments was eliminated for individuals. In addition, explicit statutory rules were enacted to authorize interest equalization between overlapping overpayments and underpayments for different taxable years and types of taxes. RRA 1998 also provided in the case of individual taxpayers for suspension of interest (and certain penalties) if taxpayers are not notified within specified time periods of their liability for tax. The legislation also requires every IRS notice that includes an amount of interest required to be paid by a taxpayer to include a detailed computation of the interest charged. Finally, authority was provided to abate the assessment of interest in situations where the time to file and pay is extended for taxpayers located in a Presidentially declared disaster area.[98]

III. Criteria For Evaluation of Penalties and Interest

A. Penalties

Economic models of tax compliance generally assume that a taxpayer engages in rational economic behavior. The taxpayer, after implicit or explicit analysis of the possibilities, is expected to take the action that maximizes his or her utility. The taxpayer's utility depends on a subjective weighing of various factors, including the economic benefit and cost of noncompliance, the non-financial consequences of misbehavior (such as social ostracism or

[96] Pub. L. No. 103-465, 108 Stat. 4809; H.R. Rep. No. 826, 103d Cong., 2d Sess. 178 (Oct. 3, 1994).
[97] The Tax Court was provided jurisdiction to determine whether, for certain taxpayers, the IRS has abused its discretion in failing to abate interest.

imprisonment), the taxpayer's preference for or against taking risk, the taxpayer's ethics, and other factors. The monetary cost of noncompliance depends both on the probability that noncompliance will be detected and the penalty for noncompliance when it is detected.

Penalties enter the compliance decision in two ways. First, penalties increase the cost of noncompliance and hence reduce its attractiveness. Penalties act as general deterrents in discouraging would-be violators and as specific deterrents to actual violators to discourage continuing noncompliance. Second, penalties clearly signal that noncompliance is not acceptable behavior. The establishment and enforcement of penalties also helps to assure compliant taxpayers that all taxpayers are expected to meet their tax obligations, and that violations by others will not be ignored. In establishing social norms and expectations, subjecting the noncompliant behavior to any penalty may be as important as the exact level of the penalty, although the penalty level does indicate the seriousness of the noncompliance.[99]

Penalties also can be considered as a source of revenue or as a form of "user fee" to compensate the government for the cost of noncompliance. In general, however, penalties should not be created or designed for revenue raising purposes. Penalties may raise revenue collaterally but this should not be a deliberate objective of penalty design and doing so can create perverse incentives. Rather, the penalty regime should raise revenue by encouraging taxpayers to remit the appropriate amount of tax in the proper fashion. Thus, although it is appropriate to consider the cost to the government associated with noncompliance in designing penalties, fostering compliance and deterring noncompliance should be the overriding goals.

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[98] Code section 6404(h).

[99] For a discussions of how penalties and other factors are expected to affect taxpayer behavior, see, e.g., Andreoni, Erard and Feinstein, "Tax Compliance," 36 J. of Economic Literature 818 (June 1998); Why People Pay Taxes: Tax Compliance and Enforcement, (J. Slemrod, ed.)(1992); Allingham and Sandmo, "Income Tax Evasion: A Theoretical Analysis," J. of Public Economics 323 (November 1972). The purposes of penalties are set forth in the IRS Penalty Handbook, which states that penalties encourage voluntary compliance by "defining standards of compliant behavior, defining remedial consequences for noncompliance, and providing monetary sanctions against taxpayers who do not meet the standard." Penalty Handbook, I.R.M. 120.1.1.2. These factors "support the public conviction that the tax system is fair and the penalty is in proportion to the severity of noncompliance." Id.

Designing a “good” penalty from the standpoint of these broad objectives subsumes a number of different and, at times, competing considerations. The 1989 Task Force Report identified the characteristics of fairness, effectiveness, comprehensibility and administrability as desirable characteristics of a penalty and, with respect to each, elucidated relevant criteria that should be considered.[100] It recognized, however, that individual penalties and the penalty regime as a whole must effectuate a balancing of these considerations.[101]

In this regard, the universe of taxpayers includes a small minority of noncompliant taxpayers, whose circumstances vary from an honest mistake to willful noncompliance. A penalty regime must attempt to distinguish among the different underlying causes of noncompliance, so that taxpayers who have made honest mistakes or are noncompliant because of financial difficulty do not feel that the penalties are so harsh as to be a barrier to correction of their delinquency. At the same time, penalties must be sufficiently harsh as to have some impact on willfully noncompliant taxpayers. A related tension exists between administrative simplicity and complexity. Penalties that do not make distinctions among different causes for noncompliance are simpler and less resource-intensive to administer initially, but may impose a greater burden on taxpayers through contacts with the IRS to obtain attention to their individual circumstances. If such attention is not provided, either in penalty design or administration, the penalties may be unfair in their application to situations involving different underlying causes.

The remainder of this section discusses the criteria for evaluating penalties: fairness, effectiveness, comprehensibility and administrability, in greater detail.

Fairness. Generally, a penalty should be fair both in that similarly noncompliant taxpayers receive the same penalty and in that degrees of culpability are sanctioned with appropriate degrees of severity. Public comments received by Treasury indicate that equity in both senses is an important consideration. A number of comments stressed the importance of distinguishing between inadvertent or one-time noncompliance and intentional or continuing

[100] See 1989 Task Force Report, supra note 10, at III-3. See also Penalty Handbook, I.R.M. 120.1.2.2.

noncompliance. Not surprisingly, there was relative unanimity that the latter be subject to more serious sanctions. The present penalty structure satisfies these equity criteria to a limited degree. For example, fraud is sanctioned more severely than negligence and virtually all penalties permit waiver for reasonable cause. Time sensitive penalties impose greater sanctions for longer durations of noncompliance. On the other hand, degrees of culpability are at times differently distinguished. The accuracy-related penalties, for example, hinge on a number of criteria related to factors other than traditional notions of fault, including whether disclosure of the position taken on the return is made and the strength of supporting authority. As a general rule, first time offenses are not treated differently than multiple offenses and a taxpayer's compliance history generally is not a factor in determining the amount of penalty nor necessarily whether it should be imposed. A number of commentators suggested consideration of these types of distinctions. Though potentially useful, making these distinctions generally requires more individualized evaluations, which are associated with higher administrative burden.

Fairness also subsumes the issue of agency discretion in administering penalties. The penalty provisions of the Code generally provide the IRS a degree of discretion to waive or abate penalties. Administrative discretion also is exercised in evaluating the facts and circumstances weighing for or against imposition of a penalty. Fairness requires that this discretion be exercised with consistency and impartiality such that similar factual situations are not treated differently. It also requires that the amount of discretion available to IRS employees be appropriately calibrated, i.e., that IRS personnel have neither too much nor too little discretion. Fairness also involves providing taxpayers with opportunity to have their interests heard and considered.

Other equitable considerations may be implicated by notions of fairness. Thus, under present law, the failure to pay penalty can be waived in circumstances of "undue hardship;" the addition to tax for failure to pay estimated tax can be waived for reasons of casualty, disaster or other unusual circumstances based on "equity and good conscience;" and penalties generally can

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[101] "Making good decisions about tradeoffs is the key to a good penalty system." 1989 Task Force Report, supra note 10, at III-10.

be waived if the taxpayer has relied on erroneous written advice from the IRS.[102] These equitable considerations do not focus so much on the conduct of the taxpayer as on other factors not always within the taxpayer's control as a basis for mitigation of penalties.

Effectiveness. It is difficult to measure the exact effect of penalties on taxpayer behavior, due to limitations in the data on penalties and compliance. In a fair tax system, penalties do not vary substantially among similar taxpayers. As a result, it is difficult to observe the effect of different penalties on taxpayer behavior. In addition, while the IRS collects data on the penalties that are assessed, it does not have data on expected penalties as perceived by taxpayers when they are making the compliance decision.[103] Nonetheless, the overall evidence suggests that penalties and audits have positive effects on compliance.

Deterrence is affected both by the size of the penalty and the certainty of its application. A penalty that is relatively certain to be applied might not need to be significant in amount; conversely, a penalty that is not certain to be applied might need to be larger to operate as an effective deterrent. In addition, as with fairness, the effectiveness of a penalty may require some agency discretion to avoid imposition of the penalty in inappropriate circumstances. Erroneous penalty assessments, even if later corrected, raise doubt as to both the impartiality and the competency of the government. Effectiveness also depends on whether penalties incorporate appropriate incentives to encourage prompt correction of delinquent conduct.

Comprehensibility. Complexity in the penalty structure can result in inconsistent or erroneous penalty assessments. Complexity might also make the penalty system seem unfair, or weaken the deterrent effect of penalties. Frequent changes in the penalty provisions, as well as complicated provisions, can cause confusion and errors. Complexity also can arise as a result of related rules. Concerns have been expressed by commentators, for example, with respect to the

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[102] See Sections V and VII, infra, for a more detailed discussion of these particular provisions.
[103] Some researchers have attempted to overcome this problem by conducting tax simulation experiments, in which penalties can be varied in a controlled and observable manner. These hypothetical tax games tend to suggest that increases in penalties and audit rates generate improvements in compliance. See, for example, Alm, Jackson and McKee, "Deterrence and Beyond: Toward a Kinder, Gentler IRS," in J. Slemrod, ed. (1992). Id.

estimated tax and deposit penalties that may really be directed toward the underlying deposit and estimated tax payment rules which are embedded in the penalty provisions. Comprehensibility may also need to be evaluated relative to the likely degree of sophistication of the taxpayer; more sophisticated or well-advised taxpayers can be expected to deal with a degree of complexity that would be unsuitable for other taxpayers.

Administrability. The design and implementation of penalties must be consistent but flexible. Reasonable cause waivers provide a degree of flexibility but are inherently susceptible to inconsistent application. Some commentators expressed concern that reasonable cause waivers are inconsistently administered by the IRS. Computer-generated penalties are apt to be more consistently applied but, correlatively, may be perceived as disproportionately applied or more frequently misapplied. Manual processing may prevent misapplication and consequent communications with taxpayers requesting penalty abatement, but also may be more resource-intensive and susceptible to misuse of discretion.

While sanctions are an integral and necessary component of our tax system, the manner or methods by which the IRS collects taxes and deals with taxpayers may be as important as the penalty and interest provisions in affecting compliance. Enhanced training of IRS employees, improved education of and outreach to taxpayers, improved and better computer systems to speed up the process of resolving problems and disputes with taxpayers, more rapid examination processes and other measures may have equally, if not more important, tangible effects than penalties. Moreover, even with the best systems and procedures in place, the IRS must allocate its resources among competing uses in order to deal effectively with a large universe of taxpayers.

B. Interest

The interest provisions of the Code raise different but related considerations.[104] Interest is not a penalty, although it may be perceived by some taxpayers as tantamount to a penalty.

[104] A more complete discussion of the policy considerations underlying interest on taxes is set forth in Treasury's Global Interest Netting Study, supra note 11.

Interest is a charge or compensation for the use or forbearance of money. Compensation for the use of money has been the principal, and at times the only, rationale for charging interest with respect to tax deficiencies or overpayments.[105] However, just as the objectives of a penalty subsume a number of different and competing considerations, the broad principle of interest as a charge for the use of money subsumes a number of different, related theories that individually may justify charging interest – that interest reflects the time value of money, that it provides incentives for prompt satisfaction of debts, or that it is compensation for the credit risk of lending money and collecting unpaid debt.

With respect to the time value of money rationale, a fundamental premise underlying financial markets is that a dollar receivable in the future is worth less than a dollar received today. The discount may be attributable to the opportunity cost of alternative investments (e.g., prevailing rates of return, including interest rates) as well as inflation and the lenders' expectations concerning risk and the creditworthiness of the borrower. In the commercial context, therefore, interest must be charged to render the lender whole (apart from any profit derived from the service of lending). The failure to charge interest on a tax debt (underpayment or overpayment) for which payment is long-delayed would leave the creditor (either the government or the taxpayer) worse off for having the right to be paid than if that party had been paid immediately.

Interest provides an incentive for prompt payment of debts. Relative interest rates on different borrowings can affect which creditors a taxpayer with limited resources will prefer to pay. If taxpayers were not charged interest on a tax debt, they would have an incentive to defer payment of their tax debt and to utilize the funds either for other investment purposes on which a positive rate of return would be earned or to pay other creditors who charged interest. The government would have a similar incentive if it were not charged interest on its tax refunds. Various legislative modifications to the interest provisions have recognized the relationship between interest rates and the promptness with which tax debts and refunds are paid. For

[105] See Alexander Proudfoot Co. v. United States, 454 F.2d 1379 (Ct. Cl. 1972); Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978); May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996).

example, the interest rate differential, when enacted in 1986, was justified on the basis that the absence of a differential "may cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate."[106] Providing that a tax debt bears a market-related interest charge neutralizes (or at least reduces) the advantages that otherwise could be obtained by avoiding payment and investing elsewhere or paying off other creditors. Consequently, interest charges are necessary in both directions to prevent either taxpayers or the government from receiving perverse incentives to fail to settle their tax accounts.

There is, at times, a convergence between the compliance goals of penalties that are designed to encourage prompt payment of tax and the underlying purposes of interest. It is sometimes difficult to determine conceptually whether certain penalties are, in actuality, an interest charge or, conversely, whether a feature of the interest provisions is in actuality a penalty. For example, the failure to pay penalty can be considered in some respects as a surrogate for an interest surcharge; similarly, the addition to tax imposed for a failure to pay estimated tax resembles interest and is determined on the basis of the underpayment interest rate for the period of the underpayment. Conversely, the now-repealed interest surcharge on tax-motivated transactions was intended to operate as a penalty.

Other factors influence the determination of the appropriate interest rate to charge or pay borrowers and lenders. Interest provides compensation for the risk of non-payment and the costs of collection. Thus, trustworthy borrowers with established credit histories generally can obtain loans at a lower interest rate than borrowers who may not be so reliable. Along similar lines, financial institutions offer preferred rates and other incentives to creditworthy customers with whom they desire longstanding relationships; such incentives may take the form of reduced borrowing rates, higher rates on deposits, or waivers of fees. Tax interest historically has not been adjusted to reflect the risk or creditworthiness of individual borrowers (on underpayments of tax). The absence of adjustment for this factor may be due in part to the fact that the government is an involuntary creditor. Individualized negotiations over the terms and conditions governing a tax debt (in particular, the applicable interest rate) are not administratively feasible

[106] H.R. Rep. No. 426, 99th Cong., 1st Sess. 849 (1985).

and would require resource-intensive evaluation of the creditworthiness of different taxpayers (or categories of taxpayers) to calibrate interest rates appropriately.[107]

In evaluating the interest provisions of the Code, one issue is the extent to which the government should be treated as if it were a commercial financial institution and the extent to which the interest rules should or must deviate from commercial practice. A related issue is the appropriate interest rates to charge. The interest provisions of the Code do not provide clear-cut guidance on these issues. As previously stated, the government does not charge different interest rates to different taxpayers based on their creditworthiness. On the other hand, since 1986 until recently, both individuals and corporations have been charged a higher interest rate on tax underpayments than the government paid on tax overpayments. This rule is more akin to commercial practice, in that commercial financial institutions typically lend (e.g., loans made to customers) at higher rates than the rates at which they borrow (e.g., deposits from customers). The change from a fixed simple interest rate to a floating compound rate also was enacted on the rationale that it was more consistent with commercial practice.

External sources of guidance also can be considered in determining the interest rates that should be charged. One potential source is the practice of other Federal agencies that borrow from, or lend to, citizens (e.g., student loans, small business loans, government contracts). But this type of comparison is limited by differences between tax debts and other types of voluntary debts or transactions between government and citizens. Another potential source of external guidance is to examine the practices of states with respect to interest rates charged on tax debts. Many states, however, model their interest provisions on the Federal government. See Appendix B.

An alternative approach is to establish a "rule of consistency" to which the interest provisions should adhere unless special reasons warrant deviation. An example of such a rule

[107] The creditworthiness of the taxpayer may be considered, however, in determining the appropriate collection method to be applied. Changes enacted by RRA 1998 with respect to certain of the IRS's collection enforcement programs, such as the offer in compromise program, suggest greater legislative preference toward more individualized evaluations of taxpayer ability to pay in the collection enforcement context.

would be that the tax laws treat the IRS as akin to commercial financial institutions unless reasons unique to the taxing function warrant deviation. This rule has the advantage of using commercial practices and rates set in the marketplace as a baseline from which to consider departures based on special tax administrative or economic circumstances, e.g., revenue timing considerations, administrative feasibility, the government's status as an involuntary creditor, or differences in the relationship of taxpayers to government when compared to actors in the marketplace.

A different consideration is the extent to which concepts of equity should be incorporated in the design or administration of the interest provisions. Because interest is a charge for the forbearance of money, equity concepts facially appear to have little or no relevance. The relevant inquiry should only be whether a tax debt exists and the impact on that debt of the considerations previously discussed, i.e., the passage of time, inflation and risk factors. For this reason, unlike the penalty provisions, the interest provisions do not provide for waiver or abatement based on reasonable cause, that is, based on nonnegligent behavior by the taxpayer.

However, the interest provisions do reflect equity concepts in a number of respects. Abatement of interest is permitted in circumstances where the government is at fault as a result of unreasonable ministerial or managerial errors or delays. In such circumstances, contributory taxpayer fault, if any, operates as a countervailing factor. The interest provisions also provide relief in certain other types of circumstances where imposition of an interest charge appears to violate concepts of equity. The provision abating interest where filing and payment extensions are granted because of a disaster is one such provision. The suspension of interest prior to notification of a taxpayer's income tax liability is another. This latter provision addresses the situation where the taxpayer is not yet informed of, nor had an opportunity to respond to, the assertion by the IRS of a tax liability. These two provisions appear to be grounded in the belief that relief should be granted in certain circumstances that are beyond the taxpayer's ability to control or manage.[108] Thus, the present-law interest provisions do not ignore equity considerations.

[108] Although the requirement that interest be suspended prior to notification may reflect legislative concern regarding the length of time administratively required to assert a deficiency.

C. Burden

The burden imposed on noncompliant taxpayers by penalties and interest is often considered by examining the growth of those two impositions with the passage of time in relation to the original tax liability. Conceptually, however, interest should not be encompassed in such a calculation because it represents the time value of money. Moreover, most penalties are not time sensitive and do not increase with the passage of time; those that are time sensitive do so because a delinquency is continuing and, in such situations, the growth in the penalty should not be viewed as disproportionate. Thus, when a delinquency continues for a significant period of time, the increasing component of the total liability represented by interest and penalties is simply the financial consequence of the passage of time. Nonetheless, concerns are periodically expressed regarding this result. These concerns appear to derive from the view that, at some point, the total liability may become so large relative to the original tax liability as to offend notions of fundamental fairness. This view is often expressed in relation to situations in which, due to no fault of the taxpayer or the government but simply the extended time involved in resolving an issue, the tax liability remains outstanding for a significant period of years. Relatedly, a taxpayer's ability to pay may not keep pace with the growth in the liability over extended periods of time (notwithstanding the economic benefit to the taxpayer from delayed payment) so as to impede the taxpayer's ability to resolve the situation. Thus, burden considerations may be relevant notwithstanding the foregoing conceptual aspects, and may compete with compliance considerations in the design or administration of a penalty.

Burden concerns implicate the broader context of statutory and administrative dispute resolution and collection mechanisms. Taxpayer burden may be a function of the degree of delinquency, but also depends on the administrative system for dealing with taxpayer disputes and resolving collection difficulties. Mechanisms that encourage rapid and efficient contact with taxpayers are one important component; mechanisms for prepayment resolution of disputes (i.e., the deficiency procedures) are another important component of this system. Others include mechanisms for advance deposits or prepayments of tax, refund procedures, administrative dispute resolution procedures, and judicial systems. Systems for collection of delinquent tax debts also play an important role, including collaborative mechanisms such as deferred payment (installment agreements) and partial payment (offers in compromise) and the panoply of enforced collection mechanisms. Concerns regarding excessive burden on taxpayers are, at times, more appropriately addressed through improvements in these mechanisms than through the penalty and interest provisions. Conversely, however, limitations in the scope or efficiency of these mechanisms, even when appropriate and grounded in sound considerations, may prompt lawmakers and administrators to address burden concerns and to provide incentives for early resolution of problems in the penalty and interest provisions themselves.

IV. Data on Taxes, Penalties and Interest

In considering the penalty and interest regime, it is important to keep these features of the tax system in proper perspective. As discussed in greater detail below, almost all of the revenue collected by the IRS is voluntarily remitted by taxpayers in a timely fashion. This is true across all major tax sources (individual income, corporate income and employment taxes). Many taxpayers pay the government more than sufficient amounts to account for their tax liability. For example, of the 123 million individual tax returns filed in fiscal year 1997, 85 million of such returns reported that a refund was due. Thus, the vast majority of the revenue is collected by the IRS without contact between the IRS and taxpayers beyond the filing of the return and transmission of funds either from or to the taxpayer.

Nonetheless, about 15 million notices are issued each year regarding some type of noncompliance. Noncompliance may range from a math error to more serious forms of noncompliance. Many of these notices result in quick resolution; others require more intensive and systematic investigation. The reasons for noncompliance are diverse, including mistake or inadvertence, inadequate understanding of tax obligations, temporary or longstanding financial difficulty, legitimate disagreement over the requirements of the tax laws, philosophical objections to the income tax, or dishonesty. Over time, the income tax laws have developed complex rules regarding the collection of taxes and gathering of information to increase the certainty with which taxes are collected, including enhanced information reporting of various types of income and the imposition of collection obligations on third-party payors. A complex set of sanctions has arisen to support this system of collection.

Not surprisingly, estimates of the degree of voluntary taxpayer compliance generally conclude that compliance among wage earners (whose income is subject to withholding by their employer) is very high. Compliance also is improved by information reporting of other types of income. Compliance among self-employed individuals and businesses is lower, due to the greater complexity of their affairs and correlative opportunity for noncompliance. These differences are exacerbated by relatively low audit rates and the difficulty in detecting certain kinds of noncompliance. For example, nonpayment of amounts reported as due on a tax return is relatively easy to detect, can be detected by computers without significant manual processing, and can be responded to with computer-generated notices requesting payment. Detection of nonfiling is more difficult, although the IRS can identify some nonfilers using information reporting or the presence of prior year returns. Detection of underreporting of the correct amount of income or deductions may be eased through information reporting and various programs used by the IRS to detect such situations, but in some cases is not readily detectable without actual examination of the return and further investigation. Studies conducted by the IRS and others on the nature of the "tax gap" suggest that underreporting of the correct income accounts for the major part of the estimated tax gap, followed by nonpayment of taxes reported as owed and by nonpayment associated with the nonfiling of returns.[109]

The next subsections of this study provide a general review of aggregate penalty statistics for recent fiscal years. Although the statistics presented provide context for a discussion of penalty issues, they do not address the relative effectiveness of the penalty system with regard to taxpayer compliance. The statistics presented also do not address the interaction between penalties and audit rates. Penalties and audit rates can be viewed as parameters set by a taxing authority to encourage voluntary compliance with the tax code. In general, any statements or conclusions regarding the relative efficiency of the penalty system must also address the audit rate and audit selection process.

The remainder of this section is separated into four subsections: (1) tax, penalty and interest revenue, (2) penalties assessed, (3) penalties abated and (4) penalties and interest written

[109] See, e.g., Internal Revenue Service, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988 and 1992 (April 1996).

off. Revenue data are presented first to provide a picture of the relative magnitude of penalty and interest revenue in the tax system.[110]

A. Tax, Penalty and Interest Revenue

In fiscal year 1996, the IRS collected approximately $1,376 billion in total tax revenue (net of refunds).[111] The primary sources of tax revenue were the individual income tax ($656 billion, 47.7 percent of total tax collections), corporate income tax ($171.4 billion, 12.5 percent) and employment taxes ($491 billion, 35.7 percent).[112] When combined, these taxes generated 95.5 percent of total tax collections in fiscal year 1996. Because these taxes also generate the preponderance of penalty assessments in any given fiscal year, most data tabulations included in this section provide statistics for these taxes only.

Tax, penalty and interest revenues result from voluntary remittance by taxpayers or from IRS enforcement and collection actions. Across all tax sources, the overwhelming majority of revenue is remitted voluntarily by taxpayers in a timely fashion. In fiscal year 1996, $637.2 billion (97.1 percent)[113] of total individual income tax revenues were collected without IRS enforcement or collection actions.[114] (See Table 1.) An additional $4.3 billion (0.7 percent) was

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[110] Data sources for statistical tables provided in this section include: (1) *IRS Databook* (various years), (2) *IRS' Abatements of Penalties for FY 1995–1998* (General Accounting Office), (3) annual reports from the Enforcement Revenue Information System (ERIS) (Financial Management Division, IRS), (4) tabulations of payments made for FY 1996 by taxpayers who have delinquent accounts and/or a payment plan with the IRS, such as an offer-in-compromise or Chapter 13 bankruptcy (Research and Statistics of Income Division, IRS) and (5) aggregate penalty and interest collection data and unpaid assessment balance data for FY 1997 and FY 1998 (Office of the Chief Financial Officer, IRS). Data sources are noted in the footnotes to the relevant tables. Certain tables combine data from several sources to present a broader picture of the current penalty regime. When possible, discrepancies between data sources were resolved and noted in the footnotes.

[111] IRS Databook, FY 1996, Table 1.

[112] For the purposes of this section, employment taxes refer to taxes remitted with Forms 940 (federal unemployment tax act), 941 (employer quarterly returns or payroll taxes), 943 (agricultural workers) and other miscellaneous employment tax returns.

[113] Note that the 97.1 percent figure applies to revenues actually remitted. This figure is net of any revenue foregone due to underground economic activity or other illegalities.

[114] Enforcement revenues are collected after the original due date of the return (excluding approved extensions) until the point in time that a taxpayer has an opportunity to make a timely

generated from IRS enforcement action while collection action generated $14.5 billion (2.2 percent). Collection revenues comprised $10.7 billion in tax payments, $1.6 billion in penalty payments and $2.2 billion in interest payments. (See Table 1, bottom half.) By payment category, $647.6 billion (98.7 percent) of total individual income tax collections was attributable to tax, $5.3 billion (0.8 percent) to penalties and $3.1 billion (0.5 percent) to interest.

The vast majority of corporate and employment tax revenues also are remitted voluntarily in a timely fashion. In fiscal year 1996, $643.6 billion (97.1 percent) of combined corporate income and employment tax revenue was remitted without IRS collection or enforcement actions.[115] Enforcement actions generated $8.7 billion (1.3 percent) while collection action generated $10.4 billion (1.6 percent) in corporate income and employment tax revenue. Collection revenues comprised $7.6 billion in tax payments, $1.8 billion in penalty payments and $1.1 billion in interest payments. By payment category, $655.7 billion (99.0 percent) of corporate income and employment tax collections was attributable to tax, $2.2 billion (0.3 percent) to penalties and $4.8 billion (0.7 percent) to interest.

Data for more recent fiscal years show similar patterns. For individual income taxes, total penalty collections averaged approximately $6 billion (0.8 percent) while average interest payments totaled $3.3 billion (0.4 percent) in fiscal years 1997 and 1998. For corporate income and employment taxes, total penalties averaged $2.1 billion (0.3 percent) while total interest payments averaged $3.3 billion (0.4 percent) in fiscal years 1997 and 1998. Therefore, for these three tax sources, combined penalty and interest revenues typically comprise approximately one percent of total collections in a fiscal year.

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response to a "first notice" sent by IRS. For example, if IRS notifies the taxpayer of an error on the original return and the taxpayer agrees with the assessment and remits the tax due, this revenue would be classified as enforcement revenue. Revenue collected after the date of a timely response to an IRS first notice is classified as collection revenue. Failure to respond in a timely fashion to the first notice moves the taxpayer into an Accounts Receivable, or delinquent, status. All payments plans are categorized as receivables (i.e., collection revenue).

[115] These taxes are combined because it was not possible to provide separate breakdowns of enforcement revenues.

It should be noted that total tax, penalty or interest payments that result from IRS collection activity (i.e., delinquent accounts or payment plans) are attributable to tax liabilities generated in many different tax years. For example, penalty payments for individual income taxes collected in fiscal year 1996 may be attributable to penalties assessed for tax year 1995, tax year 1994 or earlier tax years. (See Table 2, top half.) Because penalty payments are attributable to many tax years, a comparison of penalty payments to penalty assessments in a given fiscal year will not provide an entirely accurate picture of the percentage of penalty assessments actually collected.

A more detailed examination of tax, penalty and interest collection revenue does, however, reveal some general patterns. Table 2 (top half) illustrates that most penalty and interest payments received through IRS collection actions are attributable to tax years that precede the fiscal year by three years or more. For example, approximately 67 percent ($1.1 billion) of total penalty payments and 86 percent ($1.9 billion) of total interest payments for individual income taxes received in fiscal year 1996 through IRS collection activity was attributable to returns for tax year 1993 or earlier.

The bottom half of Table 2 presents the same data sorted by the number of years the tax return has been categorized as a "receivable." [116] Taxpayers whose returns have a receivable status of less than one year not only remit the majority of tax, penalty and interest payments ($9.2 billion, 63.6 percent of total collections), but also pay off a much higher percentage of their (imputed) fiscal year beginning balance. For fiscal year 1996, taxpayers whose individual income tax returns had a receivable status for less than one year remitted 39.3 percent of their (imputed) fiscal year beginning balance. In general, the percentage of the year-end balance paid declines rapidly with the number of years that the tax return has receivable status.

[116] Receivables are tax, penalty and interest assessments that the IRS can support through the existence of taxpayer concurrence (e.g., the taxpayer filed a return) or a court ruling. Receivables include delinquent accounts and payment plans.

B. Penalties Assessed

To encourage voluntary compliance with tax laws, the IRS assesses a significant number of penalties in any given fiscal year. In fiscal year 1978, the first year that detailed penalty statistics were published, the IRS assessed 15.4 million penalties across all taxes totaling $1.3 billion. In fiscal year 1988, the IRS assessed 26.6 million penalties totaling $10.9 billion. This significant increase in penalty assessments reflects a larger filing population, the increasing role of computers in the assessment process and specific IRS actions targeted against abuses, for example, related to federal tax deposits for employment taxes.

In fiscal year 1998, the IRS assessed 34.2 million penalties totaling $12.1 billion.[117] (See Table 3.) Data show that the number of total penalties assessed increased slightly (0.5 percent) while the dollar amount declined (-8.3 percent) between fiscal years 1996 and 1998. For individual, corporate and employment taxes, the three-year trend was mixed. While the number and amount of assessed penalties for individual income taxes increased (2.3 and 10.9 percent, respectively), both declined for employment taxes (-3.3 and –23.7 percent, respectively). For corporate income tax penalties, there was an increase in the number of penalties assessed (6.0 percent) but a significant decline in the amount of penalties assessed (-35.6 percent).[118]

For individual income taxes, the IRS assessed 22.2 million penalties totaling $4.5 billion in fiscal year 1998. In comparison, 123.1 million annual individual income tax returns were processed in fiscal year 1998.[119] Individual income tax penalties comprised approximately two-thirds of the number and one-third of the dollar amount of total penalties assessed in fiscal years 1996 through 1998. While the failure to pay penalty was assessed most frequently (12.8 million

[117] Penalty data for fiscal year 1998 are preliminary and subject to change.

[118] It is important to note that penalty assessment data in Table 3 understate the number and amount of penalties actually asserted by the IRS for a particular fiscal year. The IRS must assert certain penalties before proceeding to assess such penalties. Penalties that are asserted may never reach the assessment stage because the assertion may be withdrawn by the IRS during the examination or appeals stage. Alternatively, a judicial decision may also result in nonassessment of an asserted penalty.

[119] Statistics of Income Bulletin, Spring 1999, Table 21.

penalties, $1.3 billion), failure to file penalty assessments were largest in dollar terms (2.3 million penalties, $1.6 billion).

For corporate income taxes, the IRS assessed 845 thousand penalties totaling $911 million in fiscal year 1998. In comparison, 5.2 million annual corporate income tax returns were processed in fiscal year 1998.[120] While the failure to pay penalty was assessed most frequently (355 thousand penalties, $142 million), estimated tax penalty assessments were largest in dollar terms (339 thousand penalties, $355 million).

For employment taxes, the IRS assessed 9.9 million penalties totaling $4.1 billion in fiscal year 1998. In comparison, 29.1 million annual employment tax returns were processed in fiscal year 1998.[121] While the failure to pay penalty was assessed most frequently (4.2 million penalties, $384 million), federal tax deposit penalty assessments were largest in dollar terms (3.8 million penalties, $3.1 billion).

C. Penalties Assessed and Abated

While a significant number and amount of penalties are assessed in any given fiscal year, many penalty assessments are abated. Penalties may be abated for the following reasons, among others: (1) reasonable cause, (2) statutory penalty waiver, (3) the tax liability did not exist (e.g., incorrect substitute return, taxpayer or IRS error), (4) net operating losses carried back to a previous tax year, or (5) liability discharged due to bankruptcy or an offer-in-compromise.[122] The number and dollar amounts of penalty abatements over the fiscal year 1996 through 1998 period are also noted in Table 3, with the exclusion of abatements arising from the fifth category. Abatements also do not include reductions in liability attributable to an expiration of the statutes of limitation or the elimination of duplicate trust fund penalties.[123] Therefore, reductions in penalties attributable to (1) an expiration of the statute of limitations, (2) offers-in-compromise

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[120] Ibid.
[121] Ibid.
[122] In general, the IRS has more limited authority to abate interest. See discussion in text at Section VII.B, infra.

and bankruptcies and (3) elimination of duplicate trust fund penalties are not included in Table 3.[124]

Like penalty payments and assessments, penalty abatements that occur in a given fiscal year are attributable to tax returns filed for many different tax years. Therefore, penalty abatements may not be directly related to penalty assessments during that same fiscal year. However, if the number and amount of penalty assessments and abatements are relatively steady across tax years, then it is possible to make approximate statements regarding the general magnitude of penalty abatements relative to penalty assessments for a given fiscal year.[125]

In fiscal year 1998, the IRS abated 2.1 million individual income tax penalties totaling $891 million. (See Table 3.) (This figure excludes approximately $675 million in duplicate trust fund abatements.) Across fiscal years and penalty type, total individual income tax abatements typically comprised between 10 to 20 percent of the dollar amount of assessments made in that fiscal year. As a percent of assessments made during fiscal year 1998, failure to file abatements were greatest in both number (21.9 percent) and dollar amount (35 percent).

With respect to corporate income taxes, in fiscal year 1998 the IRS abated 145 thousand penalties totaling $483 million. Across fiscal years and penalty type, total corporate income tax abatements typically comprised between 30 to 50 percent of the dollar amount of penalty assessments made in that fiscal year. As a percent of assessments made during fiscal year 1998, failure to pay penalties were abated most often (27.2 percent), while failure to file abatements were largest (69.7 percent) in dollar terms.

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[123] The IRS generally excludes duplicate trust fund penalty assessments and abatements from any tabulations to avoid double counting the revenue potential of unpaid assessments.

[124] While duplicate trust fund penalties and abatements are not included in Table 3, General Accounting Office tabulations include these in abatements. For fiscal year 1998, approximately $675 million duplicate trust fund penalties were abated. Therefore, penalty abatement statistics will vary based on the data source. Data sources are noted in the table footnotes.

[125] Technically, for data for a single year to be indicative of the general pattern, penalty assessments and abatements must reach a "steady state." The steady state would be

With respect to employment taxes, in fiscal year 1998 the IRS abated 1.8 million penalties totaling $1.7 billion. Across fiscal years and penalty types, total employment tax abatements typically comprised between 30 to 60 percent of the dollar amount of penalty assessments made in that fiscal year. As a percent of assessments made during fiscal year 1998, failure to pay penalties were abated most often (20.6 percent), while federal tax deposit penalty abatements were largest (43.6 percent) in dollar terms.

Table 4 provides a breakdown of individual income tax, penalty and interest liabilities abated in fiscal year 1998 based on the tax year of the return. Table 4 illustrates that tax, penalty and interest abatements granted during a fiscal year are "spread" across many different tax years. Although most tax abatements are attributable to relatively recent tax years, penalty and interest abatements tend to be attributable to older tax years.

D. Penalties and Interest Written Off

Tax, penalty and interest assessments that are neither collected nor abated are eventually written-off or removed from IRS databases. When the liability is written off, collection action against the taxpayer ceases.

The upper portion of Table 5 provides aggregate statistics of penalties and interest assessed, abated, collected and written off (assessed and accrued) for fiscal years 1997 and 1998. As noted, these amounts for a specific fiscal year cannot be compared directly because they are attributable to different tax years. In fiscal year 1997, approximately $1.8 billion in assessed penalties and $1.4 billion in accrued penalties were written off across all tax sources due to an expiration of the statutes of limitation. Approximately $1.7 billion in assessed interest and $6.7 billion in accrued interest were written off. In fiscal year 1998, approximately $1.7 billion in assessed penalties and $1.0 billion in accrued penalties were written off across all tax sources. Approximately $1.7 billion in assessed interest and $6.8 billion in accrued interest were written off. The accrued interest portion of total write-offs is significant due to the continual accrual of

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characterized by constant growth in assessments and abatements and a constant "spread" of assessments and abatements across various tax years.

interest even on accounts that have no collection potential. By law, IRS must maintain these accounts on their databases and continually accrue interest until the statutes of limitation expire.

These write-offs are measures of the "flow" of outstanding liabilities for which the statutes of limitation (generally 10 years) has expired. In presenting its financial statements, however, the IRS must also show the "stock" of unpaid assessments. Under federal accounting standards, unpaid assessments are separated into three categories based on the collection potential and legal status of the assessment. As shown in the lower part of Table 5, unpaid assessment categories include receivables (collectible and uncollectible), compliance assessments, and write-offs.[126] Receivables are liabilities that the IRS can support via concurrence by the taxpayer (e.g., a tax return was filed) or by a court ruling. Receivables are subdivided into two categories based on their collection potential. Collectible receivables represent unpaid assessments with a relatively high degree of collection potential. In fiscal year 1998, collectible receivables comprised $26 billion (12 percent) of total unpaid assessments of $222 billion. (See Table 5.) Based on a random sample of accounts for fiscal year 1997, a General Accounting Office study found that most taxpayers in this category had installment agreements with the IRS (individuals, estates and corporations) or a strong history of tax compliance.[127]

The second category of receivables is uncollectible receivables. Uncollectible receivables generally include hardship cases, bankruptcies and taxpayers with inadequate resources to pay the liability. In fiscal year 1998, uncollectible receivables comprised $55 billion (25 percent) of total unpaid assessments. While uncollectible receivables are recognized as legally binding assessments, they are considered to have low collection potential.

Compliance assessments are unpaid assessments that lack acknowledgment by either the taxpayer or a court that tax is owed. In fiscal year 1998, compliance assessments comprised $22

[126] The write-off category does not imply that the liability will be written off during the current fiscal year. Instead, it is anticipated that the stock of liabilities categorized as write-offs will eventually be eliminated once the statutes of limitation expire.
[127] "Composition and Collectibility of Unpaid Assessments," General Accounting Office, October 1998.

billion (10 percent) of total unpaid assessments. Compliance assessments also are considered to have low collection potential. A General Accounting Office study found that approximately 10 percent of compliance assessment balances was attributable to penalties, while 72 percent was attributable to interest.[128] These accounts, if uncollected, will continue to accrue interest until the statutes of limitation expire.

The final category of unpaid assessments is write-offs. Write-offs are unpaid assessments that have no future collection potential. In fiscal year 1998, write-offs comprised $119 billion (53 percent) of total unpaid assessments. A significant component of write-offs reflect unpaid corporate income and payroll taxes for businesses that are bankrupt or defunct. Based on a random sample of write-off accounts, the General Accounting Office found that 32 percent of the outstanding write-off balance was attributable solely to failed financial institutions.[129] Other significant reasons for classifying liabilities as write-offs include their attribution to deceased taxpayers, taxpayers that could not be located, and taxpayers that have no means to pay the liability.

The General Accounting Office sample of write-offs also revealed that 19 percent of the dollar amount owed was attributable to penalties and 45 percent was attributable to interest. Data supplied by the IRS Office of the Chief Financial Officer support the relatively high proportion of write-offs that is comprised of penalties and interest. For both fiscal years 1997 and 1998, penalties and interest comprised approximately 70 percent of the total write-off balance. (See Table 5.)

Table 6 illustrates the low collection potential of older accounts receivable for individual income, corporate income and employment taxes in fiscal year 1996. Across all tax sources, tax, penalty and interest payments as a percent of the (imputed) fiscal year beginning balance decline rapidly with the number of years the return has been classified as a receivable. In general, taxpayers who are willing and able to remit their liability do so soon after their status becomes delinquent. Conversely, taxpayers whose accounts have been classified as a receivable for more

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[128] Id.
[129] Id.

than five years remit little or no payments, particularly with respect to unpaid corporate income or employment taxes.

E. Risk Profiles of Delinquent Taxpayers

To the extent present data permits, it is useful to consider the risk profiles of various categories of accounts receivable to assist in the design of particular intervention strategies, including penalties. Recent research conducted by the IRS Research Division in this regard yields some observations, although the research is as yet very preliminary.[130] Nevertheless, it reinforces the general observations described above regarding the significant diminution in collection of past due tax debts as the passage of time increases, and provides additional information regarding the characteristics of those who are at low and high risk for nonpayment. The research yielded the observations, among others, that approximately half of the sampled accounts were fully paid within one year, that the likelihood of payment within one year was correlated with whether the taxpayer had an outstanding balance for other years, and with income and assets. In addition, the probability of full payment was correlated with the time that elapsed before at least one payment was made and, if the first payment was not made within 180 days, the probability of voluntary payment prior to initiation of action by the IRS was low.

The study also analyzed the characteristics of individuals at high risk for nonpayment – i.e., those with more than one tax year's liability outstanding. It concludes overall that such individuals were three times more likely not to fully pay within one year than those with a single year's liability outstanding.

[130] Butler, "Payment Dynamics of Individual Accounts Receivable and a New Look at Risk," Internal Revenue Service (Draft, March 1999). This research attempts to assess risk based on such factors as timing of payments, return characteristics, current and prior accounts receivable status, and credit reporting data. The purpose is to identify factors that contribute to the likelihood of risk, and describe patterns that are ultimately of value for predicting the likely disposition of cases. Among other issues identified as within the scope of the research were whether high-risk cases could be identified before they became a financial burden, to reduce intrusiveness on low-risk cases and allow for more flexible development of strategies and efficient prioritization of resources. Id. at 1. The research was based on a panel comprising 33,263 new accounts from the two IRS districts for assessments made during the last two weeks of May, 1996. Id. at 2.

This analysis of accounts receivable strongly reinforces the importance of prompt payment of outstanding tax liabilities and avoidance of multiple liabilities to avoid chronic, long-term delinquency and accompanying growth of interest and penalties in relation to the original tax liability. That avoidance, in turn, reduces the resources the IRS must devote to collection and the frequency and intrusiveness of contacts with taxpayers to facilitate collection.

Penalty and interest provisions designed to encourage prompt payment are important to this effort. However, penalties that are designed to encourage prompt correction of delinquencies and interest provisions designed to deter preference of other creditors over the government, even if generally effective for most taxpayers in these compliance objectives, may impose significant economic burdens on those taxpayers who are not able to correct delinquencies promptly. Precisely because they tend to have lower income and assets, however, sanctions may be less effective incentives for prompt payment of outstanding liabilities. Once such debts have been outstanding for long periods of time, the likelihood that the tax debt will be paid becomes increasingly unlikely.

Thus, an effective penalty system must carefully balance two objectives. It must providing sufficient sanctions (and relief from those sanctions) to deter noncompliance and encouraging prompt correction when noncompliance does occur. At the same time, it must avoid the buildup of financial burdens on delinquent taxpayers to the point where such additional burdens act as a barrier to resolution of the delinquency and, because they are ultimately written off, fail to compensate the government for the resources employed in attempting to collect the outstanding liability.

V. Analysis of Specific Penalty Provisions

This section of the report discusses particular penalty provisions of the Code, beginning with the two most frequently assessed penalties – the failure to file penalty and the failure to pay penalty. In considering these penalties, however, it is important to recognize their relationship to the interest provisions of the Code. Under present law and administrative practice, taxpayers who are delinquent filers and owe tax generally are assessed the failure to pay penalty and the failure to file penalty, as well as interest. The two penalties are coordinated to ensure that they do not impose a greater cumulative penalty. If the liability remains outstanding for a period of years, the overall burden of interest and penalties can rise significantly in relation to the original, underlying tax liability.[131] Not surprisingly, the probability of full payment also declines significantly with the passage of time. As a consequence, these penalties should be considered together and in combination with the interest provisions when evaluating their ability to encourage compliance in filing and payment.

A. Failure to File Penalty

A principal assumption of our current self-assessment system is that taxpayers will provide a periodic accounting of their tax liability, and will do so in a prescribed form and by statutory filing dates. Taxpayers are required to report the amount and nature of their income and expenses and to compute (or have the IRS compute) the tax liability due to, or refund due from, the government. Returns also are required of tax exempt organizations and other non-taxable entities to provide an accounting of activities for the year to enable oversight of the organization's continued entitlement to tax exempt status. Payors of various types of income are also required to report those payments to enable the government to verify the sources of income reported or deductions claimed by taxpayers.

The tax return is the primary vehicle for the IRS to determine the accuracy of a taxpayer's reporting and whether or not any subsequent changes to the taxpayer's self-reporting

[131] For example, at present interest rates, after little more than four years the failure to file and failure to pay penalties, coupled with interest, can accrue to an amount equal to the initial tax liability.

are appropriate. The filing of tax returns also provides the impetus for taxpayers to maintain adequate and accurate records and enables comparison of information reported on the return with information from other sources. Over time, perceived defects in reporting accuracy have led to information reporting of various forms of income, including reporting of wage information, payments of interest and dividends, and other sources of income and deductions (e.g., mortgage interest payments).

Tax returns are filed on prescribed forms. The Secretary also is authorized to prepare a tax return for taxpayers who fail to file returns.[132] For individuals, the statutory due date for income tax returns is April 15 of the following calendar year, allowing taxpayers nearly four months to perform the necessary financial assessment and computations. For corporations, the due date is the 15th day of the third month following the end of the taxable year. The internal revenue laws recognize, however, that at times and for various reasons, taxpayers may not be able to meet the statutory filing deadline. Thus, the Code also provides for extensions of time to file, which can be readily accomplished through filing of relatively simple forms with the IRS. Roughly one percent of individual taxpayers took advantage of such extensions for the 1996 taxable year. An extension of time to file, however, does not provide a taxpayer with an extension of time to pay his or her tax liability.[133] Thus, a taxpayer who receives an extension of time to file nevertheless must pay the tax due and owing and, if the amount paid is less than the tax reported on the return when later filed, the taxpayer will be charged interest on the shortfall computed from the original due date of the return.

The internal revenue laws also recognize special circumstances when timely filing may not be feasible for significant numbers of taxpayers due to special circumstances, for example, military service in a combat zone or disaster.[134] Under other circumstances, the IRS may waive

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[132] Section 6020.

[133] Extensions of time to file are granted pursuant to Code section 6081. See Code section 6161 for extensions of time to pay tax.

[134] See, e.g., Code section 7508 (combat zone service) and section 7508A (Presidentially declared disasters).

penalties, but not interest, for taxpayers who cannot reasonably comply with the tax laws. Interest can be abated in certain statutorily-described circumstances.[135]

The preparation and filing of a tax return requires affirmative action by a taxpayer, even if the return is prepared by another party such as a paid return preparer. The filing obligation is important in permitting the government to identify the universe of taxpaying citizens and to have sufficient information to verify that the correct taxes are being paid. Accordingly, a penalty exists for failure to file tax returns timely to foster compliance in meeting the statutory filing deadlines.[136]

1. Present-law penalty

A taxpayer who fails to file his or her tax return on or before the prescribed due date (determined with regard to extensions of time to file) is subject to a penalty under Code section 6651(a). The penalty is only imposed if there is a delinquency in tax -- if the taxpayer is not in fact in arrears in tax liability, no failure to file penalty will be imposed if the return is not filed. The penalty is 5 percent of the net amount due for each month that the return is delinquent, up to a maximum of 25 percent of the net amount due.[137] The net amount due is the amount of tax required to be shown on the return reduced by the amount of any part of the tax which is paid on or before the date prescribed for payment of the tax, and by the amount of any credits against tax which may be claimed on the return.[138]

The penalty does not apply if the taxpayer demonstrates that the failure to file was due to reasonable cause and did not result from willful neglect.[139] Reasonable cause involves the exercise of "ordinary business care and prudence."[140] Willful neglect means a conscious,

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[135] See, for example, Code section 6404(h), which permits abatement of interest if extensions of time to file and pay have been granted to taxpayers as a result of a Presidentially declared disaster.
[136] See United States v. Boyle, 469 U.S. 241, 245- 46 (1985).
[137] Code section 6651(a)(1).
[138] Code section 6651(b)(1).
[139] Code section 6651(a)(1).
[140] See id.; Treas. Reg. sec. 301.6651-1(c).

intentional failure or reckless indifference.[141] The courts generally have construed the reasonable cause exception narrowly. Reliance on a third party agent, for example, may not constitute reasonable cause.[142]

In 1982, Congress modified the penalty to impose a minimum penalty on delinquent returns with small net amounts due. Thus, if a return is filed more than 60 days after its due date, then the failure to file penalty may not be less than the lesser of $100 or 100 percent of the net amount due.[143]

The failure to file and failure to pay penalties are coordinated. If a penalty for failure to file and a penalty for failure to pay tax both apply for the same month, the amount of the failure to file penalty for that month is reduced by the amount of the failure to pay penalty.[144] Thus, if a taxpayer is subject to both the failure to file and failure to pay penalties, for the first five months of the delinquency the failure to pay penalty will apply at the statutory rate of 0.5 percent and the failure to file penalty will apply at a reduced rate of 4.5 percent. Once the maximum failure to file penalty is reached after five months, if the delinquency continues, then only the failure to pay penalty will continue to apply and can potentially apply for the next 45 months until the 25 percent maximum applicable to that penalty is reached.

The failure to file penalty applies to most types of returns that are filed. That is, it applies to all income tax returns of an individual or fiduciary of an estate or trust, corporate income tax returns, self-employment tax returns, and estate and gift tax returns (i.e., returns required to be filed under subchapter A of chapter 61); returns relating to distilled spirits, beer and wine (subchapter A of chapter 51); returns relating to tobacco, cigars, cigarettes, and cigarette papers and tubes (subchapter A of chapter 52); and returns relating to machine guns and certain other

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[141] If the failure to file is fraudulent, the penalty rate is increased to 15 percent per month of the net amount due, up to a maximum of 75 percent.
[142] See, e.g., Mauldin v. Commissioner, 60 T.C. 749, 762 (1973).
[143] Code section 6651(a). As originally proposed, a failure to file penalty also would have been imposed in situations where the tax return was delinquently filed but where no balance due was reported. Congress did not enact the provision in this form but, instead, imposed a minimum penalty where a small balance was owed.
[144] Code section 6651(c)(1).

firearms (subchapter A of chapter 53). The penalty does not apply to the failure to file estimated tax returns with respect to estimated taxes required to be paid under Code sections 6654 or 6655. A separate penalty under Code section 6698 is also imposed for failure to file a partnership return.[145]

2. Historical background

Reflecting the fundamental importance of the filing obligation, the failure to file penalty has long been a feature of the Code and was enacted in the Revenue Act of 1928. As originally enacted, the penalty was not time sensitive – it was imposed at a flat rate of 25 percent of the net amount of tax due. The time-sensitive feature of the present-law penalty was enacted in the Revenue Act of 1936 and has continued unchanged since that time. The de minimis penalty for small balances was added by the Tax Equity and Fiscal Responsibility Act of 1982.

3. Comparison with state law failure to file penalties

Treasury examined the failure to file penalties in a sample of seven states (Arizona, California, Colorado, New York, Pennsylvania, Virginia and Vermont) that have a state income tax. As a general rule, these states impose failure to file penalties similar to those imposed by the Federal government. The rate imposed is generally five percent per month (six percent in Virginia) with caps ranging from 12 percent to 36 percent. The penalty usually is coordinated with the failure to pay penalty if such a penalty is imposed. See Appendix B.

4. Analysis

Notwithstanding any complexities or burdens associated with the return filing obligation, the vast majority of taxpayers comply with the filing requirement and the record of the U.S. tax system in this respect is extremely good. For example, in fiscal year 1998, the failure to file penalty was assessed against less than two percent of individual taxpayers. In a report published

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[145] The penalty is $50 multiplied by the number of persons who were partners in the partnership during any part of the taxable year, for each month (or fraction thereof) during which such failure continues (but not to exceed five months), unless the failure is due to reasonable cause. There is no maximum penalty and the penalty is assessed against the partnership.

in 1996, the IRS estimated that in 1992 the gross nonfiling tax gap[146] ranged from $13.5 to $13.8 billion, which accounted for approximately 2.5 percent of the estimated true tax liability.[147] Of this amount, the IRS estimated that $3 billion, or less than one-third, ultimately would be collected through IRS enforcement measures.[148] That same research estimated that the underreporting and underpayment tax gaps are more serious compliance problems than the nonfiling tax gap. This suggests that the basic filing obligation is well understood by the public at large and accepted as an appropriate norm in a self-assessment system.[149]

Nonetheless, a substantial number of failure to file penalty assessments are made by the IRS each year. In fiscal year 1998, approximately 1.8 million failure to file penalties were assessed against individuals (net of abatements for the same fiscal year). Another 118,000 were assessed against corporations; and 1.5 million were assessed with respect to delinquent employment tax returns. In fiscal year 1998, the failure to file penalty (net of abatements) accounted for approximately 9 percent of the total number of penalties and 29 percent of the total dollar amount of penalties (net of abatements) assessed against individuals.[150] Research conducted on individual nonfilers whose returns were more than one year late is reported in a 1996 report by the General Accounting Office.[151] According to this report, a substantial proportion of the individual returns that were more than one year late were not filed until two or more years had passed.

Evaluation of options for change. Because of the importance to the current self-assessment system of the filing requirement and the burden imposed on the system of tax

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[146] Defined as the amount of tax liability owed by taxpayers who do not voluntarily and timely file required returns, net of amounts prepaid through withholding, estimated payments, and other credits (and excluding legitimate nonfilers). This amount is the gross tax gap and does not net amounts later remitted or collected late. Internal Revenue Service, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988 and 1992 (Rev. April 1996) at pages v, 1-2.
[147] Id. at 7.
[148] Id. at 10.
[149] This conclusion also was reached by the 1989 Task Force Report, based on a report of focus group sessions conducted. See 1989 Task Force Report, supra note 10, at VI-2.
[150] 1998 IRS Databook/Commissioner's Annual Report.
[151] General Accounting Office, IRS' Nonfiler Strategy (1996).

administration and processing by the absence of timely filed returns, it is appropriate that a penalty be imposed for failure to timely file. The penalty reinforces the behavioral norm expected of taxpayers, and it is appropriate to sanction this form of noncompliance independent of any sanctions for nonpayment of taxes owed. Although in principle, the current law penalty is designed to provide an incentive to correct a delinquent filing as quickly as possible, it quickly imposes a significant financial burden on nonfilers who owe tax and does not provide a continuing incentive to correct a filing delinquency beyond the first five months. Thus, Treasury considered a number of issues in considering whether the penalty should be modified.

Front-loading of penalty. Treasury considered whether the present "front-loading" of the penalty in the first five months should be reconsidered, notwithstanding the longstanding nature of this penalty feature. As noted above, this feature is designed to encourage prompt filing of delinquent returns but the front-loading of the penalty does not provide a continuing incentive to file. In combination with the failure to pay penalty and interest if a tax liability is also outstanding, this feature of the failure to file penalty may pose a significant impediment to later resolution of the taxpayer's liability and, perversely, could encourage continuing noncompliance in cases where the noncompliance is due to financial difficulty rather than willful nonfiling. It is somewhat anomalous that the penalty is the same for a six-month filing and three-year filing delinquency. Moreover, it is anomalous that a taxpayer may delay filing a return at least four months beyond the normal filing date by requesting an automatic extension of time to file, but close to the maximum penalty is imposed on a taxpayer who files four months late without requesting an extension (in addition, in both cases, to interest and a failure to pay penalty for taxes due and not timely paid).

Treasury believes that consideration should be given to a penalty structure that provides a continuing incentive to file over a much longer period of time and imposes a lower penalty in the first few months of the delinquency. This approach would recognize the importance of filing, but not impose as large a penalty on noncompliance of a shorter duration. The penalty should provide continuing incentive for correction without discouraging financially troubled taxpayers from resolving their noncompliance and without impairing compliance by the majority of taxpayers who timely file. This would be accompanied by modifications, discussed below, to the failure to pay penalty to place greater emphasis on prompt correction of nonpayment. The failure to file and failure to pay penalties would not be linked, which would have the effect of treating each type of noncompliance separately. Thus, a taxpayer who did not file or pay amounts due and owing would have both penalties imposed at their respective rates. The higher failure to file penalty of current law would be maintained for fraudulent nonfiling.

Penalty for nonfiling where no tax is owed. Treasury also considered whether it is appropriate to impose a minimum flat fee for delinquent filings where no tax was shown on the return as owed, i.e., in "refund due" or "zero balance" situations not presently subject to the late filing penalty. A significant portion of late filed returns involve "refund due" or "zero balance" situations. If the filing obligation is treated as independent of the payment obligation, there is logic to the imposition of a fee for late filing, irrespective of whether any balance is owed. Burdens are imposed on the system of tax administration and processing by the nonfiling or late filing of returns. The IRS, for example, may prepare a substitute for return based on information reports, assess tax and subsequently be required to abate tax, interest and penalties if the taxpayer later files a return demonstrating that no tax is owed. The processing required in such a situation is somewhat more costly than that associated with a timely filed "refund due" return (and more intrusive in dealing with taxpayers). Available information on abatements of the failure to file penalty suggests that this type of situation is not an infrequent occurrence.[152] In addition, it is somewhat anomalous that the present system imposes a disproportionate, if de minimis, penalty for delinquent filing of returns with very small balances due, but imposes no fee to reflect compliance costs in a refund due situation. On the other hand, taxpayers who file late and are due a refund are denied the use of their overpayments, or earnings on such overpayments, until they file a return and receive their refund. This opportunity cost can be viewed as a sufficient sanction for delayed filing in the refund due situation, and as sufficient recompense for the government which retains the funds for a longer period of time. On balance, Treasury believes that consideration should be given to a de minimis charge for late-filed "refund due" or "zero balance" returns, at least in situations where the IRS has already contacted the taxpayer regarding the situation.

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[152] General Accounting Office, IRS' Abatement of Assessments in Fiscal Years 1995-1998 (June 1999) at 43.

First time filer waiver. Treasury also considered whether it is appropriate to provide relief for "first time filers" or "first time offenders" -- that is, those who are new to the taxing system or who otherwise have a good compliance history. The reasons for late filing by new filers or those who otherwise have good compliance histories may be varied, including a lack of understanding of their tax obligations, temporary or sudden economic difficulty, dilatoriness and/or lack of diligence in the necessary record-keeping, or other reasons short of willful and chronic noncompliance. The goal in such cases should be to get the taxpayer current in his or her tax obligations as quickly as possible so as to discourage continuing noncompliance. On the other hand, the importance of the filing obligation, the ready availability of extensions of time to file, the availability of relief from penalty for reasonable cause, coupled with the ability to enter into installment payment arrangements or, in cases of serious economic difficulty, to enter into an offer in compromise suggest that there are considerable means available for taxpayers to keep current with their filing obligations and handle any accompanying payment difficulties. Treasury concludes that, on balance, these considerations weigh against a grant of automatic relief from the filing obligation for "first time filers" or "first time offenders." Nevertheless, these are factors that should be considered in the penalty abatement process and, where willful noncompliance is not involved or other countervailing factors are not present, waiver of the penalty contingent on future compliance should be considered.

Recommendations

Treasury recommends that the failure to file penalty be converted to a penalty that provides a continuing incentive to correct a filing delinquency. For example, the penalty could be in the range of one-half percent per month for the first six months, and one percent a month thereafter, up to a maximum of 25 percent. Fraudulent failures to file would be penalized at the current law, higher rate of 15 percent per month, up to a maximum of 75 percent.

Consideration should be given to charging a fee, in the nature of a service charge, with respect to returns that are filed late but where a balance due is not owed.

Late filing in the case of first time filers or taxpayers with otherwise good compliance histories should not result in automatic waiver of the penalty, but this factor should be considered in establishing "reasonable cause" for abatement of the penalty.

B. Failure to Pay Penalty

The failure to pay penalty does not have as long a lineage as the failure to file penalty. As previously described, it was instituted in 1969 largely in response to perceptions that the interest rate charged on unpaid tax liability was too low. Given the changes that have subsequently occurred in the interest provisions, it is appropriate to consider whether the failure to pay penalty retains viability.

1. Present-law penalty

Taxpayers are required not only to file returns timely, but to pay any amounts shown as unpaid on the return timely filed and to pay the correct amount of tax. A taxpayer who fails to timely pay tax that is due is subject to penalty under Code sections 6651(a)(2) and 6651(a)(3). Under section 6651(a)(2), the penalty may be imposed for failure to pay the tax shown on a return. This penalty is computed from the due date of the return, determined without regard to extensions of time for filing.[153] Thus, the penalty is structured to accrue from the same point in time as interest accrues on the unpaid tax liability. Under section 6651(a)(3), a failure to pay penalty is imposed for failure to pay tax required to be, but not, shown on the return for which the IRS has issued a notice and demand for payment. The penalty is computed from the date the tax is assessed. This penalty applies, for example, in cases where a taxpayer understates his or her tax due to a mathematical error. However, this penalty does not apply if the amount shown

[153] In instances where the taxpayer fails to file a return and the IRS prepares a substitute for return (generally as a result of information reporting), the substitute return is treated as if it were prepared by the taxpayer and the failure to file penalty is assessed as of the original due date of the return. However, if the tax computed on the substitute for return is overstated, only the amount actually due is subject to penalty. See Code sections 6651(g) and 6651(c)(2). The treatment of a substitute for return as the taxpayer's return for purposes of the failure to file penalty was enacted in 1996. Prior to that time, no failure to pay penalty was imposed if the return was prepared by the IRS pursuant to Code section 6020(b).

in the notice and demand for payment is paid within 21 days (or within 10 business days if the amount shown is $100,000 or more).[154]

In either case, the penalty rate is 0.5 percent per month, up to a maximum of 25 percent. This penalty is coordinated with the failure to file penalty in cases where both penalties apply. The failure to file penalty is reduced by the amount of the failure to pay penalty. Thus, in the first five months of a delinquency in filing and payment, the failure to file penalty will be assessed at a rate of 4.5 percent per month and the failure to pay penalty at its statutory rate of 0.5 percent per month. Thereafter, only the failure to pay penalty will be assessed for continuing delinquency at a rate of 0.5 percent per month. This coordination, however, cannot cause the failure to file penalty to be reduced below the rates applicable in the case of delinquencies exceeding 60 days. The penalty rate is increased to one percent per month once the IRS proceeds to collect either by way of a notice of intent to levy or by notice and demand for payment after a jeopardy assessment.[155]

The amount subject to penalty is reduced each month by payments made before the month for which the penalty is imposed and by any credits that may be applied against the tax. Payments made during any month for which the penalty is applicable do not reduce that month's penalty.

The penalty can be abated if the failure to pay is shown to be due to reasonable cause and not willful neglect. Under Treasury regulations, the taxpayer must show that "ordinary care and prudence in providing for the payment of tax" was exercised or that the taxpayer would have

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[154] The period permitted for payment following notice and demand prior to imposition of the failure to pay penalty was increased in 1996 from the previously-permitted period of 10 days following the date of notice and demand. This change provides taxpayers with all but the largest unpaid amounts additional time to pay after notice and demand.

[155] Code section 6651(d). The effective date of the rate increase is either the first day of the month that begins (1) at least 10 days after the levy date for taxes subject to levy or (2) after the jeopardy assessment date. Code section 6651(d)(2)(A). This provision was added in 1986 to reflect the additional cost to the IRS of enforced collection action against taxpayers who ignored multiple requests for payment. Pub. L. No. 99-514, 100 Stat. 2085.

suffered “undue hardship” if the tax were paid on the due date.[156] Factors indicative of failure to exercise ordinary business care include lavish or extravagant living expenditures that reduce a taxpayer’s ability to pay or investments in illiquid or speculative assets.[157] “Undue hardship” is not defined in the regulations issued under Code section 6651, but is defined in regulations issued under Code section 6161 in connection with extensions of the due date for payment of taxes. “Undue hardship” in this context is defined to mean “more than mere inconvenience to a taxpayer. The taxpayer must be faced with substantial financial loss if a timely payment were made.”[158] The penalty also is reduced in the situation where a taxpayer timely filed a return (determined with regard for extensions of time to file) and later enters into an installment agreement. The penalty is reduced to 0.25 percent for any month that the installment agreement is in effect. This reduction in the penalty rate was enacted by RRA 1998 and takes effect for determining penalties in months beginning after December 31, 1999.[159] The stated rationale was that because the failure to pay penalty serves to encourage timely payments, it was logical to reduce the penalty when taxpayers evidence their willingness to pay overdue amounts by entering into an installment agreement with the Service.[160]

Like the failure to file penalty, the failure to pay penalty applies to most types of returns that are filed. That is, it applies to all income tax returns of an individual or fiduciary of an estate or trust, corporate income tax returns, employment tax returns, and estate and gift tax returns (i.e., returns required to be filed under subchapter A of chapter 61); returns relating to distilled spirits, beer and wine (subchapter A of chapter 51); returns relating to tobacco, cigars, cigarettes,

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[156] Treas. Reg. sec. 301.6651-1(c)(1). Reasonable cause also will be presumed for an individual taxpayer with a valid filing extension who has paid at least 90 percent of the tax due by the original return due date with respect to the remaining balance, provided the remainder is paid with the filing of the return at the extended due date. Treas. Reg. sec. 301.6651-1(c)(3).

[157] Id.

[158] Treas. Reg. sec. 1.6161-1(b).

[159] Code section 6651(h). This reduction does not apply if the rate was increased by section 6651(d). See footnote 155, supra.

[160] See Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 76 (1998)(“The Congress believed it inappropriate to apply the full amount of the penalty for failure to pay taxes to taxpayers who are paying their taxes through an installment agreement.”).

and cigarette papers and tubes (subchapter A of chapter 52); and returns relating to machine guns and certain other firearms (subchapter A of chapter 53).

2. Historical background

This penalty was enacted in 1969 primarily out of concern that the interest rate then charged on underpayments was too low and provided incentive for taxpayers to treat the government as a low-cost source of borrowing. The legislative history stated in this regard that because the then

> current cost of borrowing [was] substantially in excess of the 6 percent interest rate provided by the Internal Revenue Code, it was to the advantage of taxpayers in many cases to file a return on the due date but not to pay the tax shown as owing on the return. For the period the tax remained unpaid, the taxpayer was, in effect, borrowing from the Government the amount of tax at a 6 percent rate of interest. Similar borrowings could result from failure to pay deficiencies or to make deposits of taxes.[161]

Since that time, the basic structure of the penalty has remained intact, with the aforementioned modifications to increase the applicable penalty rate after the IRS has taken enforcement action (enacted in 1986), to expand the time for paying after notice and demand before the penalty under section 6651(a)(3) applies (enacted in 1996), and to reduce the applicable penalty rate during the pendency of an installment agreement (enacted in 1998).

3. Comparison with state law failure to pay penalties

Most of the states sampled by Treasury imposed failure to pay penalties in addition to failure to file penalties and generally coordinated the two penalties. The penalties range from one-half percent per month to 6-percent per month but most imposed a 5-percent per month penalty. See Appendix B.

[161] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969, 91st Cong., 2d Sess. 258 (Dec. 3, 1970).

4. Analysis

The legislative history of the failure to pay penalty suggests that its original purpose was to serve as an effective increase in the interest rate applicable to unpaid tax liability in response to the perception that the then-prevailing 6-percent simple interest rate was inadequate to encourage timely payment and to discourage use of the government as a low-cost source of borrowing. As the interest provisions have been subsequently modified to calibrate the rate structure more closely to market interest rates, it would appear that this original rationale has lost persuasive force. Other features of the failure to pay penalty, however, suggest that it now should be viewed as a penalty rather than as an interest surcharge. For example, the reduction in the penalty rate during the pendency of an installment agreement can be seen as a penalty response to compliance considerations or, alternatively, as a reduction in the interest rate reflecting an assessment of creditworthiness based on the taxpayer's evidenced willingness to make payment arrangements. The penalty also has aspects of a user fee in that an increased penalty rate is applicable to failures to pay that necessitate IRS enforcement action and the legislative history lends some support to this characterization.[162]

A significant number of failure to pay penalties are assessed every year. In fiscal year 1998, 11.5 million such penalties (net of abatements) were assessed on individuals, in amounts totaling $1.2 billion dollars. Approximately 258,000 were assessed on corporations and 3.3 million with respect to employment taxes. Failure to pay penalties comprise one of the largest component of penalties assessed against individuals both in terms of numbers and amounts – in fiscal year 1998 they comprised 57 percent of net penalties assessed and 32 percent of net amounts assessed.[163]

Evaluation of options for modification. The issue of whether, as suggested by some commentators, repeal of the failure to pay penalty is appropriate hinges importantly on whether it

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[162] Code section 6651(d); H.R. Rep. No. 426, 99th Cong., 1st Sess. 831-32 (1985).

[163] Failure to pay penalties comprise a lesser but still significant component of penalty numbers and amounts assessed against corporations and with respect to employment taxes – 37 percent and 13 percent, respectively, for corporations and 41 percent and 11 percent, respectively, with respect to employment taxes in fiscal year 1998.

serves, and should serve, solely as an interest charge or as a penalty. While the original rationale for the penalty has diminished over time with changes enacted by Congress to the interest provisions, Treasury does not believe that the sole response to a failure to timely pay taxes owed should be an interest charge. The failure to pay penalty should function as a separate penalty to further encourage prompt payment of liabilities and to sanction delay in payment. There are several reasons for this conclusion.

First, even assuming that interest rates charged by the government on underpayments can be calibrated to approximate the appropriate market rate of interest for all taxpayers, the primary purpose of such interest is to compensate the government for the lack of funds due and owing to it. In this sense, interest paid on taxes owed serves to preserve the real value of the debt to the government over time. There should be a positive incentive, however, to prefer the government over other creditors and to work out payment difficulties promptly. Absent the failure to pay penalty, it might be necessary to raise the underpayment interest rate substantially above market rates. Raising the underpayment interest rate for this specific purpose can have ancillary effects, however, including on the overpayment rate (or differential between the underpayment and overpayment rates), on interest abatement provisions, and on other Code provisions where the underpayment or overpayment rate is applicable.[164] Moreover, although some taxpayers may be troubled as to why an interest charge is not the only (or primary) sanction for failures to pay, they may be equally troubled by imposition of a higher interest rate in lieu of a penalty, and also by the reduced scope for abatement of interest.

It seems appropriate, therefore, to continue to impose a failure to pay penalty for nonpayment of outstanding tax liabilities, recognizing that the penalty will be structured to resemble an interest surcharge for late payment. The penalty should be imposed on the amount of outstanding balance so as to foster prompt resolution of payment problems. It is also appropriate to continue the approach of present law in reducing the penalty rate for taxpayers who have entered into, and adhere to, payment arrangements with the IRS.

[164] For example, in relation to lookback rules that apply to recognition of income from long-term contracts and the income forecast method of computing depreciation.

Recommendations

Treasury recommends that the failure to pay penalty be restructured to impose a penalty of 0.5 percent (the current law rate) per month on the net amount due for the first six months of a payment delinquency, with a higher rate of one percent per month thereafter, up to a maximum of 25 percent. The penalty rate in the first six months would be decreased to 0.25 percent if the taxpayer enters into a payment arrangement with the IRS in that time to which the taxpayer adheres. The one percent penalty rate, likewise, would be reduced to 0.5 percent per month if the taxpayer makes a payment arrangement after the lapse of six months (to which the taxpayer adheres). Consideration could be given to whether, as under current law, a higher penalty rate should apply once the IRS takes collection enforcement action.

To further facilitate adherence to installment agreements, consideration should be given to providing the IRS with authority to utilize a fixed interest rate to apply to an installment agreement, which rate would be determined at the time the agreement is entered into, rather than the current-law floating rate. Under current installment agreement practice, the payment schedule agreed to with the taxpayer only amortizes the liability for tax and interest that accrue before the beginning of the agreement. The scheduled payments do not cover additional interest that accrues during the term of the agreement or the failure to pay penalty on that amount. Taxpayers are required to pay these additional amounts after the schedule of installment payments has been completed. Taxpayers thus can end up owing an additional payment after their scheduled payments are made. A fixed interest rate during the pendency of the agreement would permit computation of a fixed payment schedule for taxpayers.

C. Penalties for Failure to Pay Estimated Tax

Taxpayers generally are required to pay their income taxes during the year on a "pay-as-you-go" basis as the income is generated, rather than after the close of the year when their tax returns are actually filed. Wages and salaries and certain other income of individuals are subject to withholding when paid. Corporations and individual taxpayers who have substantial amounts of income not subject to withholding (or whose withholding is not sufficient) are generally required to make payments of the estimated amount of their tax liability which is not paid through withholding. The estimated tax payments generally are required to be made quarterly; that requirement prevents a substantial disparity in the timing of tax payments between income subject to withholding and other income. As a general rule, taxpayers can make estimated tax payments based on their estimates of current year's tax liability or based on their prior year's tax liability. The difficulty of estimating current year tax liability and required estimated tax payments depends on the stability and predictability of the taxpayer's income throughout the year. Failure to make such payments subjects a taxpayer to an addition to tax for the underpayment under Code section 6654 (for individuals) or 6655 (for corporations).

1. Estimated tax payment rules

a. Individuals

For individuals, the estimated tax payment rules require that timely estimated tax payments (through a combination of withholding and estimated tax payments) be at least equal to (1) 90 percent of the tax shown on the return for the current year or (2) 100 percent of the tax shown on the return for the prior year (the "prior year safe harbor").[165] However, the prior year safe harbor is higher for taxpayers with adjusted gross income (AGI) above $150,000 ($75,000 if married and filing separately) for the current year. For example, the prior year safe harbor for such taxpayers is 110 percent of the prior year's tax liability if the prior taxable year begins in 2002.[166] In addition, estimated tax payments are not required if the tax shown on the current

[165] Code section 6654(d)(1)(B). Withholding is treated as an estimated tax payment for this purpose. Code section 6654(g).

[166] The applicable prior year safe harbor percentage for taxpayers with AGI over $150,000 varies under current law where the prior year begins prior to 2002: 105 percent if the prior taxable year

year's return (or current year's tax liability, if no return is filed) exceeds the amount withheld by less than $1,000.[167]

Generally, estimated tax payments are required to be made quarterly. For calendar-year taxpayers, the installments must be paid on or before April 15, June 15, and September 15 of the tax year and on January 15 of the next tax year.[168] Generally, each quarterly payment must be at least 25 percent of the amount by which the lesser of 90 percent of current year liability or the appropriate safe harbor percentage of prior year liability exceeds the amount of taxes withheld for the current year.

Taxpayers whose income fluctuates during the year may reduce their required estimated tax installments if the taxpayer's annualized income installment is less than the installment otherwise payable under the rules.[169] An annualized income installment is the excess of (1) an amount equal to the applicable percentage of the tax for the year calculated by placing on an annualized basis the taxable income, alternative minimum taxable income, and adjusted self-employment income for months in the taxable year ending before the due date of the installment, over (2) the aggregate amount of any prior required installments for the taxable year.[170]

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begins in 1998; 106 percent if in 1999 or 2000; and 112 percent if in 2001. The prior year safe harbor does not apply if the taxpayer did not file a tax return for the prior tax year or if the prior year was a taxable year of less than 12 months.

[167] Code section 6654(e)(1).

[168] Code section 6654(c)(2). If the payment due date falls on a Saturday, Sunday, or holiday, then the payment is due on the next day that is not a Saturday, Sunday, or holiday. If, on or before January 31 of the following taxable year, the taxpayer files a return for the taxable year and pays in full the amount computed on the return as payable, then no addition to tax is imposed with respect to any underpayment of the fourth required installment for the taxable year. Code section 6654(h).

[169] Any such reduction must be recaptured in subsequent estimated tax installments that are not computed under the annualized income method. Code section 6654(d)(2).

[170] The applicable percentages are: (1) 22.5 percent for the first installment; (2) 45 percent for the second installment; (3) 67.5 percent for the third installment; and (4) 90 percent for the fourth installment. Code section 6654(d)(2)(C)(ii).

Special rules apply to farmers and fisherman, who are required to pay only one installment of tax for any taxable year, which installment is due on January 15 of the following taxable year and must be equal to 66 2/3 percent of the tax shown on the return for that year or 100 percent of the tax shown on the return for the prior year.[171] Special rules also apply to nonresident aliens.[172]

b. Corporations

Corporations generally are required to make quarterly estimated tax payments of at least 25 percent of the lesser of (1) 100 percent of the tax shown on the return for the current year or (2) 100 percent of the tax shown on the return for the prior year. The prior year safe harbor is not available to corporations with taxable income of at least $1 million in any of the three prior years, but such corporations may use the prior year's tax as the basis for the first quarterly estimated tax installment. Estimated tax payments are not required if tax liability is less than $500. Estimated tax payments generally are due on the 15th day of the fourth, sixth, ninth, and twelfth months of the corporation's fiscal year.[173]

Corporations whose income fluctuates throughout the year may base their estimated tax payments on the annualized amount of their income received through the month prior to the required date for the estimated tax payment. Under this provision, the required payment is the appropriate percentage of annualized liability due by the particular payment date, less the amounts previously paid.[174]

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[171] Code section 6654(i)(1)(A). An individual is a farmer or fisherman if gross income from that activity for the current and prior taxable years is at least 66 2/3 of total gross income from all sources for those taxable years. Code section 6654(i)(A)(2). Alternatively, no estimated tax payments are due for a taxable year if the farmer or fisherman files his or her return and pays his or her tax in full by March 1 of the following year. Code section 6654(i)(1)(D)(i).

[172] Nonresident aliens are required to pay estimated tax in three installments, on June 15, September 15, and January 15 of the following tax year. Code section 6654(j). The June 15 installment must be equal to 50 percent of the required annual payment.

[173] As for individuals, if the due date of the installment payment falls on a Saturday, Sunday, or holiday, the due date is the following day that is not a Saturday, Sunday, or holiday.

[174] Any reduction in an installment resulting from this rule must be recaptured by increasing the amount of the next required installment by the amount of such reduction, and by increasing

2. Additions to tax for failure to pay estimated tax

Code sections 6654 and 6655 impose an addition to tax for an underpayment of estimated tax.[175]

a. Individuals

If an individual taxpayer (or an estate or trust) does not make the required estimated payments, as described above, an addition to tax is imposed under Code section 6654. The amount of the addition to tax is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.[176] In essence, the penalty amount is equivalent in dollar amount to interest on the underpaid amount for the period of the underpayment. The amount of the underpayment is the excess of the required payment over the amount (if any) paid either by estimated tax payment or withholding[177] on or before the due date of the installment.[178] The period of the underpayment runs from the due date of the installment to the earlier of (1) the due date of the return (generally, the 15th day of the fourth month following the close of the taxable year), or (2) the date on which each portion of any underpayment is made.[179] A payment of estimated tax is credited against unpaid but required installments in the order in which such installments are required to be made.[180] The underpayment interest rate is the rate under Code section 6621(a)(2), that is, the AFR plus three percentage points.

There are several different types of situations in which the addition to tax for failure to make estimated tax payments does not apply. No addition to tax is owed if the tax shown on the return for the taxable year (or the tax, if no return is filed), reduced by Federal income tax

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subsequent required installments to the extent that the reduction has not previously been recaptured. Code section 6655(e)(1)(B).

[175] No income tax deduction is permitted for this addition to tax. Code section 162(f); Treas. Reg. sec. 1.162-21(b)(ii).

[176] Code section 6654(a).

[177] For estimated tax purposes, amounts withheld on wages are deemed to be paid as estimated tax in equal amounts throughout the taxable year unless the taxpayer establishes otherwise. Code section 6654(g).

[178] Code section 6654(b)(1).

[179] Code section 6654(b)(2).

withholding, is less than $1,000.[181] The penalty also can be waived in certain circumstances. The penalty can be waived to the extent the Secretary determines that the taxpayer has suffered a casualty, disaster, or other unusual circumstances where imposition of the penalty would be against equity and good conscience.[182] The penalty is also waived if the underpayment is due to reasonable cause and not willful neglect when the Secretary determines that the taxpayer either (1) retired after attaining age 62, or (2) became disabled in the current or prior taxable year.[183] No other reasonable cause exceptions apply. In addition, relief from the addition to tax has frequently been provided statutorily when increases in tax liability have been the result of changes in the tax laws.[184]

b. Corporations

If a corporation fails to make timely estimated tax payments, then a penalty is imposed under Code section 6655. The penalty amount is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.[185] The amount of the underpayment is the excess of the required payment over the amount (if any) of the installment paid on or before the due date. The period of the underpayment runs from the due date of the installment to the earlier of (1) the 15th day of the third month following the close of the taxable year, or (2) the date on which each portion of any underpayment is made.[186] A payment of estimated tax is credited against unpaid required installments in the order in which such installments are required to be paid.[187] The addition to tax for failure to make estimated tax

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[180] Code section 6654(b)(3).

[181] Code section 6654(e)(1). The addition to tax also does not apply if there was no tax liability for the prior taxable year (provided it was a 12-month taxable year), the individual had no liability for tax for such year, and the individual was a citizen or resident of the U.S. throughout the year. Code section 6654(e)(2).

[182] Code section 6654(e)(3)(A).

[183] Code section 6654(e)(3)(B).

[184] See, e.g., H.R. 2014, 105th Cong., 1st Sess. sec. 1(d) (1997).

[185] Code section 6655(a).

[186] Code section 6655(b)(2).

[187] Code section 6655(b)(3).

payments is not imposed if the tax shown on the return for the taxable year (or the tax, if no return is filed) is less than $500.[188]

2. Historical background

a. Individuals

The estimated tax payment requirements have changed over time. Prior to 1967, the total of estimated tax payments and withholding was required to be at least 70 percent of the current year tax liability. Between 1967 and 1986, current tax payments had to be at least 80 percent of the current year tax liability. The percentage was increased to 90 percent in 1987. The minimum amount of tax liability, less withheld amounts, below which estimated tax payments are not required has been increased in several steps from an initial $50 to the current law $1,000 threshold. In addition, for 1992 and 1993, the prior year safe harbor was not available for taxpayers whose current year income was in excess of $75,000 ($37,500 for married taxpayers filing separate returns) and whose income in the current year exceeded their AGI in the prior year by at least $40,000. Beginning in 1995, special rules applied to taxpayers whose prior year AGI exceeded $150,000 ($75,000 for married taxpayers filing separate returns). For such taxpayers, the prior year safe harbor was only met if current year payments equaled or exceeded certain percentages of the prior year tax liability as shown on the return.[189]

b. Corporations

Corporations became subject to the estimated tax payment rules with adoption of the 1954 Code. Over time, the estimated tax payment dates were imposed and accelerated, and required estimated tax payment levels were increased. A number of the changes over the past two decades have been related to the availability of the prior year safe harbor. As late as the

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[188] Code section 6655(c).

[189] For such taxpayers, the prior year exception was only met if current year payments equaled or exceeded the following percentages of the current year tax liability as shown on the tax return: 110 percent for 1994 through 1997; 100 percent for 1998 and varying percentages for future years. See footnote 166, supra.

early 1980s, a corporation, regardless of size, that did not have any prior year liability was not required to make estimated tax payments for the current year.

4. Analysis

Addition to tax as "interest" or "penalty". The addition to tax for failure to make timely estimated tax payments has features of both an interest charge and a penalty. The interest features are reflected in the use of the underpayment interest rate and length of the period of underpayment to determine the amount of the penalty. Penalty features exist in its nondeductibility and the limited reasonable cause waivers prescribed by statute. It is logical to treat the sanction more as a penalty to the extent that estimated tax payments are treated as an analog to withholding so that the sanction is an analog to the deposit penalty. In addition, both withholding and estimated tax payments are legally treated as advance remittances of tax rather than payments of tax until the date upon which the payment of tax is legally due. Interest is not paid by the government with respect to these advance remittances (or other types of advance remittances). Treating the addition to tax as interest rather than a penalty logically raises the issue of whether such amounts, when paid by corporations, should be deductible and whether reasonable cause exceptions like those under current law should be provided. Related issues are whether statutory interest abatement provisions should apply if the addition to tax were converted to interest and whether and how interest netting should apply. On balance, Treasury believes that it is appropriate for this sanction to remain nondeductible and for the existing reasonable cause waivers to remain in place. For these reasons and notwithstanding the conceptual ambiguity surrounding this addition to tax as "interest" or "penalty," Treasury does not recommend converting the existing sanction to an interest provision.[190]

Mitigation for errors. Treasury also considered whether the complexity in the estimated tax payment rules warrants modification to avert unintentional taxpayer violations of the rules and consequent imposition of penalties. Although taxpayers may self-assess estimated tax penalties on their tax returns, many of these penalties are calculated for taxpayers by the IRS.

Taxpayers who do self-assess may use simplified methods which do not minimize the amount of the penalty but which do reduce the administrative complexity, and associated cost, of the computations. Minimization of the penalties can involve complex and burdensome calculations. These procedures may require taxpayers effectively to determine income separately for each quarter of the year, to calculate additional pro forma tax returns for part of the year, and to determine the exact date of each income tax payment, including withheld amounts. Much of this complexity may be necessary and the burdens imposed alleviated by use of computer software or paid preparers. Nonetheless, the large number of penalties assessed each year (6.8 million for individual taxpayers in fiscal year 1998) suggests it is important to consider whether further measures are appropriate either to reduce the number of penalties, the number of taxpayers who must make the computations, or the complexity of the computations.

Taxpayers who can run afoul of the estimated tax payment rules may include, in particular, individuals who are transitioning from employee to non-employee status. Present law accommodates this transition to an extent in the waiver provisions for the newly retired or disabled. It may be appropriate to expand this reasonable cause waiver to include other individuals who are first-time estimated tax payers. This expansion could be restricted to situations where the balance due shown on the return is less than some threshold amount and is paid with the return. Waiver in this circumstance would recognize that first-time difficulties with the estimated tax payment rules can arise for taxpayers in different types of circumstances and provide the IRS with enhanced flexibility to accommodate those circumstances in situations where the unpaid balance is relatively small.

Current law also provides that estimated tax payments are not required if an individual's tax liability as shown on the return, reduced by withholding and overpaid social security tax, is less than $1,000.[191] This standard permits taxpayers subject to withholding to avoid consideration of whether estimated tax payments are necessary if the difference between their

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[190] Hereinafter, this report uses the term "penalty" with respect to this addition to tax for ease of exposition notwithstanding the interest attributes described in the text.
[191] Code section 6654(e)(1).

withholding and tax liability is a de minimis amount. Moreover, in effect, it provides taxpayers with small tax liabilities (of less than $10,000) with an estimated tax safe harbor percentage that is more generous than the 90 percent safe harbor generally applicable. For example, a taxpayer with tax liability shown on the return of $5,000 will avoid the penalty if withholding exceeds $4,000, even though that amount of withholding is only 80 percent of the tax shown on the return. This $1,000 de minimis exception is appropriate to mitigate application of the 90 percent current year's tax safe harbor where dollar amounts of tax liability are small and where modest changes in income can potentially subject taxpayers to penalties.

Estimated tax payments made during the year, however, are not included in the determination of whether the threshold amount is satisfied. Their exclusion from the computations has been predicated on concern of potential abuse by taxpayers who could underpay their first three estimated installments but make a sufficiently large payment for the last installment to satisfy the $1,000 threshold. For example, (ignoring the prior year safe harbor), a taxpayer with tax shown on the return of $15,000 and no withholding during the year would be required to make four estimated tax installment payments such that at least 90 percent of $15,000 (i.e., $13,500) was paid through estimated tax. If estimated tax payments were included in the determination of the $1,000 threshold, however, the penalty could be avoided even if the first three installments were not fully paid if the total paid in all four installments, including withholding, was $14,001.[192]

Nonetheless, retirees and others with substantial amounts of income not subject to withholding, but whose overall tax liability is under $10,000, may benefit from the availability of a bright-line test that avoids being potentially subject to the penalty.[193] Thus, consideration

[192] A related issue is whether the $1,000 threshold should be raised. This threshold was last raised, from $500 to $1,000, by the Taxpayer Relief Act of 1997. See H.R. Rep. No. 220, 105th Cong., 1st Sess. 648 (1997). Given the recent increase in the threshold, Treasury believes that it may be premature to raise the threshold at this time. Raising the threshold would reduce taxpayer and administrative burdens but a higher threshold might increase IRS enforcement and collection burdens and result in loss of some tax revenues.
[193] It should be noted that these taxpayers should have the availability of the prior year safe harbor.

could be given to a change that, without opening the door to abuse, would provide taxpayers making estimated tax payments with a dollar amount bright-line rule. Such a safe harbor could be provided for many or most affected taxpayers by using a simplified average of estimated tax payments for the year. The weights would be based on both the size of the payments and the quarter in which the payments were made. The simplified average amount of estimated tax payments could be used, together with withheld taxes, to determine if all but $1,000 of tax liability had been paid on a "pay-as-you-go" basis. If the taxpayer did not meet the modified method of calculating that all but $1,000 of current year's tax liability had been paid, the taxpayer then would follow current procedure to determine the amount, if any, of the estimated tax penalty.

A simplified annual average amount could be based on payments that are made on or before each estimated tax due date. For purposes of the simplified calculation, which would only be used for determining if the $1,000 safe harbor were met, late payments would not be treated as being made until the next payment date. If larger than average payments were made on the last two estimated tax payment dates, the weighted average for the year would fall. However, if the earlier payments were larger, the simplified average would not be higher than if the four payments were of equal size. That is, the simplified average could not exceed the sum of the four actual payments.

Under the simplified method, the calculation of the average annual amount of estimated tax payments and whether the taxpayer satisfied the requirement of having $1,000 or less of modified unpaid liability could be made on a worksheet, as shown below. The calculations shown in the worksheet could be incorporated into a revised portion of Part II of IRS Form 2210, "Underpayment of Estimated Tax by Individual, Estates and Trusts." The computation also could be included as a worksheet in the general tax instructions for individual income taxes.

Worksheet for Bright-Line Test Which Includes Estimated Tax Payments

Do I Owe an Underpayment Penalty for 2000?

1.	Enter your tax liability for 2000…………				________
2.	Enter the amount of income tax withheld during 2000………			________	
		--- Col. (a) ---		--- Col. (b) ---	
3.	Enter the amount of estimated taxes you paid on or before April 15, 2000. (Be sure to include overpayments from 1999 applied as tax payments for 2000.) …………	________	x 4 =	________	
4.	Enter the amount of estimated taxes you paid from April 16, 2000 to June 15,2000 …………	________	x 3 =	________	
5.	Enter the amount of estimated taxes you paid from June 16, 2000 to Sept. 15,2000 …………	________	x 2 =	________	
6.	Enter the amount of estimated taxes you paid from Sept. 16, 2000 to Jan. 15, 2001…………	________	x 1 =	________	
7.	Add lines 3, 4. 5, and 6 in columns (a) and (b)	________		________	
8.	Multiply line 7, column (b) by 0.4 …………			________	
9.	Enter the smaller of line 7, column (a) or line 8 …………			________	
10.	Add lines 2 and 9 …………				________
11.	Subtract line 10 from line 1 …………				________

- **If line 11 is less than $1,000, you do not owe any penalty.**
- **If line 11 is $1,000 or more, complete Form 2210 (Underpayment of Estimated Tax by Individuals, Estates, and Trusts) to determine the amount, if any, of your penalty.**

Example. Consider a taxpayer with $4,999 of liability and no withholding.

(a) If that taxpayer made four equal quarterly estimated tax payments of $1,000 each, the weighted amount of those payments would be $4,000, and line 11 of the worksheet would show $999, indicating that the taxpayer met the bright-line de minimis safe harbor and did not owe any penalty and did not have to perform any further calculations.

(b) If the same taxpayer made a single estimated tax payment of $4,000 on April 15, 2000, the weighted amount would be limited to the actual payment amount of $4,000. Again, the taxpayer would have a balance due of $999 (with $999 also being shown on line 11 of the worksheet), and the taxpayer would meet the safe harbor and not owe any penalty.

(c) However, if the same taxpayer made a single $4,000 payment on January 15, 2001, the weighted amount of the estimated tax payments for the year would only be $1,600, and for purposes of determining if the taxpayer met the safe harbor, the amount of tax not paid on a "pay-as-you-go" basis would be $3,399, as shown on line 11 of the sample filled-in worksheet below. In this situation, the taxpayer would be required to complete Form 2210 to calculate the size, if any, of the penalty.

Sample Worksheet for Taxpayer Making Only One Payment At End of the Year

Do I Owe an Underpayment Penalty for 2000?

1.	Enter your tax liability for 2000……						4,999
2.	Enter the amount of income tax withheld during 2000………				0		
		--- Col. (a) ---			**--- Col. (b) ---**		
3.	Enter the amount of estimated taxes you paid on or before April 15, 2000. (Be sure to include overpayments from 1999 applied as tax payments for 2000.) ………	0	**x**	**4 =**	0		
4.	Enter the amount of estimated taxes you paid from April 16, 2000 to June 15,2000 ……	0	**x**	**3 =**	0		
5.	Enter the amount of estimated taxes you paid from June 16, 2000 to Sept. 15,2000 ……	0	**x**	**2 =**	0		
6.	Enter the amount of estimated taxes you paid from Sept. 16, 2000 to Jan. 15, 2001……	4,000	**x**	**1 =**	4,000		
7.	Add lines 3, 4. 5, and 6 in columns (a) and (b)	4,000			4,000		
8.	Multiply line 7, column (b) by 0.4 ……				1,600		
9.	Enter the smaller of line 7, column (a) or line 8 ……				1,600		
10.	Add lines 2 and 9 ……						1,600
11.	Subtract line 10 from line 1 ……						3,399

♦ **If line 11 is less than $1,000, you do not owe any penalty.**

♦ **If line 11 is $1,000 or more, complete Form 2210 (Underpayment of Estimated Tax by Individuals, Estates, and Trusts) to determine the amount, if any, of your penalty.**

Mitigation of small penalty amounts. Many estimated tax penalties are quite small. Nevertheless, they impose significant paperwork burdens for both taxpayers and the IRS in preparing, submitting, processing, and storing the additional tax forms. In some cases, the penalties may be sufficiently small that the IRS will not assert the penalties. Many conscientious taxpayers, however, may self-assess and pay such penalties, with the associated paperwork burdens. These burdens may be alleviated somewhat by use of computer software or paid preparers. Even so, consideration could be given to a de minimis rule whereby small penalties, in the range of $10 to $20, would not need to be paid. Either separately or as part of establishing a de minimis level for estimated tax penalties, consideration also could be given to abatements of penalties for taxpayers who incur modest penalties after a period of years of full compliance. A level below which abatement would be automatic may be appropriate or, alternatively, the taxpayer could be provided with a notice to monitor payment levels more closely in the future but with collection action held in abeyance pending future compliance. Such a policy would be similar to a "first offender" exception from relatively modest estimated tax penalties for taxpayers with a history of compliance. However, these types of approaches would not necessarily relieve taxpayers from a degree of computational burden to determine if a penalty in the de minimis range were owed. Also, abatement based on past and future compliance would impose some additional administrative burden on the IRS.

Modifications to calculations. Calculations of estimated tax penalties can be lengthy, difficult conceptually, involve complex allocations of income and tax payments to particular quarters of tax years, and other potentially burdensome calculations. Despite these burdens for taxpayers attempting to minimize their penalties, Treasury believes that changes to the calculation procedures should be approached with caution. Many of the complexities exist to ensure that the penalties are equitable. In many cases, taxpayers need not use, and do not use, the more complicated procedures unless the benefits of doing so exceed the additional costs incurred. Simplifying procedures by removing such optional provisions may impair the equitable underpinning for their inclusion. Removing such options may be especially costly for corporations that have greater need to base their estimated tax payments on current year's tax liability estimates. A number of the complicated allocations of income also may already be done by corporations for internal purposes or to comply with other, nontax reporting requirements.

For example, public corporations issue quarterly earnings statements. Technology is also mitigating the burdens associated with lengthy and complex calculations involving several alternative methods.

Recommendations

Treasury recommends maintaining the current treatment of the addition to tax for failure to pay estimated tax as a penalty. In recognition, however, of the potentially cumbersome nature of complying with the estimated tax payment requirements, the following simplifying changes are recommended for consideration:

Individuals should not be subjected to estimated tax penalties if the balance due with the return is less than $1,000. Thus, estimated tax payments should be included in determining whether the $1,000 threshold has been satisfied, but Treasury recommends this change under a simplified averaging method to avoid potential abuse.

Treasury recommends that a reasonable cause waiver from penalty should be permitted for individuals who are first-time estimated tax payers, provided the balance due on the tax return is below a threshold amount and is paid with a timely filed return. Penalty waiver authority also could be provided for individual estimated tax penalties below a de minimis amount, in the range of $10 to $20.

D. Deposit Penalties

The backbone of our Federal individual tax payment system has been employer withholding from wages and salaries. Similarly, employee portions of Social Security and Medicare taxes (commonly called FICA taxes) are paid with withholding from wages. Together with the employers' matching shares of FICA taxes, these taxes generally are paid by employers to the Federal government by deposits at designated financial institutions or by electronic transfers. The method of deposit may depend on the total amount of an employer's payroll tax liability during a predetermined "base" period or the size of the particular deposit. Certain other taxes also are paid by tax deposit rather than by check payable to the U.S. Treasury. These include Federal Unemployment (FUTA) taxes, other withheld income taxes, and Federal corporate income taxes.

The Secretary is granted broad authority under Code section 6302 to determine the time and mode for the collection of Federal taxes, but the mode and timing of certain large payments is specified explicitly in the Code.[194] The Secretary also has authority to designate certain types of financial institutions as depositaries or financial agents of the United States to accept tax payments on the government's behalf and to prescribe conditions under which the Secretary may accept such payments as payments of tax.[195]

Code section 6656 subjects taxpayers to a penalty for failure to make required deposits in the time and manner prescribed. The significant size of this penalty relative to unpaid or underpaid amounts reflects the importance of this mode of tax collection to our system. It also reflects the importance of the proper transmission, and the prompt and full transmission to the Federal government, of taxes that have been withheld, generally from employees, by employers and others as agents of the government.

Although the structure of the failure to deposit penalty is straightforward, the underlying deposit requirements can be very exacting. For example, large employers may have as little as

[194] Code section 6302(a).
[195] Code section 6302(b).

one business day from the time the funds are withheld until they must be deposited. Even relatively modest-sized employers may have to make a federal tax deposit at a local banking institution or an electronic payment within as little as two business days after the end of semi-weekly accounting periods. A penalty can be triggered by a failure to meet the deposit deadline or by depositing in the improper manner, e.g., depositing at a local financial institution if an electronic payment is mandated. The IRS publishes detailed instructions about the manner for making deposits, including the amount, timing, location, and method of payment. Failure to abide by any of the requirements can trigger a penalty.

1. Present-law penalty

The present law deposit penalty is comprised of a four-tier penalty rate structure for failures to make deposits. This tiered structure is intended to encourage prompt correction of deposit shortfalls, either voluntarily or upon demand by the IRS. The applicable penalty rates are as follows:

Tier 1 penalty: 2 percent if the correct deposit is one to five days late.[196]

Tier 2 penalty: 5 percent if the correct deposit is six to 15 days late.[197]

Tier 3 penalty: 10 percent if the correct deposit is more than 15 days late.[198]

Tier 4 penalty: 15 percent if the correct deposit is not paid within 10 days after the IRS issues a delinquency notice under Code section 6303 (or on the date the IRS issues an immediate payment demand in jeopardy cases).[199]

Deposit penalties are calculated based on the amount of the tax that has not been deposited times the penalty rate. Thus, if a $10,000 deposit is late by one day, the penalty is $200 (2 percent of $10,000). If the deposit remains unpaid for 16 days, the amount of the penalty increases to $1,000 (10 percent of $10,000).

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[196] Code section 6656(b)(1)(A)(i).
[197] Code section 6656(b)(1)(A)(ii).
[198] Code section 6656(b)(1)(A)(iii).
[199] Code section 6656(b)(1)(B).

Prior to amendments enacted by RRA 1998, deposits of taxes under administrative procedures were allocated by the IRS to the earliest period within that tax year or calendar quarter for which such a deposit was due; thus, if a taxpayer missed or made an insufficient deposit, later deposits would first be applied to satisfy the shortfall for the earlier period; the remainder then would be applied to satisfy the current period deposit obligation. This allocation rule could result in cascading penalties as payments that would otherwise be sufficient to satisfy current liabilities were applied to satisfy earlier shortfalls, generating sequential shortfalls in later periods. To address this problem, RRA 1998 provided that, effective for deposits made more than 180 days after enactment, taxpayers can designate the period to which deposits are applied. This designation must be made within 90 days after the IRS mails the related penalty notice. This statutory revision to the designation rules also provides that, beginning with deposits due after December 31, 2001, the IRS must apply each deposit to the most recent open balance period rather than the earliest period, unless the taxpayer designates otherwise.[200]

The IRS has published guidance with respect to the designation rules for deposits due prior to December 31, 2001. The depositor can make the designation by calling a toll-free number and designating the period to which the payment should be applied.[201]

Deposit penalties can be waived in certain circumstances. To be eligible for a waiver, the depositor must (1) meet the net worth requirements applicable for an award of attorneys' fees (i.e., this means a net worth of $2 million or less (for individuals, estates and trusts) or $7 million or less (for corporations or other business entities)) and have no more than 500 employees; (2) have inadvertently failed to comply with the deposit requirements; (3) have timely filed the related return; and (4) be subject for the first time to either the deposit requirements themselves or to a more frequent deposit schedule than the one to which the taxpayer was previously subject.[202] The penalty also can be abated if the taxpayer establishes that the failure was due to reasonable cause and not willful neglect.[203]

[200] Code section 6656(e)(1).
[201] Rev. Proc. 99-10, 1999-2 I.R.B. 11.
[202] Code section 6656(c).
[203] Code section 6656(a).

2. Historical background

Prior to 1989, the failure to deposit penalty was a flat 10 percent of the underpayment; the penalty was not time-sensitive. Because the 10 percent penalty was perceived as too harsh in certain circumstances and to provide greater encouragement for prompt correction of missed deposits, the tiered penalty structure of present law was enacted.[204] Previously, the penalty had undergone two major changes. The 5-percent flat rate penalty, enacted as part of the Tax Reform Act of 1969, replaced a time-sensitive penalty of one percent per month, or fraction thereof, but not exceeding six percent of the underpayment. The Omnibus Budget Reconciliation Act of 1986 doubled the penalty rate from 5 percent to 10 percent.

The waiver for first-time depositors was enacted originally in 1996 pursuant to the Taxpayer Bill of Rights 2 and was subsequently expanded by RRA 1998. The waiver authority as originally enacted applied only to first-time depositors. Expansion of the waiver authority to encompass a first-time change in the frequency of deposits was added by RRA 1998. The rules regarding designation of the periods to which deposits apply and mandated future changes in the designation rules to be followed by the IRS were added by RRA 1998 to mitigate the problem of multiple penalties arising from a single late deposit or shortfall. These modifications collectively were intended to address certain compliance problems that were perceived to be largely inadvertent but which resulted in imposition of potentially significant penalties.

3. Analysis

Although most employers (and other required depositors) satisfy the deposit requirements most of the time, the large number of deposit penalties which are imposed each year suggest that fulfilling deposit requirements is burdensome. In a typical year, many employers may have a deposit penalty assessed against them, although after abatements, substantially fewer penalties are actually paid. This large number of penalties is a matter of concern because of the resulting significant burdens imposed on both taxpayers and the IRS. Dealing with penalty notices from the IRS is a time-consuming and expensive process for employers, regardless of whether the notice is correct. There may be circumstances where it is less costly for employers or their payroll preparers to pay a disputed penalty, or one that might be abated, than to incur the costs attendant on requesting abatement of the penalty. Even though virtually all failure to deposit notices are generated automatically and involve little manual intervention or assessment of the circumstances surrounding the failure to deposit, the consequences of these notices do require IRS and employer resources.

To minimize administrative burdens while preserving the integrity of the underlying deposit system, which is a highly efficient system for collecting tax revenue, requires recognition of certain underlying aspects of the deposit regime. The majority of penalties that are ultimately collected are paid by taxpayers who are generally compliant but have been penalized for an atypical event. To the extent that such asserted penalties are not, or cannot be, abated, these taxpayers are subject to the same penalty rates as taxpayers who are intentionally or willfully noncompliant. Taxpayers who make unintentional errors tend to rectify their missed deposits as soon as they become aware of the error, either voluntarily or after notification by the IRS. Generally, the errors made by compliant taxpayers that subject them to penalties involve failures to deposit on time or in the proper manner. Deposits made in insufficient amounts generally are less of a problem for generally compliant taxpayers. Deposit penalties thus may be perceived as overly harsh for this category of taxpayers. However, penalties calibrated to this category of taxpayers may be unduly light when applied to willfully noncompliant taxpayers. It also must be recognized that the assessment of a penalty imposes a cost on taxpayers even when the penalties are later abated. In addition, taxpayers are more likely to make errors when changes in their circumstances require a different deposit method or timing of deposits than has been required in the past. Moreover, many employers utilize payroll processing firms to prepare their payrolls, to actually make their payroll deposits, and prepare the associated forms and returns. When such intermediaries make errors, large numbers of taxpayers can be affected by a single error, and many penalties may result. Even when the intermediary takes responsibility for the error, the IRS must assess a penalty on, and communicate with, each affected employer that bears the legal responsibility for the actions (or inaction) of the intermediary. Finally, deposit errors and

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[204] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239; H.R. Rep. No. 247, 101st Cong. 1st Sess. 1382 (Sept. 20, 1989).

associated burdens can be addressed either through the deposit rules themselves or penalties, but any changes made should not impair the basic efficiency of the deposit rule system.

Based on the foregoing, reducing the burden of deposit penalties while preserving the integrity of the collection system requires consideration of several different types of situations: (1) one-time or infrequent errors that are atypical of a taxpayer's normal pattern of compliance; (2) failures caused by technical or processing errors, often by intermediaries which affect large numbers of taxpayers; (3) errors when deposit requirements change for a particular payor; (4) payments made other than by tax deposit or use of the incorrect deposit transmission method; and (5) cascading errors from a single missed deposit.

Legislative changes described above already have been enacted to address the last category of cascading errors. These changes will not become fully effective until January of 2002. Thus, it would be prudent to wait for a few years after the final effective date for these changes to occur before considering whether additional changes are necessary.

Mitigation for taxpayer errors. The first three categories of errors could be mitigated by permitting the IRS administratively to reduce penalties or by substituting the imposition of a charge somewhat above interest for current penalties in situations involving a limited number of failures to deposit by generally compliant taxpayers, although the determination of whether a given taxpayer is generally compliant will involve some administrative difficulties. A complete omission from penalty for a limited number of errors also could be provided, although if errors involved large amounts, the Treasury would suffer a loss from the delayed receipt of funds unless a penalty were charged at least equal to the interest cost from delayed payment. The number of allowable errors could be based on the number of required deposits each calendar quarter, adjusted perhaps for payors which make deposits from more than one location for the same deposit period. Reduced penalties might be appropriate if the missed deposit or electronic payment were rectified quickly, as appropriate for the mode and timing of payment. Alternatively, incentives could be provided for prompt correction by making the reduced penalty time-sensitive (e.g., a penalty based on the missed deposit amount times the annual interest rate (or higher) times the number of days outstanding/365). The reduced penalty also could be subject to abatement, although many taxpayers might find as a practical matter that paying the reduced penalty was more cost effective than requesting abatement. This type of approach could reduce the number of penalties being asserted, the amount of penalty imposed, and large number of abatements for generally compliant taxpayers without an adverse impact on compliance. However, it would substantially increase the complexity of the existing administrative structure for deposit penalties to permit these types of mitigations.

$100,000 threshold. Another issue considered by Treasury relates to the $100,000 threshold for next day payments and inadvertent failures to comply due to accelerated deposits. Some taxpayers who deposit in advance of required deadlines can inadvertently be subject to penalties. The IRS has recently taken administrative action to address these situations. The IRS will abate these penalties by using the authority granted in RRA 1998 to waive penalties when a taxpayer is subject to a change in deposit frequency. Taxpayers who incur deposit penalties due to a change in required frequency will be able to request an abatement. If the IRS verifies that the employer's penalties are due to a change in required deposit frequency, penalties will be abated. The abatement will cover the calendar quarter in which the change occurred and for the portion of the following calendar quarter prior to the IRS's notification to the taxpayer.

De minimis penalty waiver. Another component of reduced penalties would be a de mimimis rule establishing an amount below which a reduced penalty would be waived. A de minimis threshold could be set by considering the cost to the government of processing an incoming payment and crediting the payment to the proper account. Taxpayer processing costs also could be considered. For example, if a taxpayer's deposit of $5,000 is inadvertently one day late, the penalty under current law is $100 (2 percent of $5,000). Assuming a de minimis penalty rate of, for example, 0.2 percent, the tentative reduced penalty would be $10. In this example, therefore, the de minimus penalty threshold could be $10 or more, in which case no penalty would be asserted. Even with a de minimis rule, however, it would be important for a notice to be sent the taxpayer to make the taxpayer aware of the error. Notice would also be important in situations where a payroll processor had made the error to alert the taxpayer regarding the error of their agent.

Use of wrong deposit method. Taxpayers who use the wrong deposit method (e.g., deposit at a local depository rather than by electronic transfer) or make direct payment to the IRS rather than a deposit are treated as if they did not make the deposit at all and may be subject to the penalty rate of 10 percent. Although the improper payment method may result in some additional processing costs for the government and some degree of delayed receipt in the proper form, a 10-percent penalty appears unduly harsh. Imposition of a lower penalty, for example, 2 percent, would appear to accomplish the objective of encouraging payment by the proper method.

Recommendations

Treasury believes that time is required for recent changes to the deposit rules to be implemented and evaluated. Thus, Treasury does not favor the addition of significant complexity to these rules at this time. However, Treasury recommends consideration of various methods of providing relief for inadvertent or unintentional errors of short duration that do not add undue administrative complexity or burden on the IRS. Any such changes should not be implemented until and unless administratively feasible. For example, a reduced penalty (above an interest charge) may be appropriate for a one-day deposit delay.

Treasury also suggests the modification discussed above in relation to use of the wrong deposit method to provide authority to impose a lower penalty of 2 percent.

Treasury also believes that the IRS should continue to work with payroll professionals to resolve serious systemic problems and emphasize educational efforts with respect to the deposit rules. Treasury and the IRS should work with the payroll community to develop a possible “proxy” penalty to alleviate the difficulties associated with dealing with large numbers of employers utilizing a payroll processor in cases of occasional or inadvertent error.

E. Accuracy-Related and Preparer Penalties

The accuracy-related penalties of Code section 6662 impose a sanction for an underpayment of tax resulting from an understatement of tax liability. Presently, the accuracy-related penalties impose a sanction based on one of several different causative factors, including negligence, a substantial understatement, and different types of valuation overstatements or understatements. The substantial understatement penalty was added to the Code in 1982 in response to perceptions that the negligence and fraud penalties were inadequate to deter aggressive reporting of tax positions on income tax returns.[205] The widespread proliferation of syndicated tax shelters in the 1970s and 1980s eroded confidence that the reasonable basis standard adequately deterred aggressive reporting.[206] A reasonable basis standard essentially treats taxpayers and the IRS as adversaries and permits taxpayers to take what is essentially a litigating position on their tax return. In the substantial understatement penalty, a different approach was taken to impose more stringent accuracy criteria and to require disclosure of positions that were merely litigating positions.

Congress also reacted to the increasing reliance by taxpayers on paid preparers and reports of abuse by such persons. Pursuant to legislation enacted in 1976, a penalty was imposed under Code section 6694 on tax preparers who assist taxpayers in understating tax liability on their returns.[207] The preparer penalty recognizes that tax professionals have a dual role to advise

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[205] The negligence standard had its analog in ABA Formal Opinion 314 (1965), which imposes a reasonable basis standard on attorneys advising clients regarding tax reporting positions.

[206] Tax shelter cases under examination increased from 195,000 in 1980 to 331,000 in 1984. The inventory of the U.S. Tax Court increased from 34,865 cases in 1980 to 63,598 cases in 1984. See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 485 (1984). See also Treasury Corporate Tax Shelter White Paper, supra note 7, at 65.

[207] Added by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520. Code section 6695 also was enacted to sanction certain types of conduct associated with the preparation of tax returns, and has been amended several times to extend the penalty to other acts or omissions. This penalty now penalizes failures to (1) furnish a copy of the return to the taxpayer, (2) sign the return, (3) furnish an identifying number, (4) retain a copies of prepared returns, (5) file correct information returns, and (6) be diligent in determining a taxpayer's eligibility for the earned income credit. It also penalizes the endorsement or negotiation of a taxpayer's refund check. Code sections 6695(a) through (g). This report makes no recommendations with respect to this particular penalty.

their clients and to protect the integrity of the tax system as a whole. Tax professionals are subject to the ethical rules that guide their profession and also, with respect to practice before the IRS, standards of practice promulgated by the Treasury under Circular 230. Prior to 1976, these ethical norms and standards of practice governed preparer conduct. The enactment of the preparer penalty reflected the perception that these norms and standards were inadequate deterrent mechanisms.[208]

1. Present-law penalties

a. Accuracy-related penalties

The accuracy-related penalties of Code section 6662 impose a penalty of 20 percent on the portion of any underpayment of tax that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.[209] A substantial understatement exists if the correct income tax for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent or $5,000 ($10,000 in the case of certain corporations).[210]

In determining whether a substantial understatement exists, the amount of understatement generally is reduced by any portion for which (1) there was substantial authority for the position, or (2) the facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for the tax position.[211] Both the reasonable basis standard and the substantial authority standard are intended to be a relatively objective criteria of accuracy.[212] Substantial authority is dependent upon a weighing of the relevant precedential authority. Treasury

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[208] See discussion in the text at Section II, infra, regarding the background to the preparer penalties.
[209] Code section 6662(b)(1) – (b)(5).
[210] Code section 6662(d)(1). The $10,000 threshold applies to corporations other than S corporations and personal holding companies.
[211] Code section 6662(d)(2)(B).
[212] Treasury regulations provide that the substantial authority standard "is an objective standard involving an analysis of the law and application of the law to relevant facts." Treas. Reg. sec.

regulations enumerate the types of authorities that are relevant for this purpose.[213] The regulations define the substantial authority standard as less stringent than the "more likely than not" standard but more stringent than the "reasonable basis" standard.[214] The weight of authorities supporting the tax treatment must be substantial in relation to the weight of authorities supporting the contrary treatment.[215] If substantial authority does not exist, then the taxpayer may rely upon the reasonable basis standard,[216] but only if adequate disclosure is also made. However, a corporate taxpayer will not have reasonable basis for the tax treatment of an item attributable to a multi-financing transaction unless such treatment clearly reflects the income of the corporation.[217]

The accuracy-related penalties also can be avoided if the taxpayer satisfies the reasonable cause standard of Code section 6664. Pursuant to that provision, no penalty will be imposed if there was reasonable cause for the portion of the underpayment otherwise subject to penalty and the taxpayer acted in good faith with respect to such portion.[218] Whether reasonable cause and good faith exist depends on all pertinent facts and circumstances.[219] Good faith and reasonable reliance on the opinion of a professional tax advisor's analysis of the pertinent facts and authorities may constitute reasonable cause.[220]

1.6662-4(d)(2). Substantial authority is determined at the time the return is filed or on the last day of the taxable year to which the return relates. Treas. Reg. sec. 1.6662-4(d)(3)(iv)(C).

[213] Treas. Reg. sec. 1.6662-4(d)(3).

[214] Treas. Reg. sec. 1.6662-4(d)(2).

[215] Id.

[216] The reasonable basis standard is defined in Treasury regulation section 1.6662-3(b)(3) as "significantly higher than the not frivolous standard" applicable to preparers under Code section 6694.

[217] Code section 6662(d)(2). Adequate disclosure also does not suffice, even if the taxpayer has a reasonable basis, if the item or position on the return was not properly substantiated, or the taxpayer failed to keep adequate books and records with respect to the item or position. Treas. Reg. sec. 1.6662-4(e)(2).

[218] Code section 6664(c). Special rules apply in the case of certain valuation overstatements, where reasonable cause cannot be satisfied without a qualified appraisal and a good faith investigation of the value of the property. Code section 6664(c)(2).

[219] Treas. Reg. sec. 1.6664-4(b). Generally, the most important factor is "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Id.

[220] Treas. Reg. secs. 1.6664-1(b)(2); -4(b), (c). Reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law or if the taxpayer fails to disclose a fact that the taxpayer knows, or

The negligence penalty applies without regard to whether an understatement of tax is substantial. Negligence involves the failure to make a reasonable attempt to comply with the provisions of the tax laws.[221] Generally, this has been interpreted to require that the taxpayer exercise the care of a reasonably prudent person.[222] The negligence penalty also can be imposed for careless, reckless or intentional disregard of a rule or regulation.[223]

Higher standards of accuracy are imposed in relation to tax shelter items. A tax shelter is defined for this purpose as any partnership or other entity, investment plan or arrangement, or any other plan or arrangement if "a significant purpose of such [arrangement] is the avoidance or evasion of Federal income tax."[224] With respect to tax shelter items of non-corporate taxpayers, the penalty can be avoided if the taxpayer establishes that, in addition to substantial authority, the taxpayer believes that the treatment claimed is "more likely than not" the proper treatment.[225] Disclosure does not permit the non-corporate taxpayer to have a lower standard of accuracy with regard to tax shelter items. Corporate taxpayers are subject to stricter standards.[226]

Thus, the accuracy-related penalty with respect to a substantial understatement provides three different standards relating to (1) non-tax shelter items, (2) tax shelter items of individuals, and (3) tax shelter items of corporations. These standards generally incorporate different accuracy criteria for disclosed and nondisclosed positions. Reflecting heightened concern regarding aggressive reporting, the level of accuracy required varies with the expected degree of taxpayer sophistication (corporate and noncorporate) and type of transaction (shelter and nonshelter).

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should know, to be relevant to the proper tax treatment of an item. Treas. Reg. sec. 1.6664-4(c)(1).

[221] Code section 6662(c).

[222] See, e.g., Neely v. Commissioner, 85 T.C. 934, 947 (1985).

[223] Code section 6662(c).

[224] Code section 6662(d)(2)(C)(iii).

[225] Code section 6662(d)(2)(C)(i).

[226] A discussion of the standards applicable in the context of corporate tax shelters is set forth in the Treasury Corporate Tax Shelter White Paper, supra note 7, at 74-77.

b. Preparer penalty

The section 6694 preparer penalty penalizes tax return preparers with respect to positions reported on tax returns. A "return preparer" for this purpose includes "any person who prepares for compensation, or who employs one or more persons to prepare for compensation," any return or claim for refund of income tax.[227] The preparation of a substantial portion of a return or refund claim constitutes return preparation.[228] A person who furnishes to a taxpayer or other preparer sufficient information and advice such that completion of the return or refund claim is largely a mechanical or clerical matter is treated as a preparer. However, a person who only advises on specific issues of law is not a preparer unless the advice is rendered with respect to events that already have occurred and the advice is directly relevant to the determination of the existence, characterization or amount of an entry on a return or claim.[229] No more than one individual associated with a firm is treated as a preparer with respect to the same return or refund claim, which will be the signing individual or, if there is no signing individual, a nonsigning individual with overall supervisory responsibility. An individual and the individual's firm can both be subject to the penalty if one or more members of the firm participated in or knew of the proscribed conduct, and the firm either failed to provide reasonable and appropriate review procedures or such procedures were disregarded.[230]

A return preparer is subject to a $250 penalty with respect to a return or refund claim if (1) the return or refund claim reflects a position for which there is not a realistic possibility of being sustained on the merits, (2) the taxpayer's liability is understated as a result, (3) the preparer knew, or reasonably should have known, of such position, and (4) the position was not

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[227] Code section 7701(a)(36); see also Treas. Reg. secs. 1.6694-1(b)(1); 301.7701-15(a).

[228] Excluded from the definition are individuals who (1) furnish typing, reproduction, or other mechanical assistance, (2) prepare a return or claim of an employer (or of an officer or employee of the employer) for whom the individual is regularly or continuously employed, (3) prepare returns or claims as a fiduciary of other persons, or (4) prepare claims for refund in response to a notice of deficiency issued to a taxpayer or waiver of restriction after the commencement of an audit of a taxpayer. Code section 7701(a)(36)(B). Persons who prepare returns not for compensation or pursuant to certain tax counseling services are not treated as preparers. Treas. Reg. sec. 301.7701-15(a)(4), (7).

[229] Treas. Reg. sec. 301.7701-15(a)(2).

[230] Treas. Reg. sec. 1.6694-2(a)(2), -3(a)(2).

adequately disclosed or was frivolous.[231] The penalty will not apply if there is reasonable cause for the understatement and the preparer acted in good faith.[232] A higher penalty of $1,000 is imposed in the case of a willful attempt to understate the tax liability of any person or reckless or intentional disregard of rules or regulations.[233] The penalties are coordinated, where both would apply, by reducing the higher penalty to $750. An "understatement" of liability for this purpose exists if, viewing the return or refund claim as a whole, there is an understatement of the net amount payable or an overstatement of the net amount creditable or refundable with respect to any tax imposed by subtitle A.[234]

Special procedures apply to contest the preparer penalty. The deficiency procedures do not apply.[235] Following notice and demand for payment of the penalty, the preparer can pay 15 percent of the penalty amount and file a claim for refund. Collection action is prohibited (and the collection period of limitations suspended) during the pendency of the refund claim until its final resolution. If the claim is denied or not acted upon, within 30 days of the denial of the claim a suit for refund may be filed in the appropriate U.S. district court.[236] The IRS may counterclaim for the balance of the penalty (or, if earlier, within 30 days after the expiration of 6 months). The assessment of the penalty also must be abated (and any amount paid refunded) upon a final determination that the taxpayer's liability was not understated.[237]

A preparer generally may rely in good faith without verification upon information furnished by the taxpayer. However, the preparer may not ignore the implications of information known by the preparer or furnished by the taxpayer and must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.[238]

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[231] Code section 6694(a).
[232] Id.
[233] Code section 6694(b).
[234] Code section 6694(e); Treas. Reg. sec. 1.6694-1(c).
[235] Code section 6671.
[236] Code section 6694(c).
[237] Code section 6694(d).
[238] Treas. Reg. sec. 1.6694-1(e).

The "realistic possibility of being sustained on the merits" standard is clarified in Treasury regulations to mean that a person knowledgeable in the tax law, having made a reasonable and well informed analysis of the position, would conclude that there is a one in three, or greater, likelihood of being sustained on the merits.[239] In making this assessment, the possibility that the position may not be challenged by the IRS cannot be taken into account.[240] The authorities to be taken into account are those relevant in determining the presence of substantial authority for purposes of the substantial understatement penalty.[241] For purposes of avoiding the penalty on the basis of adequate disclosure and a position that is not frivolous, a position that is "frivolous" is one that is "patently improper."[242] Disclosure of positions that do not satisfy the "realistic possibility of success" standard must be made by the signing preparer on a properly completed Form 8275 or 8275-R or, in the case of a limited class of return positions specified in annual revenue procedures issued by the IRS, on the return itself. Disclosure on the return itself generally is sufficient for a nonsigning preparer.[243]

In determining whether the exception for reasonable cause and good faith exist, factors to consider include whether (1) the error resulted from "a provision that was so complex, uncommon, or highly technical that a competent preparer of returns or claims of the type at issue reasonably could have made the error;" (2) the understatement was the result of an isolated error rather than a number of errors, unless the isolated error was so obvious, flagrant or material that it should have been discovered; (3) the understatement was material or immaterial; (4) the preparer's normal office practice, considered with other facts and circumstances, indicates the error in question would rarely occur; or (5) the preparer relied in good faith on another preparer reasonably believed to be competent to render the advice.[244]

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[239] Treas. Reg. sec. 1.6694-2(b)(1).
[240] Id.
[241] Id.
[242] Treas. Reg. sec. 1.6694-2(c)(2).
[243] Treas. Reg. sec. 1.6694-2(c)(3), -4(f).
[244] Treas. Reg. sec. 1.6694-2(d).

2. Historical background

As discussed above, the preparer penalties were instituted in 1976 and the accuracy-related penalties in 1982 in response to reported abuses by preparers and the proliferation of syndicated tax shelters, respectively. Congress enacted a number of substantive and penalty provisions in response to these concerns.[245] In 1989, the accuracy-related penalties were restructured and coordinated to encourage taxpayers and preparers to accurately report tax liabilities and report aggressive positions. The preparer penalty was restructured to place more emphasis on the strength of the position taken rather than the conduct of the preparer.[246] The "realistic possibility of success" standard was adopted "because it generally reflects the professional conduct standards applicable to lawyers and to certified public accountants" and was stricter than prior law.[247] Since that time, a number of revisions have occurred, principally to tighten the standards. Regulations initially prescribed the minimum standard for a disclosed return position for both taxpayers and preparers to be the "not frivolous" standard, defined as not being "patently improper." In 1993, this standard was tightened for taxpayers (but not preparers) to the "reasonable basis" standard, thus divorcing the standards applicable to taxpayers and tax preparers. The legislative history did not define the reasonable basis standard beyond stating that it is a relatively high standard.[248] Subsequently, the accuracy-related penalty was tightened for corporations, including elimination of the section 6662 standards for penalty avoidance (leaving only the section 6664 reasonable cause exception), and by broadening the definition of a "tax shelter" from a plan or arrangement with "the principal purpose" of tax avoidance or evasion to

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[245] See Treasury Corporate Tax Shelter White Paper, supra note 7, for a more complete discussion of the various approaches taken to combat tax shelters, including the promoter and abusive tax shelter penalties and changes to substantive provisions of the tax laws.

[246] Prior to 1989, the preparer penalty was imposed in the amount of $100 for negligent or intentional disregard of rules or regulations; in the amount of $500 for a willful attempt to understate liability.

[247] H.R. Rep. No. 386, 101st Cong., 1st Sess. (Nov. 21, 1989).

[248] Treasury regulations issued in 1998 state that a reasonable basis is "significantly higher" than "not patently improper" but otherwise also do not define the standard. Treas. Reg. sec. 1.6662-3(b)(3).

one with that objective as "a significant purpose." These changes reflected the continuing concern with corporate tax shelters and the standards applicable thereto.[249]

3. Analysis

Given the ongoing concern regarding underreporting of correct tax liability, it is appropriate to consider whether the standards applicable to the accuracy-related and preparer penalties should be modified to strengthen the deterrent to aggressive reporting of tax positions. This report does not analyze the accuracy-related and preparer penalties as applied to corporate tax shelters because they were fully addressed in the Treasury Corporate Tax Shelter White Paper, which makes a number of recommendations with respect to the penalties for corporate tax shelters.[250] The discussion and recommendations in that report are incorporated herein by reference.

Accuracy and preparer penalty standards. The substantial understatement penalty and the preparer penalty impose different standards. Summarized below are the standards applicable in the case of the substantial understatement penalty to non-shelter items and non-corporate shelter items and the preparer penalty applicable in the absence of willful or reckless conduct:

[249] A special category of penalty also was added in the 1990s pertaining to transfer pricing adjustments. This penalty only can be avoided through compliance with detailed rules governing contemporaneous documentation and production of such documentation upon audit.
[250] See Treasury Corporate Tax Shelter White Paper, supra note 7, at 87-95.

Type of Penalty	**Type of Tax Item**	**Standard If No Disclosure**	**Standard With Disclosure**
Understatement penalty	Non-shelter items	Substantial authority	Reasonable basis
Understatement penalty	Shelter items (noncorporate)	Substantial authority and “more likely than not” chance of success	Substantial authority and “more likely than not” chance of success
Preparer penalty	Non-shelter and shelter items	Realistic possibility of success	Not frivolous

The Treasury Department believes that the foregoing standards should be better coordinated to encourage disclosure of controversial positions and to rationalize the standards applicable to taxpayers and preparers. At the same time, the Treasury Department believes that taxpayers and preparers must have incentives to report tax positions that are reasonably well supported in fact and law to ensure that the self-assessment system operates properly and with fairness to all taxpayers. The “not frivolous” and “reasonable basis” standards are grounded in a view of the tax system as an adversarial one and essentially impose litigating standards on the taxpayer. Treasury believes that this premise must be modified in light of the practical limitations on the IRS’s ability to audit returns and reliance of the tax system on the self-reporting of taxpayers and policing function of tax practitioners. Moreover, with regard to the differences in taxpayer and preparer standards, it appears somewhat anomalous that a preparer can avoid a penalty for a disclosed position that is merely not “patently improper” whereas a taxpayer must have a reasonable basis for such position. Likewise, it appears anomalous that, in the absence of disclosure, a preparer can avoid a penalty for a position that does not have substantial authority when a taxpayer cannot. Although the ultimate responsibility for the accuracy of a tax return rests with taxpayers, preparers have an obligation to understand the Federal tax laws and their application to a taxpayer’s facts and circumstances and should be held to at least as rigorous a standard. Preparers must serve an important “policing” function to protect the integrity of the taxing system. The use of paid preparers is prevalent; across most adjusted gross income categories, over half of 1997 individual tax returns filed bore the signature of a paid preparer, a percentage that rises with reported adjusted gross income.[251]

More generally, the majority of taxpayers do not have an opportunity to play the "audit lottery," as their sources of income are subject to withholding and reported to the IRS. A perception of unfairness exists if other taxpayers have such an opportunity because of the sources of their income and, even if audited, face penalties that are subject to several different standards which, in turn, are subject to interpretation, negotiation and/or litigation. Reduction in the number of standards, consistency among them, and standards that impose accuracy criteria more stringent than a litigating position better assure all taxpayers that some taxpayers cannot take advantage of the complexity of their tax affairs, low audit rates, and better financial resources to advance aggressive reporting positions with a degree of impunity. In addition, the standards should be calibrated to provide incentives for disclosure to better enable the IRS to detect aggressive reporting. This argues for a less stringent standard for disclosed than for nondisclosed positions.

The Treasury Department believes that the accuracy standards for taxpayers and tax preparers should be identical, that the accuracy standard for disclosed non-shelter items should be strengthened beyond a litigating standard, and that the distinctions drawn by the accuracy standards between nonshelter and shelter items should be the same for taxpayers and preparers. More specifically, Treasury recommends that the minimum standard for undisclosed positions be the "substantial authority" standard and, for disclosed positions, be the "realistic possibility of success" standard. The "more likely than not" standard[252] would continue to apply, in conjunction with the substantial authority standard, for disclosed tax shelter items of individuals

[251] Statistics of Income Bulletin, Spring 1999 at 153. On average, of the 123 million individual returns filed for the 1997 tax year, 64.8 million (52.7 percent) were filed with a paid preparer's signature.

[252] The "more likely than not" standard generally requires that a taxpayer reasonably conclude, based on all the facts and circumstances, that the tax treatment of the item is more likely than not the proper treatment, i.e., that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged. Good faith and reasonable reliance on the opinion of a tax advisor can meet the standard if the opinion unambiguously concludes that a greater than 50

with respect to both taxpayers and preparers. A more stringent standard would apply for nondisclosed individual shelter items that would require a reasonable and good faith belief that the position "should" prevail if challenged on the merits. A "should" standard is commonly understood to impose a significantly higher standard of accuracy than a "more likely than not" standard. Treasury's proposed standards are set forth in the table below:[253]

Type of Penalty	**Type of Tax Item**	**Standard If No Disclosure**	**Standard With Disclosure**
Understatement penalty and preparer penalty	Non-shelter items	Substantial authority	Realistic possibility of success
Understatement penalty and preparer penalty	Shelter items (noncorporate)	Substantial authority and belief that position "should" prevail if challenged on the merits	Substantial authority and "more likely than not" chance of success

Treasury's recommendations would make the substantial authority standard the minimum standard for nondisclosed positions for non-shelter items. In the case of nonshelter items, if this standard could not be met or was difficult to apply, disclosure would enable a taxpayer and preparer to rely on the "realistic possibility of success" standard. Treasury recognizes that the "realistic possibility of success" standard is more stringent than the current law "reasonable basis" or "not frivolous" standards and, consequently, would not permit avoidance of the penalty for positions that are essentially litigating positions. This is not to say that taxpayers could not take reporting positions for which they had only a reasonable basis but, rather, that taxpayers who chose to report such positions would take the risk that, if successfully challenged, they

percent likelihood exists that the tax treatment of the item will be upheld. Treas. Reg. sec. 1.6662-4(g)(1)(B), (g)(4).

[253] At minimum, the Treasury Department believes that the "not frivolous" standard for preparers for disclosed positions should be raised to the "reasonable basis" standard applicable to taxpayers.

would be subject to the accuracy penalty. Treasury does not believe that imposition of such risks on taxpayers and preparers is unreasonable in a self-assessment system. More stringent standards would apply to shelter items.

Substantiality requirement and negligence penalty. Treasury also recommends that the "substantial" requirement of the substantial understatement accuracy penalty be modified in accordance with the recommendation contained in the Administration's Budget Proposal. Under that proposal, the substantiality requirement for corporations would be changed from the current law standard[254] to the lesser of $10 million or 10 percent of the tax required to be shown on the return. This proposal would deter aggressive reporting by large corporations with tax liabilities in excess of $100 million.

Treasury also recommends that consideration be given to whether the negligence penalty should be confined to situations involving understatements below the monetary thresholds of the substantial understatement penalty to better harmonize the two penalties. Although the substantial understatement penalty and negligence penalties were originally designed to address different degrees of conduct, the former addressing the probable accuracy of the reporting position and the latter negligent reporting, subsequent interpretations have brought them closer together. For example, the reasonable cause exception applies to both. Treasury regulations clarified that substantial authority could not be determined based solely on a legal analysis, but on demonstrable facts relevant to the legal analysis.[255] Thus, for example, the failure of the taxpayer to create and maintain records of business expenses would cause a deduction for an unsupported amount on the return to lack substantial authority; although there is ample authority to deduct substantiated expenses that are ordinary and necessary for the operation of a business, there is no authority to deduct unsubstantiated expenses.[256]

[254] Currently, Code section 6662(d)(1) provides that the substantial understatement penalty will only be applied where the understatement is the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for corporations).
[255] Treas. Reg. sec. 1.6662-4(d)(2) states that the "substantial authority standard is an objective standard involving an analysis of the law and application to relevant facts."
[256] Further, although it may initially have been assumed that the substantial understatement penalty applied only to filed returns and the negligence penalty to unreported liabilities when no return was filed, it became clear that the substantial understatement penalty likewise applied

The elements and scope of the delinquency and substantial understatement penalties were coordinated and more closely converged in 1989. Both were modified to apply only to filed returns, were calculated based on the items that were misreported, were determined at the same 20-percent rate, could not be applied cumulatively, and were subject to the same reasonable cause exception. Penalty waiver based on disclosure, previously only available with respect to the substantial understatement penalty, was made available with respect to the negligence penalty. Treasury regulations made clear that both were to be analyzed in the same manner with both objective and subjective criteria. As a consequence, conduct that would subject a taxpayer to the negligence penalty is potentially subsumed within the standards applicable to the substantial understatement penalty, so that the negligence penalty may primarily be applicable in situations where the understatement is not substantial.

Preparer penalty amount. Treasury also believes that the current preparer penalty is too low in relation to the potential tax liabilities involved and in relation to the substantial understatement penalty imposed on taxpayers, while recognizing that primary responsibility for reporting positions should continue to reside with the taxpayer. However, presently, the sanctions for tax reporting errors are substantially discordant between taxpayers and preparers. The following examples in the context of the negligence penalty illustrates the point:

Example 1: Preparer A, at the source of a $10,000 negligent underpayment, is penalized $1,000, Preparer B, at the source of a $50,000 negligent underpayment, is penalized $1,000.

Example 2: Taxpayer A, at the source of a $10,000 negligent underpayment, is penalized $2,000. Taxpayer B, at the source of a $50,000 negligent underpayment, is penalized $10,000.

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when no return was filed or a position was taken only on a delinquently filed return. Woods v. Commissioner, 91 T.C. 88 (1988); McClanahan v. Commissioner, 95 T.C. 98 (1991); Hesselink v. Commissioner, 97 T.C. 94 (1991).

Moreover, the relatively low level of the preparer penalty, particularly for conduct that is not willful or involves reckless disregard of rules or regulations, discourages its assessment by the IRS in terms of the resources that must be devoted to determining if the penalty is applicable. The low number of assessments of this penalty (roughly three-tenths of one percent of audited individual returns with paid preparers presently are assessed the section 6694(a) penalty of $250) potentially indicates the limited devotion of administrative resources to this penalty. Accordingly, an approach based on the amount of preparer fees or other approach not based on a flat dollar amount and related more closely to the amount of the understatement of tax may merit Congressional consideration.

Recommendations

Treasury recommends that the accuracy standards for the accuracy and preparer penalties be the same and that the standards be modified such that, for non-shelter tax items, the standard for disclosed positions is a "realistic possibility of success on the merits" and the standard for nondisclosed positions is substantial authority. The standards for individual tax shelter items would be modified so that substantial authority and a reasonable belief that the position has a "more likely than not" chance of success would apply with respect to disclosed positions. Substantial authority and a reasonable belief that the position "should" prevail would be required for nondisclosed positions.

Treasury recommends modification of the "substantiality" requirement as proposed in the Administration's FY 2000 Budget proposals and suggests consideration of better harmonization of the negligence and substantial understatement penalty. Treasury also recommends that consideration be given to modifying the preparer penalty based on an approach other than a flat dollar amount to more closely correlate the penalty to the amount of the underlying understatement of tax.

VI. Interest Provisions

The Code imposes an interest charge when a taxpayer or the IRS fails to satisfy a payment obligation by the requisite due date. Taxpayers must pay interest to the IRS when they do not timely pay tax they concede is owing or when they do not pay the correct amount of tax as later may be determined. Conversely, the IRS must pay interest to a taxpayer when it fails to remit an overpayment of tax to a taxpayer in a timely manner. Over the years, greater sensitivity has been reflected in these Code provisions to time value of money considerations and commercial business practice, as well as compliance concerns regarding use of the government as a low-cost source of funds.

A. Present-law interest provisions

Although our tax system operates as a "pay-as-you-go" system, interest generally is not paid or owed from the time of receipt of the funds but, rather, based on the time prescribed by law for payment. Thus, although most taxpayers make payments during the year through withholding or estimated tax payments, overpayment interest is not paid by the government on those funds from the date of payment. Correlatively, interest is not charged on a shortfall in such payments during the year. For interest purposes, a taxpayer is considered to have until the legal due date of the return to determine its liability and remit any taxes owed. Of course, deposit and estimated tax payment rules effectively impose payment requirements prior to the due date of the return, but until the payment is treated as a payment of tax, interest is not owed, even if penalties in lieu of interest are imposed. The IRS also is given a period of time after the due date of the return (or if later, the date the taxpayer files the return) to make any refund shown on the return. The date that a payment is treated as a payment of tax thus is generally the operative date from which interest begins to accrue, either underpayment interest on a shortfall in the tax payment, or (if the IRS does not timely make a refund) overpayment interest on an excessive tax payment.

1. Underpayment interest

A taxpayer is required to pay interest to the government if it fails to pay the correct amount of any tax imposed under the Code by the statutory due date.[257] For this purpose, penalties, additional amounts or additions to tax are treated as a tax and similarly subject to underpayment interest.[258] Interest generally accrues on an underpayment of tax from the last date prescribed for payment of the tax until the tax is paid. For payments of tax that must be paid with the filing of the return, the due date of the tax is generally the same date as the due date of the return. The Code makes provision for extensions of time to file returns, but this extension does not similarly extend the statutory deadline for payment of the tax.[259] Thus, for example, a taxpayer who requests and receives an extension of the time to file from April 15 to August 15 is nevertheless required to remit any tax due on April 15 and, if the taxpayer does not do so, interest will accrue on the underpayment beginning on April 15 until the date paid.

A grace period of 21 days (10 business days if the underpayment is in excess of $100,000) is provided for payment following the issuance of a notice and demand for payment. No interest will be charged during this period if payment is made within the grace period.

If a change in the amount of an underpayment results from the carryback of a tax attribute, such as a net operating loss, the change generally is not taken into account until the due date of the return that includes the tax attribute.[260]

2. Overpayment interest

Likewise, the IRS is required to pay interest to a taxpayer if it does not timely refund an overpayment of tax.[261] Overpayment interest accrues on the overpayment from the later of the

[257] Code section 6601(a).
[258] Code section 6601(e)(2).
[259] Code section 6081.
[260] Code section 6601(d).
[261] Code section 6611(a). Included as an overpayment for this purpose is the portion of taxes paid that exceeds actual liability, refundable credits, and any taxes that were assessed or

due date of the return or the date the payment is made until a date not more than 30 days before the date of the refund check. This 30-day period permits the IRS to transmit the relevant refund information to the Financial Management Service of the Treasury, which actually issues the refund checks. If the overpayment is credited or offset against another liability, interest will accrue until the date so credited or offset. No interest is accrued if the IRS makes a refund within 45 days of the later of the filing or due date of the return showing the refund. If a refund is not made within 45 days, overpayment interest accrues for the entire period of the overpayment. If an overpayment is established by the filing of an amended return, overpayment interest accrues from the original due date of the return or, if later, the date the taxes were paid. The IRS is provided with a similar grace period following the filing of the amended return to pay the refund. If an adjustment initiated by the IRS results in a refund or credit of an overpayment, interest on such overpayment is computed by subtracting 45 days from the overpayment period.[262]

A payment is not considered made by a taxpayer earlier than the time the taxpayer files a return reporting the liability or, if later, the due date of the return. A taxpayer may not submit a remittance as a deposit or prepayment of tax and earn interest on such funds.

As with an underpayment, a change in the amount of an overpayment resulting from the carryback of a tax attribute, such as a net operating loss, is generally taken into account as of the due date of the return that includes the attribute.[263]

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collected after the expiration of the applicable period of limitations. Additionally, any interest and penalties previously paid by a taxpayer with respect to an underpayment of tax are treated as overpayments of tax to the extent the underpayment is later determined not to have existed.

[262] Code section 6611(e)(3).

[263] Code section 6611(f). If the availability of the attribute for carryback was itself created by the carryback of a separate item from a subsequent year, the period of overpayment generally does not begin until the due date of the subsequent year, i.e., the year in which the original carryback arose.

3. Interest rates

Both the underpayment and overpayment interest rates are based on the short-term applicable Federal rate (AFR), which represents the average market yield on outstanding marketable obligations of the Federal government with remaining periods to maturity of three years or less. This rate is adjusted quarterly and interest on both underpayments and overpayments is compounded daily. The short-term AFR is determined for the first month of each calendar quarter. As discussed in Section II.B, above, this was not always the case. At one time, the interest rate was a simple 6-percent interest rate that did not rise or fall with market rates.

For most of the history of the income tax, interest rates on underpayments and overpayments were identical. In 1986, a rate differential was introduced for the first time – the underpayment rate remained equal to the AFR plus three percentage points, but the overpayment rate was equal to the AFR plus two percentage points. In subsequent years, the differential between the underpayment and overpayment rates on large corporate underpayments and overpayments was enlarged. The rate on corporate underpayments of $100,000 or more was increased to equal the AFR plus five percentage points (triggered by failure to pay the amount shown within 30 days of the issuance of the first letter of proposed deficiency) ("hot interest" rate),[264] and the rate on overpayments over $10,000 was reduced to the AFR plus one-half percentage point (GATT overpayment rate).[265] Pursuant to the RRA 1998, the differential between the underpayment and overpayment rates was eliminated for individual taxpayers, effective for calendar quarters beginning on or after January 1, 1999. The applicable underpayment and overpayment rate for individuals presently is the AFR plus three percentage points. The rate differential, "hot interest" and GATT overpayment interest rates continue to apply with respect to corporations.

[264] Enacted by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508.
[265] Enacted by the Uruguay Round Agreements Act, Pub. L. No. 103-465.

4. Interest equalization

As a result of RRA 1998, a special net interest rate of zero applies to the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B on equivalent underpayments and overpayments by the same taxpayer.[266] Interest must be both payable and allowable for interest netting to apply. Each underpayment and overpayment is taken into account only once for this purpose. The net interest rate of zero applies regardless of what type of tax is underpaid or overpaid for the same period. Where interest is payable and allowable on an equivalent amount of underpayment and overpayment that is attributable to a taxpayer's interest in a passthrough entity, the benefits of the zero rate provision are to apply. In general, the net interest rate of zero applies to interest for periods beginning after the date of enactment of RRA 1998, but a special rule provides that the provision applies to interest for periods beginning before the enactment date if the taxpayer (1) reasonably identifies and establishes periods of overpayments and underpayments for which the net interest rate of zero applies, and (2) requests application of the net interest rate of zero by December 31, 1999.

As set forth in greater detail in Treasury's Global Interest Netting Study,[267] a net interest rate of zero can be achieved in alternative ways. If the underpayment on which interest is payable and the overpayment on which interest is allowable are both outstanding, the two amounts may be offset against each other and no interest is imposed on the overpayment or underpayment with respect to equivalent amounts for the overlapping period. Alternatively, if the underpayment or overpayment has previously been satisfied and interest paid at the underpayment or overpayment rate, the net interest rate of zero can be achieved by charging the same rate that was paid (on the underpayment or overpayment) to an equivalent amount of the corresponding overpayment or underpayment, or by requiring repayment or refund of the interest differential.[268] The new statutory provision mandating netting does not specify which approach is to be taken but the legislative history states that "where interest is both payable from and allowable to an individual taxpayer for the same period, the Secretary will take all reasonable

[266] Code section 6621(d).
[267] See footnote 11, supra.

efforts to offset the liabilities, rather than process them separately using the net interest rate of zero."[269]

The IRS issued guidance in March 1999[270] with respect to application of the net interest rate of zero provisions to interest for periods prior to the date of enactment. That guidance provided that with respect to interest accruing prior to October 1, 1998, the statute of limitations for both the underpayment and overpayment years must be open as of July 22, 1998.[271] It reiterated the statutory requirement that interest must be both payable and allowable for interest netting to apply. It prescribed procedures for filing a refund claim by December 31, 1999. The guidance also recognized that, in certain situations, taxpayers would be unable to provide the IRS with the requisite interest computations because tax years were still open or audits had not commenced. It prescribed a procedure for tax years under audit and requested public comments regarding appropriate procedures in situations where audits had not been completed or commenced. Treasury and the IRS expect to issue further guidance with respect to these procedures.

Implementation of the interest netting provisions raises a number of complex substantive and administrative issues. First is the issue of whether interest should be both payable and allowable in order for the zero net interest rate to be available. The statutory requirement that interest be both payable and allowable means that, for the net interest rate of zero to apply, a taxpayer must both owe and be owed interest for the same period on equivalent underpayments and overpayments. Underpayments and overpayments, accordingly, are not taken into account to the extent interest does not accrue. For example, if a taxpayer timely files a return reporting an overpayment of tax but requests that the overpayment be refunded, and the IRS refunds the

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[268] See Treasury Global Interest Netting Study, supra note 10, at 28-33 for examples demonstrating the economic equivalence of the credit offset and interest equalization methods.
[269] H.R. (Conf. Comm.) Rep. No. 599, supra note 4, at 257.
[270] Notice 99-19, 1999-13 I.R.B. 10.
[271] Pub. L. No. 105-206, as amended by Pub. L. No. 105-277, provides that "[s]ubject to any applicable statute of limitation not having expired with regard to either a tax underpayment or a tax overpayment, the amendments made by [section 6621(d)] shall apply to interest for periods beginning before the date of enactment," provided the statutory identification and notice requirements are met by the taxpayer.

overpayment within 45 days, interest on the overpayment will not accrue. Similarly, if the taxpayer requests that the overpayment be credited to the subsequent year's taxes, interest does not accrue on the credited overpayment. These rules ensure parity between taxpayers who receive refunds and taxpayers who elect to credit overpayments to subsequent year's taxes. In effect, the taxpayer who elects to credit the overpayment is treated as if it received a timely refund (without interest) and paid those funds to the government as an estimated tax payment toward the next year's tax liability. To extend the example, if the credited overpayment was in relation to the taxpayer's 1999 tax year and it was determined that the taxpayer had an underpayment for its 1998 income tax, the zero net interest rate would not apply to the underpayment of 1998 taxes for any period that the underpayment overlapped with the overpayment because interest was not allowable on the overpayment.[272] This rule preserves parity of treatment between taxpayers who receive refunds of overpayments without interest and taxpayers who have an overpayment but an overlapping period of underpayment.

A second source of complexity arises with respect to related taxpayers. The zero net interest rate only applies where interest is payable by and allowable to the "same" taxpayer.[273] The zero net interest rate does not apply where interest is payable by one taxpayer and allowable to another taxpayer. However, taxpayers may be related. If related taxpayers joined in a consolidated return, both entities are severally liable for the group's income tax and interest payable on that tax. However, the rules for consolidated returns under the Code do not allow related taxpayers in all instances to join in a consolidated return, even in the situation where one taxpayer is a wholly owned subsidiary of the other. Moreover, over time corporate taxpayers may be part of a consolidated return for certain periods, stand alone entities for other periods, and part of the same or other consolidated returns for other periods. Situations may arise, as a result, where conceptual issues exist with respect to whether and to what extent the zero net interest rate should apply.

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[272] Nevertheless, in this instance deficiency interest might not accrue while the government had the "use of money" of any overpayment for the 1998 return that was elected to be applied to 1999 estimated taxes. See Rev. Rul. 99-40, 1999-40 I.R.B. 441.

[273] A rationale for limiting interest netting to the same taxpayer is to avoid situations where taxpayers would affiliate and disaffiliate simply to share netting adjustments.

For example, adjustments to the taxable income of one taxpayer can result in correlative adjustments to the income of a related taxpayer, such as adjustments under Code section 482. If interest netting is not available, the interest rate differential on an underpayment and overpayment by the related taxpayers may result in an interest adjustment. This situation, for example, can arise with respect to a wholly-owned foreign sales corporation (FSC). However, allowing interest netting in the FSC setting (or other specific situations) raises complex conceptual issues. First, the rules applicable to interest netting must be considered in relation to the rules applicable to offsetting[274] so as to preclude inappropriate disparity in results. Second, to the extent that a corporation is liable for a tax underpayment (even if it is not the entity that created the underpayment), it is appropriate that it be able to offset or net that underpayment against its overpayment. This approach, however, does not encompass a FSC/parent relationship because those entities are not liable for each other's taxes

More generally, a degree of administrative complexity is associated with the implementation of interest netting, particularly with respect to its retroactive application to interest accruing for periods prior to the effective date of RRA 1998. Applying a zero net interest rate effectively renders every tax module[275] of a taxpayer's account for relevant years eligible for netting. Given the sequential nature of the IRS's current computer processing capability, the IRS computer system presently does not have the flexibility to freely access all tax modules on the IRS Master File so as to facilitate interest netting between modules for the same tax. Moreover, older modules are aged off to a retention register retained in a different storage medium and not all types of taxes paid by a taxpayer are maintained on the same system. Complexity arises in keeping track of the appropriate start and end dates for the underpayment and overpayment periods, and of interest rates applicable for different periods of time, including, for example, "hot interest," GATT overpayment interest, or interest surcharges under prior law for "tax motivated transactions." Further complexity arises because each interest netting computation may result in a period of underpayment or overpayment and an amount of underpayment or overpayment that is not utilized in the netting computation and can be

[274] Code section 6601(f).

[275] A tax module is a record of one account for one taxpayer covering one type of tax for one tax period. An account is a record of a taxpayer's assessments, abatements, and credits.

otherwise utilized for a different netting computation. An example is set forth below to illustrate the variables the IRS must be able to monitor as a result of a netting computation.

> On October 1, 1997, Corporation A pays an underpayment of $203,000 determined for its 1994 taxable year ending March 31, 1994. A 30-day letter was issued on December 10, 1995. On March 23, 1998, a refund of $39,000, plus interest, was paid with respect to A's 1996 taxable year ending March 31, 1996.
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> In this example, the underpayment period begins on June 15, 1994 (the due date of A's 1994 return) and extends through October 1, 1997 (the date the underpayment was paid). The overpayment period begins on June 15, 1996 and extends to March 14, 1998. The period of overlap of the underpayment and overpayment extends from June 15, 1996 through October 1, 1997. The amount of the overlap is $39,000. The net zero interest rate will apply to $39,000 of mutual indebtedness for the overlap period. The applicable underpayment interest rate would be the "hot interest" rate (AFR plus 5 percentage points) due to the issuance of a 30-day letter prior to the period of overlap. The applicable overpayment rate will be the GATT overpayment rate (AFR plus 0.5 percentage points) for the amount in excess of $10,000 and the normal overpayment rate for $10,000. Taxpayer A still has an underpayment period extending from June 15, 1994 through June 14, 1996 that could be netted against a different overlapping overpayment period. Because the amount of mutual indebtedness during the overlap period was $39,000, A still has $164,000 of underpayment amount ($203,000 less $39,000) available to be utilized in another netting computation.

As a result of the administrative complexity associated with interest netting and limitations of present computer systems, the IRS presently must rely to some degree on manual processing to verify the computations of taxpayers who request interest netting for periods beginning prior to the effective date of RRA 1998. To do so, it has instituted a complex set of guidelines for its employees to facilitate such manual computations. Specialists in interest computations are being trained for this purpose, and new computer programs are being developed for future application.

B. Analysis

Although it is well established that it is appropriate for the government to charge interest on underpayments and pay interest on overpayments of tax, a number of issues arise with respect to the current law interest provisions given the changes enacted in 1986 and thereafter. One critical issue is whether the concept of an interest differential retains viability in light of recent legislative elimination of that differential for individuals and the enactment of the zero net interest rate provisions. A second issue is whether interest rates are appropriately calibrated. Other issues arise in connection with, and separate from, these two issues.

Interest differential. The rationale articulated by Congress for an interest differential has its basis principally, although not exclusively, in commercial practice. As previously discussed, the differential was enacted originally to align interest rates more closely to commercial rates to reduce "distortive effects,"[276] where differences between borrowing and lending rates are prevalent, and during a period where a number of changes to the interest rates (quarterly adjustments, daily compounding) were enacted to "modernize" the government's approach to interest on Federal taxes in line with commercial borrowers and lenders. This rationale seemingly is as relevant today as when the differential was enacted. The differences in the marketplace between borrowing and lending rates may be due to market imperfections and the assumption by lenders of the risk of non-payment. This latter rationale also holds true for the government, which is a low-risk borrower relative to the risk it assumes of non-payment by taxpayers. Relatedly, the legislative history suggests that the potential for distortion between tax interest rates and other interest rates in the economy could lead sophisticated taxpayers to manipulate their tax liabilities into an underpayment or overpayment posture to maximize the differential with available returns in the rest of the economy.[277] The differential is intended to discourage use of the government as a low-cost source of funds and, conversely, to discourage taxpayers from using the government as a depository.[278]

However, in RRA 1998, Congress eliminated the differential for individuals by raising the overpayment rate to the underpayment rate, and provided all taxpayers with net zero rates for periods where interest is payable and allowable on equivalent overpayments and underpayments. Elimination of the differential for all taxpayers is arguably an extension of these two legislative enactments and would prospectively eliminate the necessity for interest netting. On the other hand, differences between borrowing and lending rates do exist in the commercial sector and

[276] See H.R. Rep. No. 426, 99th Cong., 1st Sess. 849 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 184 (1986).
[277] See Treasury Global Interest Netting Study, supra note 11, at 18-20 for a more complete discussion of the policy considerations underlying differential interest rates.
[278] See footnote 95, supra.

may be appropriately applied to corporations. Moreover, global interest netting is currently being implemented. Given the recent enactment of global netting interest rules, it would be premature to adjust interest rates to eliminate existing interest rate differentials.

Interest rates. The issues of interest rate equalization and the appropriate interest rates are intertwined. Presently, the underpayment rate is approximately 8 percent. This rate contrasts for individual taxpayers to recent rates of interest on consumer credit card loans of approximately 12 to 21 percent, on personal loans of approximately 13 to 14 percent, and on used car loans of approximately 12 percent.[279] To deter taxpayers from using the government either as a low-cost source of borrowing or as a depository, interest rates should approximate market rates so that taxpayers are either relatively indifferent between sources of credit and earnings, or have some incentive to prefer the government over other voluntary creditors and not prefer the government over other sources of earnings. Striking this balance is made more difficult by rate equalization because interest rate differentials exist in the marketplace. Moreover, different borrowing and lending rates are relevant to different categories of taxpayers.

The current underpayment rate of AFR plus three percentage points may be somewhat below the typical market rate of interest for individuals on unsecured personal loans. The divergence may be greater for taxpayers with greater credit risk. This argues for a somewhat higher underpayment rate than under current law. Higher rates, however, may cause additional payment problems for taxpayers in financial difficulty. On balance, Treasury believes that interest rates should approximate market rates to the extent feasible given the diversity of actual borrowing and lending rates in the marketplace and the limited number of interest rates used in the tax laws. Treasury believes that the appropriate underpayment interest rate should be in the range of AFR plus two to five percentage points.

[279] Federal Reserve Bulletin, June 1999 at A-36, Terms of Consumer Credit. Rates for secured debt, such as home mortgages, are lower. However, tax debts are more closely analogous to unsecured debt.

Treasury also recommends that, when administratively feasible, the 45-day rule restricting overpayment interest on refunds should be applied, in the case of early-filed returns, to the date the return was received, rather than the last day prescribed for filing the return.

Tax treatment of overpayment and underpayment interest. Under the general rules relating to the Federal income tax treatment of interest expense, businesses generally are permitted to deduct interest on underpayments of tax.[280] Individual taxpayers, by contrast, are not allowed to deduct underpayment interest.[281] Overpayment interest, like other interest income, generally is includible in income by both corporate and noncorporate taxpayers.[282] Prior to RRA 1998, the interest rate spread between the underpayment and overpayment rate for corporations was 4.5 percent and for individuals was one percent. However, because corporations can deduct underpayment interest, the after-tax spread in interest rates for corporations was approximately three percent.[283] This rate was roughly in parity with the effective underpayment rate for individuals, who could not deduct interest expense.[284]

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[280] Code section 163. Current deduction may not be allowed if underpayment interest is combined with other unallocated interest expenditures and a current deduction is not allowed with respect to some portion.

[281] Code section 163(h). This provision prohibits deduction of personal interest expense. Temporary regulations issued thereunder provide that personal interest includes interest paid on underpayments of Federal income tax, regardless of the source of the income generating the tax liability. Temp. Treas. Reg. sec. 1.163-9T(b)(2). See also H.R. Rep. No. 841, 99th Cong., 2d Sess. II-154 (1986)("Personal interest also generally includes interest on tax deficiencies."); Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 266 (1987). The validity of the temporary regulation has been upheld by several circuit courts of appeal that have considered the issue. See, e.g., Kikalos v. Commissioner, 84 A.F.T.R.2d 99-5933 (7th Cir. 1999); McDonnell v. United States, 180 F.3d 721 (6th Cir. 1999); Allen v. United States, 173 F.3d 533 (4th Cir. 1999); Redlark v. United States, 141 F.3d 936 (9th Cir.1998), Miller v. United States, 65 F.3d 687 (8th Cir. 1995).

[282] Code section 61(a)(4).

[283] For corporations, the maximum after-tax differential is (1-t)(AFR +5 percent) – (1-t)(AFR +0.5 percent) = (1-t)(4.5 percent), which approximately equals three percent (with a corporate tax rate t of 35 percent).

[284] For individuals, the after-tax differential was (AFR + 3 percent) – (1-t)(AFR + 2 percent), which is approximately three percent (with an individual tax rate t of 28 percent and an AFR of 5 percent).

RRA 1998, however, eliminated the interest rate differential between underpayment and overpayment rates for individuals and other noncorporate taxpayers, effectively achieving interest netting for those taxpayers. It also enacted interest netting provisions applicable to all taxpayers. As a result, the effective net interest rate for corporations on overlapping tax indebtedness is zero and for individuals in all cases is zero. However, the net interest rate for individuals is zero only on a pre-tax basis (absent section 6621(d)), whereas interest netting provides corporations with a net interest rate of zero on a pre-tax and post-tax basis. This occurs because in equalizing the interest rates for individuals, the rules requiring overpayment interest to be included in the income of noncorporate taxpayers and underpayment interest to be nondeductible were not modified. Equivalent effective interest rates would be achieved if the same rate and same treatment applies for Federal income tax purposes to both types of interest, i.e., both types of interest must either be included or excluded from income. Permitting an exclusion of interest income for individuals would equalize rates on an after-tax basis.

On the other hand, the original decision by Congress to disallow a deduction by individuals for consumer interest applies to all consumer interest,[285] not just to interest on tax underpayments. Presently, individuals must report interest income (e.g., from deposit accounts) but cannot deduct consumer interest paid on personal debts (e.g., personal loans or credit card debts). Permitting a deduction from income for underpayment interest would diverge from this policy. For this reason, Treasury does not believe a deduction for personal interest is warranted.

[285] Excepting those types of consumer interest, e.g., on a qualified residence, excepted by statute.

VII. Abatements of Penalties and Interest

A. Penalties

Virtually all penalties can be waived upon a demonstration by the taxpayer of reasonable cause. Treasury believes that the availability of reasonable cause waivers is generally sound tax policy.[286] Public comments received in connection with this study generally concurred, but concerns were expressed regarding the consistency with which reasonable cause criteria are applied by the IRS. The GAO study commissioned by the staff of the Joint Committee on Taxation also highlighted the disparate administration of penalty abatements among IRS districts.

Penalties also can be abated in certain other, statutorily-prescribed circumstances. Like tax and interest, penalties can be abated if the assessment is excessive in amount, assessed after the expiration of the applicable period of limitations, or erroneously or illegally assessed.[287] Penalties also can be abated if the penalty is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS.[288] The written advice must be in response to a specific written request of a taxpayer and the taxpayer must have reasonably relied on the advice. Moreover, the penalty cannot result from a failure by the taxpayer to provide adequate or accurate information.[289]

Data collected by the IRS on penalty abatements indicates that a significant number of penalties are abated each year. This information does not reveal in detail the reasons why penalties are abated. According to the report of the General Accounting Office, most penalty abatements appear to be handled either in the collection and customer service divisions of each IRS district office or in the customer service and automated collection branches of IRS service

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[286] See, however, the discussion regarding the reasonable cause exception in the context of corporate tax shelters in the Treasury Corporate Tax Shelter White Paper, supra note 7, at 91-93.
[287] Code section 6404(a).
[288] Code section 6404(f). This provision was added by the Technical and Miscellaneous Revenue Act of 1988.
[289] Code section 6404(f)(2).

centers. The reasons for penalty abatements are more difficult to discern because the IRS does not collect data that fully analyzes this issue.

A number of different circumstances can result in abatement of penalties. The IRS Penalty Handbook states that relief from penalties is available as a result of reasonable cause, statutory exceptions, administrative waivers or correction of IRS error.[290] As a general rule, reasonable cause abatements distinguish between nonnegligent and negligent or intentional actions that have resulted in penalties. A number of commentators stressed that penalties should distinguish between honest or inadvertent mistakes, first time offenders, taxpayers with good compliance histories, errors corrected before discovery by the IRS, or reliance on professionals. Treasury believes that whether reasonable cause exists depends on all the facts and circumstances. Consequently, as a general rule Treasury does not favor automatic abatements for first time offenders, taxpayers with good compliance histories or taxpayers who have relied on other parties. These factors are appropriate to consider but should not be dispositive as they may be outweighed by countervailing factors in any particular case. The IRS Penalty Handbook takes this approach. Reasonable cause is evaluated based on all the facts and circumstances and "is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but is unable to comply with those obligations."[291] The Penalty Handbook provides examples of circumstances to assist IRS personnel in determining whether a taxpayer has established reasonable cause for certain types of frequently-imposed penalties. It also directs IRS personnel to consider not only taxpayers' reasons for noncompliance, but taxpayers' prior compliance history, the length of time that has elapsed between compliance and noncompliance, and whether the circumstances were beyond the taxpayer's control.[292] In Treasury's view, this is a sound approach.

[290] Penalty Handbook, I.R.M. 120.1.1.2.2. In addition, Appeals may recommend the abatement or nonassertion of a penalty based on hazards of litigation. I.R.M. 120.1.1.3.
[291] Penalty Handbook, I.R.M. 120.1.1.3.1.
[292] I.R.M. 120.1.1.3.1.2. The Handbook states, however, that a first time failure to comply does not by itself establish reasonable cause. In evaluating whether ordinary care and prudence was exercised, the Penalty Handbook also provides direction to IRS personnel in relation to commonly asserted grounds for abatement, including claims of: (a) ignorance of the taxpayer's legal obligations, (b) mistake, (c) forgetfulness or an oversight by another party, (d) death, serious illness, or unavoidable absence, and (e) inability to obtain records. I.R.M. 120.1.1.3.1.2.

In addition, the offer-in-compromise program provides another potential mechanism to mitigate penalties in cases where hardship or other equity considerations warrant relief. RRA 1998 enacted new provisions affecting this program. Treasury issued temporary and proposed regulations this year implementing the provisions of RRA 1998. These regulations expanded the grounds upon which an offer in compromise can be accepted and specifically requested public comment on the application of the new provisions to the compromise of penalties and interest. The regulations set forth standards to permit compromise of a taxpayer's liability in the case of economic hardship or where, regardless of financial circumstances, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance. These new standards are in the early stages of implementation.

Treasury does recommend that the IRS take all administratively practicable measures to improve the documentation of reasons for abatement and to improve quality review of abatement decisions. In this regard, programs should be developed to assist IRS personnel to better monitor penalty abatements and evaluate grounds for abatement.[293]

Recommendations

Treasury does not believe at this time that further legislative changes to the penalty abatement provisions are warranted. Present law provides wide latitude for abatement in appropriate circumstances. Treasury also recommends that the IRS, on an ongoing basis,

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Compare guidelines promulgated by the Revenue Canada for waiver or cancellation of penalties or interest, which provide as examples of potential circumstances warranting abatement: (a) disasters, (b) civil disturbances or eruptions, (c) serious illness or accident, or (d) serious emotional or mental distress, such as caused by a death in the family. See Revenue Canada, IC92-2 Guidelines for the Cancellation and Waiver of Interest and Penalties. Waiver also can be considered if the penalty or interest arose primarily as a result of actions of Revenue Canada or where there is an inability to pay in order to facilitate collection. Id.

[293] The IRS presently uses "reason codes" to record grounds for penalty abatement. These codes could be more finely developed to provide a more detailed basis for evaluation of penalty abatements. In addition, presently under development is a Reasonable Cause Assistant program to assist IRS personnel in evaluating grounds for abatement. These programs, or similar or similar mechanisms and programs should be developed and used nationwide.

B. Interest

The circumstances under which interest can be abated or suspended are specifically prescribed in the Code. There is no general authority provided the Secretary to abate interest for reasonable cause similar to the reasonable cause exception for penalties. This dissimilarity in approach is based on the distinction between penalties as a sanction and interest as a charge for the forbearance of money. The reasonable cause standard is based on expectations regarding a taxpayer's conduct, and is intended to permit penalty abatement in those situations where the taxpayer's conduct does not amount to negligence or intentional misconduct. By contrast, the interest abatement provisions have recognized only errors or mistakes by the IRS, in the absence of any contributory action by the taxpayer, or special circumstances such as a disaster, as legitimate causes for abatement; otherwise interest is treated as the financial consequence of an underpayment of tax irrespective of the underlying causes for the liability.[294]

1. Present law

In general, the Secretary is authorized to abate interest if the interest is excessive in amount,[295] was assessed after expiration of the applicable period of limitations,[296] or was erroneously or illegally assessed.[297] The Secretary also is authorized to abate interest if, under uniform rules prescribed by the Secretary, the administration and collection costs would not warrant collection of the amount due,[298] or as a result of a mathematical error by an IRS employee assisting the taxpayer in the preparation of the return.[299] Interest also can be abated if the time for filing a return and paying tax is extended for any taxpayer located in a Presidentially

[294] See H.R. (Conf. Comm.) Rep. No. 841, 99th Cong., 2d Sess. (1986) at 810 (referencing the "IRS' longstanding position that once tax liability is established, the amount of interest is merely a mathematical computation based on the rate of interest and due date of the return").
[295] Code section 6404(a)(1).
[296] Code section 6404(a)(2).
[297] Code section 6404(a)(3).
[298] Code section 6404(c).
[299] Code section 6404(d).

declared disaster area,[300] and suspension of interest is provided for taxpayers serving in a combat zone.[301]

An assessment of interest on a deficiency[302] also may be abated if the assessment is attributable in whole or part to any unreasonable error or delay by an officer or employee of the IRS (acting in his or her official capacity) in performing a ministerial or managerial act,[303] but only if no significant aspect of the error or delay is attributable to the taxpayer.[304] Abatement relates only to periods after the taxpayer has been contacted in writing with respect to the deficiency. The legislative history states that "the provision therefore does not permit abatement of interest for the period of time between the date the taxpayer files a return and the date the IRS commences an audit, regardless of the length of that time period. Similarly, if a taxpayer files a return but does not pay the taxes due, this provision would not permit abatement of this interest regardless of how long the IRS took to contact the taxpayer and request payment."[305] Interest abatement only applies to the period of time attributable to the failure to perform the act. In general, the rule authorizes, but does not require, abatement of interest. Abatement is at the discretion of the Secretary. According to the legislative history, Congress did not intend that the provision be used routinely to avoid the payment of interest but, rather, where failure by the IRS to perform an act resulted in the imposition of interest, and the failure to abate the interest would be "widely perceived as grossly unfair."[306]

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[300] Code section 6404(h).
[301] Code section 7508.
[302] The statute specifically authorizes abatement of interest assessed on "any deficiency" or "any payment of any tax described in section 6212(a)." A deficiency is defined in section 6211 as the amount by which the tax imposed by Subtitle A or B or chapters 41 through 44 of the Code exceeds the amount of such tax shown on the return or previously assessed. Section 6212(a) also refers to deficiencies with respect to the same subtitles and chapters. The Tax Court has held that, based on the statutory language, the Secretary's authority to abate interest does not extend to interest on employment taxes, which are contained in subtitle C. Woodral v. Commissioner, 112 T.C. 19 (1999).
[303] Code section 6404(e).
[304] Id.
[305] H.R. Rep. No. 426, supra note 276.
[306] Id.

An exception to this discretionary authority exists in the case of erroneous refunds less than or equal to $50,000. In that situation, the Secretary is required to abate interest unless the taxpayer caused the erroneous refund.[307] If a taxpayer does not repay the erroneous refund when requested to do so by the IRS, interest will begin to accrue on the amount of the erroneous refund.[308]

The legislative history describes a ministerial act as limited to nondiscretionary acts where all of the preliminary prerequisites, such as conferencing and review by supervisors, have taken place. A ministerial act also is described as a procedural action and does not include a decision in a substantive area of the tax law.[309] The legislative history provides an example of what constitutes delay in performing a ministerial act, i.e., an unreasonable delay in the issuance of a statutory notice of deficiency after the IRS and the taxpayer have completed efforts to resolve the matter.[310] Treasury regulations provide a definition of "ministerial act" and examples of errors or delays in performing a ministerial act. The term "ministerial act" is defined to mean "a procedural or mechanical act that does not involve the exercise of judgment or discretion, and that occurs during the processing of a taxpayer's case after all prerequisites to the act, such as conferences and review by supervisors, has taken place. A decision concerning the proper application of federal law (or other federal or state laws) is not a ministerial act."[311] The absence of discretion is the distinguishing feature of a ministerial act. In a recent case of first impression regarding the meaning of a ministerial act, the Tax Court held that the mere passage of time in the litigation phase of a tax dispute does not establish error or delay by the IRS in performing a

[307] Code section 6404(c)(2). The legislative history expressed particular concern about "IRS errors that cause taxpayers to receive much larger refunds than they are entitled to" and that interest, with the exceptions noted, should not be charged on the erroneous amount. H.R. Rep. No. 426, supra note 276. As originally proposed, the requirement of abatement of interest on erroneous refunds would have applied to refunds of $1 million or less, but in conference was limited to refunds of $50,000 or less. H.R. Rep. No. 841, supra note 292, at 811.
[308] H.R. Rep. No. 841, supra note 294, at 811.
[309] H. R. Rep. No. 426, supra note 276, at 845; S. Rep. No. 313, supra note 276, at 209.
[310] Id. at 845.
[311] Treas. Reg. sec. 301.6404-2(b)(2).

ministerial act because the decision by the IRS as to how to proceed in the litigation phase of a case necessarily requires the exercise of judgment and thus cannot be a ministerial act.[312]

The legislative history also provides examples of error or delay with respect to managerial acts, including “extensive delays resulting from managerial acts such as the loss of records by the IRS, IRS personnel transfers, extended illnesses, extended personnel training, or extended leave.” It clarifies, however, that interest will not be abated resulting from general administrative decisions. It provides as an example of a general administrative decision an IRS decision on how to organize the processing of tax returns or its delay in implementing an improved computer system.[313] Treasury regulations define a managerial act as an administrative act that occurs during the processing of a taxpayer’s case involving the temporary or permanent loss of records or the exercise of judgment or discretion relating to the management of personnel.[314] Examples are provided that distinguish between managerial acts and general administrative decisions, including delay because the IRS has failed to assign appropriate personnel to a taxpayer’s case (managerial act) or loss or misplacement of a taxpayer’s files (managerial act).

Taxpayers can request abatement of interest by filing a claim on Form 843 with the Internal Revenue Service Center that has assessed the interest. The Tax Court has jurisdiction to review denials by the IRS of requests for abatement of interest. To invoke the court’s jurisdiction, the taxpayer must satisfy the net worth requirements for an award of attorneys’ fees under Code section 7430(c)(4).[315] To prevail, it must be demonstrated that, in not abating interest, the Secretary exercised his discretion arbitrarily, capriciously, or without sound basis in fact or law.[316] A judicial action must be brought within 180 days after the date of the Secretary’s final determination not to abate interest.

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[312] Lee v. Commissioner, 113 T.C. No. 10 (Aug. 18, 1999). The Court further held that the IRS’s grant of innocent spouse relief to the petitioner’s spouse was not a ministerial act. See also Taylor v. Commissioner, 113 T.C. No. 16 (Sept. 15, 1999)(decision by IRS not to proceed with civil case while criminal investigation and prosecution pending was not a ministerial act).
[313] H.R. Rep. No. 506, 104th Cong., 2d Sess. 27 (Mar. 28, 1996).
[314] Treas. Reg. sec. 301.6404-2(b)(1).
[315] Code section 6404(i).
[316] Woodral v. Commissioner, supra note 302, at 32; Lee v. Commissioner, supra note 312.

The Secretary also is required to abate any portion of any penalty or addition to tax attributable to erroneous written advice by the IRS.[317] This advice must be furnished in writing by an IRS officer or employee, given in response to a specific written request of the taxpayer, the taxpayer must have reasonably relied on the advice, and the taxpayer must have provided adequate and accurate information. Under this provision, only penalties and addition to tax are abated, and interest will be abated only to the extent it is attributable to abated penalties and additions to tax. Interest attributable to an underpayment of tax which, in turn, was the result of the taxpayer's reasonable reliance on erroneous written advice of the IRS, is not subject to abatement under this provision.

The Secretary is required to suspend the accrual of interest if the taxpayer is not contacted by the IRS specifically stating the taxpayer's liability and the basis for such liability within 18 months of the later of the date on which the return is filed or the due date of the return (without regard for extensions) (12 months for taxable years beginning on or after January 1, 2004).[318] Interest suspension begins on this date and ends twenty-one days after the IRS sends the required notice.[319] This provision does not apply to self-assessments of tax by the taxpayer, i.e., amounts reported as owed on the return, and is applied separately with respect to each item or adjustment.[320] The provision only applies to taxes imposed by subtitle A (i.e., income taxes) and the taxpayer must have timely filed the return (including extensions).

2. Historical background

Prior to 1986, interest generally could be abated only in the case of an erroneous or illegal assessment on the aforementioned rationale that interest is the financial consequence of an underpayment and should only be adjusted to reflect adjustments in the underlying liability. Subsequently, however, Congress expressed concern that the IRS's own errors and delays caused

[317] Code section 6404(f).
[318] Code section 6404(g).
[319] Code section 6404(g)(3).
[320] Code section 6404(g)(1)(B); (g)(2); H. R. Rep. No. 599, supra note 5, at 259-60. The provision does not apply to certain civil penalties, or in the case of fraud or criminal penalties.

taxpayers to incur additional interest charges and modified the interest abatement provisions to permit abatement for error or delay caused by a ministerial act. Pursuant to Taxpayer Bill of Rights 2 passed in 1996, this relief was expanded to encompass errors or delays in managerial acts by IRS personnel, but was modified to limit relief to unreasonable error or delay caused by either a ministerial or managerial act. RRA 1998 added the interest suspension provision as a result of concerns over extended periods of time lapsing prior to an IRS audit or other communication with the taxpayer.

3. Analysis

The IRS abates a significant amount of interest each year. In fiscal year 1998, IRS published statistics record 3.5 million abatements of interest totaling $2.1 billion. This compares to $7.2 billion of interest collected in the same year (in relation to individual, corporate and employment taxes) and a higher amount written off. (See Table 5). The majority of such abatements appear to be the result of adjustments of the underlying tax liability, resulting in a reduction in tax and associated abatement of interest. This type of abatement is qualitatively different from other types of abatements in that abatement derives from the absence of an underlying tax debt. Correlatively, a substantial portion of such abatements are accomplished through the IRS's automated processes.

<u>Expanded interest abatement authority</u>. Several commentators have suggested that interest abatement should be permitted for all unreasonable IRS errors or delays or in cases where assessment of interest would result in inequity. By contrast, others have recommended that further expansion of the interest abatement provisions be dealt with "gingerly" and that the relatively new interest abatement provision in the case of error or delay as a result of managerial acts and interest suspension provisions be provided an opportunity for evaluation.

Expansion of existing interest abatement provisions raises a number of issues. First is the conceptual distinction between interest and penalties. Some taxpayers may perceive the accrual of interest as, in essence, a penalty, but this is conceptually incorrect. As discussed above, interest arises because of the existence, and accrues during the duration, of a tax debt.

Nonetheless, interest accrual generates concern among taxpayers most often due to delays attendant upon identification or resolution of disputes regarding the correct tax liability and this concern necessarily implicates the issue of fault. Where such delays are caused by taxpayers, any resulting taxpayer burden is arguably outweighed by the inequity of penalizing the government for such delay from the standpoint of time value of money considerations or heightened credit risk associated with delayed payment. Where delay is caused by the government, the balance arguably shifts but administrative delays are not always a matter of governmental fault. They are often simply a matter of process and resource allocation and involve considerations of equity for all taxpayers in the administration of the tax laws. Drawing the distinction is critical, notwithstanding that the resulting delays can be significant and, to taxpayers, may compare unfavorably with their experience with commercial businesses that generally initiate contact with delinquent customers in relatively short periods of time. Historically, Congress generally has not considered delay resulting from the general administrative processes of the IRS to warrant abatement and only recently made an exception to this rule through the interest suspension provision. That exception appears intended to provide relief from interest accrual in situations where taxpayers have not had the opportunity to learn of, or respond to, the IRS's determination of a tax liability. For this reason, it does not apply to self-assessments of tax and requires that the taxpayer not contribute to delay by timely filing his or her return.

Treasury believes that, on balance, current law makes an appropriate distinction between instances of clear governmental fault and the general administrative processes and decisions that may result in delay. Expanding the present law provisions to allow interest abatement for any unreasonable IRS error or delay, whether or not involving a ministerial or managerial act, would necessarily implicate those general administrative decisions that are presently excluded from the interest abatement provisions. As a practical matter, it would potentially require the IRS and, if such decisions were judicially reviewable, the courts to evaluate many types of administrative decisions for unreasonableness, both generally and in relation to their impact on interest accrual in a particular taxpayer's case. It would be highly problematic to subject such decisions (and decisionmakers) to a reasonableness determination and/or an abuse of discretion type of review, and potentially would implicate managerial decisions at various levels within the agency, from high-level agency decisions to the more routine front-line management decisions. Moreover, it does not seem appropriate to subject this type of decision-making to a reasonableness determination based on the impact in a particular taxpayer's case rather than the broader considerations that motivated the decision.

It may be appropriate, however, to provide for abatement of interest in situations where erroneous advice has been provided to a taxpayer by the IRS, that is, analogous to the situation where abatement of penalties is permitted. Abatement in this circumstance should hinge on the same factors as under section 6404(f). In other words, the advice must be written, must be in response to a written request by the taxpayer, and the taxpayer must have reasonably relied on the advice. In addition, the portion of interest must not result from a failure of the taxpayer to provide adequate or accurate information.

A different issue is whether the IRS should have expanded authority to abate interest for equitable reasons other than governmental "fault." The interest suspension provision enacted by RRA 1998 can be viewed as an equitable provision that prevents interest accrual on a tax debt of which the taxpayer is unaware. In Treasury's view, equitable considerations should be considered in the context of the recent changes made by RRA 1998, particularly to the IRS's offer-in-compromise program. As described above, this program, in addition to other relief mechanisms under current law such as the disaster-relief provisions, offers an avenue for mitigation of accumulated interest in appropriate situations. As a consequence, Treasury believes it is premature to consider a broader, equity-based expansion of the interest abatement provisions.[321] Treasury will continue to work with the Congress and the IRS, however, to

[321] An ancillary consideration is a proliferation of equity criteria in the Code. The Code and published guidance already contain a number of different equity-based standards, including (1) the "economic hardship" standard of Code sections 6343 (release of levy) and 7122 (offers in compromise), (2) the "undue hardship" standard of Code section 6651 and 6166 and the new innocent spouse provisions of Code section 6015 (Notice 98-61, 1998-91 I.R.B. 13), (3) the "significant hardship" standard of Code section 7811 (National Taxpayer Advocate assistance), and (4) the "equity and good conscience" standard of Code section 6654 (waiver of estimated tax penalty in certain circumstances). Treasury believes that caution should be exercised in promulgating a multiplicity of equity standards that must be defined, coordinated and implemented in a coherent and consistent manner. Equity-based standards are inherently

identify situations where relief may be warranted and may not be available under current law or regulation.

Cap on interest and penalties. Some commentators also suggested that, in lieu of broader abatement authority, an absolute cap on interest and penalties, in relation to the original tax liability, would be appropriate. It has been suggested, for example, that interest and penalties should comprise no more than 200 percent of the original tax liability. This suggestion reflects concerns about burden considerations, i.e., the practicality of collecting liabilities that have accumulated to this extent, and proportionality considerations. A number of penalties contain monetary limitations, but generally where multiple acts of noncompliance are likely to arise.[322] Limitations on interest accrual, however, are not provided and are conceptually at odds with the concept of interest as a charge for the forbearance of money. Moreover, any such limitations necessarily should not extend to situations where taxpayers have caused the interest accumulation or where payment would not result in financial hardship. A limitation on total interest and penalty accumulation also would provide perverse incentives once the cap was reached to delay payment in order to reduce the real value of the outstanding liability.

Elimination of cap on abatement in connection with erroneous refunds. The Treasury Department also considered whether it was appropriate to eliminate the monetary limitation on mandatory interest abatement in the case of erroneous refunds. There are procedural impediments to the ability of the IRS to recover erroneous refunds by assessment in all cases and litigation is required in some circumstances. Consequently, Treasury believes that any modification of the cap should be coupled with consideration of the adequacy under current law of means by which the IRS can recover erroneous refunds.

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dependent on facts and circumstances, cannot be administered by automated processes, and are susceptible to inconsistent application.

[322] See, for example, Code section 6713 (disclosure or use of client information by preparer, penalty capped at $10,000 per calendar year); 6721 (failure to file correct information returns, capped at $250,000 per calendar year).

Recommendations

Treasury recommends that the current law interest abatement provisions be expanded to permit interest abatement in situations where the IRS has issued erroneous written advice to taxpayers under circumstances similar to those that apply under current law with respect to penalty abatements. At the present time, Treasury does not recommend further expansion of the interest abatement provisions by reason of hardship or other equity-based grounds. Consideration of the monetary threshold for mandatory interest abatement in the case of erroneous refunds should be coupled with consideration of the adequacy of available means for the IRS to recover erroneous refunds.

VIII. Other Penalties

A. Frivolous Return Penalty

Code section 6702 imposes a penalty on the filing by an individual of a frivolous return, i.e., a return that (1) does not contain information on which the substantial correctness of the self-assessment may be judged or (2) which contains information that on its face indicates that the self-assessment is substantially incorrect.[323] The penalty is imposed if, in addition to the foregoing, the conduct is based on a position that is frivolous or a desire (which appears on the purported return) to delay or impede the administration of Federal income taxes.[324]

The penalty imposed for filing a frivolous return is $500. The penalty is assessable by the IRS; the deficiency procedures do not apply and it can be imposed in addition to any other penalty imposed by law.[325] This penalty was enacted in 1982 by TEFRA and the amount of the penalty has not changed, although other penalties for frivolous actions, e.g., for filing frivolous petitions with the U.S. Tax Court, have been increased since that time. In the last several years, the IRS has assessed several thousand such penalties each year, and dealing with such returns,

[323] Code section 6702(a)(1). See 1989 Task Force Report, supra note 10, at V-49 – V-50 for the historical background of this penalty.
[324] Code section 6702(a)(2).
[325] Code section 6702(b).

and the frivolous positions taken, are resource-consuming for the IRS.[326] Due to the nature of the penalty, no "reasonable cause" waiver applies; however, the IRS has had some limited success in persuading filers of such documents to correct their returns. The IRS wants to increase its attention and educational effort to bring more such taxpayers into compliance with their tax obligations and provide an incentive for correct return filing.

Recommendation

Treasury recommends that the penalty be increased to $1,500 per document. At the same time, Treasury recommends that the IRS be provided the authority to abate the penalty if the taxpayer, after communication with the IRS, files a nonfrivolous return or amends the prior frivolous return with a reasonable period of time.

B. Penalties Relating to Employee Benefits/Plans

1. Present law

Employee benefit plans generally are required to file annual information returns stating information with respect to the status and operation of the plan. Every employer who maintains a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation is required, under Code section 6058, to file such an annual information return. ERISA section 104 contains a parallel return obligation, applicable not only to funded retirement plans but also to other types of plans subject to ERISA (such as welfare benefit plans), to file annual reports with the Department of Labor ("DOL"). In addition, ERISA section 4065 imposes on funded pension plans subject to Title IV of ERISA a separate annual filing requirement with the Pension Benefit Guaranty Corporation ("PBGC"). Finally, Code section 6039D imposes an annual reporting obligation on certain types of fringe benefit plans (which are generally not subject to ERISA).

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[326] The number of frivolous return penalty assessments are as follows: fiscal year 1995: 2,443; fiscal year 1996: 2,817; fiscal year 1997: 3,235; fiscal year 1998: 4,516. At the same time, frivolous positions have become more creative; a recent approach the IRS has seen, for example, has been to state the entire amount of prior years' social security (FICA) taxes paid or withheld

Code section 6652(e) imposes a $25 per day penalty, with a maximum of $15,000 per return, for failures to file the annual reports required of funded retirement plans and fringe benefit plans. This penalty applies unless it is shown that such failure is due to reasonable cause. ERISA section 502(c)(2) gives the DOL the authority to impose penalties of "up to" $1,100 per day on plan administrators not filing acceptable annual reports. Under DOL regulations, this penalty may be waived upon a showing of "reasonable cause." Finally, the PBGC may impose a penalty on plan administrators failing to satisfy Title IV's annual reporting obligation; that penalty shall "not exceed" $1,100 per day.

Since 1995, the DOL has maintained the Delinquent Filer Voluntary Compliance Program ("DFVC Program"). The DFVC Program encourages voluntary compliance in exchange for a reduction in applicable ERISA penalties. The DFVC Program applies only to ERISA Title I penalties and does not waive or reduce the penalties imposed under the Code or ERISA Title IV.

2. Analysis

Employee benefit plans are, depending on kind, subject to one or more federal regulatory regimes. Annual reporting requirements correspond to those regulatory regimes, and provide the regulators with information necessary to apply and enforce the law. In addition, annual reports are available to plan participants, and thus provide important information to plan participants and their representatives about a plan's operations.

Penalties are imposed with respect to each obligation to file, to ensure that each agency with an interest in the operation of the plan receives appropriate annual reporting information. Failure-to-file penalties have been an important enforcement tool in encouraging compliance, not only with respect to annual reporting obligations, but also with respect to the requirement that an independent certified public accountant issue a report regarding the plan's financial statements

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as withheld income taxes in the current year; a claim is then made for refund of those taxes in the current year.

which is included with the annual filing for larger plans. Moreover, because there is a coincidence of failures to file proper annual reports and failures to comply with the law governing the operation of the plan, a failure-to-file penalty can be useful in encouraging operational compliance in the context of examining plans.

In recent years, the annual reporting and filing requirements have to a large extent been coordinated by agreement of the agencies. The annual reporting requirements of the Code and ERISA are generally satisfied by filing a single annual report (Form 5500) with the IRS. The IRS then disseminates the information collected from the filings to the appropriate agencies. Beginning with the 1999 plan year, all Forms 5500 and related schedules (including filings with respect to non-ERISA plans, such as fringe benefit plans) will be processed centrally by a contractor through a new electronic filing (EFAST) system. The DOL has taken the lead in developing the EFAST program, and will be the agency in closest contact with the contractor. The processed returns or return information will be sent by the contractor to the IRS, DOL or PBGC, as appropriate.

The current penalty scheme seems confusing and unnecessarily duplicative in many cases. Qualified pension plans can be subject to three differing penalties for failures to file a Form 5500, and other penalties also apply to failures to file related Form 5500 attachments, such as the SSA and Schedule B.

An additional complexity applies to plans seeking a waiver or reduction in applicable failure to file penalties. Each of the agencies has historically taken the position that it has the ability to completely waive a penalty upon a showing of reasonable cause. This means that an employer may be put in the position of dealing with, and negotiating with, three separate agencies as to what constitutes reasonable cause. The tri-partite structure requires, at best, multiple written submissions and, at worst, a prolonged process of negotiation and, perhaps, inconsistent outcomes.

Moreover, while the DOL and PBGC have interpreted their statutes as permitting reduced penalties because their statutes use the phrases “up to” or “shall not exceed”, the IRS has the statutory authority only to waive the failure-to-file penalty completely, and not to reduce the penalty. This all-or-nothing penalty is not an effective regime for encouraging compliance, because practitioners believe that the IRS will more commonly waive the applicable penalty for reasonable cause than apply the statutorily required penalty. A similar statutory constraint leads the IRS to decline development of, or participation in, amnesty programs, because such programs offer a waiver or reduction without a showing of reasonable cause.

Recommendations

The penalties that apply to a qualified retirement plan's failure to file Form 5500 should be consolidated to a single penalty not in excess of a specified amount per day not to exceed a monetary cap per return, that may be waived or reduced upon a showing of reasonable cause. Welfare and fringe benefit plans should also be subject to a similar single penalty.

The consolidated penalty should be administered by the DOL. The DOL has been the lead agency in the Form 5500 design and implementation, is the agency who will be the liaison with the central processor of all Forms 5500, and is actively auditing compliance with reporting requirements.

The DFVC voluntary compliance program should continue to provide relief from late-filing or failure-to-file penalties in connection with delinquent Forms 5500. The program should continue to be administered by the DOL

Table 1

Tax, Penalty and Interest Revenue (1)
(billions of dollars)

	FY 1996			FY 1997			FY 1998		
	Voluntary Remittance	Enforcement and Collection	Total	Voluntary Remittance	Enforcement and Collection	Total	Voluntary Remittance	Enforcement and Collection	Total
All Taxes			1,376.1			1,482.2			1,600.7
Individual Income Tax									
Tax (2)	634.2	13.4	647.6	687.6	14.6	702.2	784.5	13.7	798.1
Penalty	3.0	2.3	5.3	3.4	2.5	5.9	3.7	2.5	6.2
Interest	-	3.1	3.1	-	3.3	3.3	-	3.4	3.4
Total	637.2	18.8	656.0	691.0	20.5	711.4	788.2	19.5	807.7
Corporate Income and Employment Taxes									
Tax (2)	643.5	12.3	655.7	691.0	11.8	702.8	725.4	10.0	735.4
Penalty	0.1	2.1	2.2	0.1	2.1	2.2	0.1	1.9	2.0
Interest	-	4.8	4.8	-	2.8	2.8	-	3.8	3.8
Total	643.6	19.2	662.7	691.1	16.8	707.9	725.5	15.7	741.2

	Individual Income	Corporate Income	Employment	
FY 1996 Enforcement Revenue	4.3	na	8.7	(3)
FY 1996 Collection Revenue				
Tax (2)	10.7	2.3	5.3	
Penalty	1.6	0.1	1.7	
Interest	2.2	0.6	0.4	
Total Collection	14.5	3.1	7.4	

(1) All payments are net of refunds. Components may not sum to totals due to rounding.
(2) Includes payments made for costs of collection. Approximately $93 million for individual income taxes in FY 1996.
(3) Includes corporate income and employment enforcement revenues combined.
Sources: Total taxes from IRS Databook, various years; Collection Revenue detail from Treasury tabulations of IRS Accounts Receivable data; total enforcement and collection data from annual ERIS reports, various years.

Table 2

Tax, Penalty and Interest Payments for Individual Income Tax Accounts Receivable
Collection Revenue in FY 1996
(billions of dollars)

Return Tax Year	FY 1996 Imputed Balance (1)	Amount Total Payments	Amount Tax Payments	Amount Penalty Payments	Amount Interest Payments
Pre 1985	16.29	0.55	0.18	0.05	0.32
1985 to 1990	34.58	2.28	1.12	0.35	0.81
1991 to 1993	22.39	5.14	3.74	0.65	0.75
1994	8.69	4.39	3.71	0.40	0.28
1995	6.36	2.09	1.95	0.12	0.02
1996	0.01	0.01	0.01	0.00	0.00
Total	88.32	14.46	10.72	1.57	2.18

Number of Years Return a Receivable	FY 1996 Imputed Balance (1)	Amount Total Payments	Amount Tax Payments	Amount Penalty Payments	Amount Interest Payments
More Than Ten Years	3.65	0.06	0.02	0.01	0.04
Five to Ten Years	22.51	0.72	0.29	0.10	0.33
Two to Five Years	25.97	2.34	1.30	0.38	0.66
One to Two Years	12.81	2.14	1.49	0.30	0.35
Less Than One Year	23.38	9.21	7.61	0.79	0.81
Total	88.32	14.47	10.72	1.57	2.18

(1) Imputed balance at beginning of fiscal year. Equal to year end balance plus all payments. Write-offs occuring during fiscal year are exluded from imputed balance.
Source: Treasury tabulations of payments from Accounts Receivable database for FY 1996.

Table 3

Penalty Assessments and Abatements (1)

	FY 1996				FY 1997				FY 1998			
	Assessments		Abatements		Assessments		Abatements		Assessments		Abatements	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Individual Income Tax (2)	**21,709**	**4,076**	**1,693**	**644**	**21,891**	**4,251**	**1,798**	**645**	**22,214**	**4,519**	**2,076**	**891**
Failure to File	2,444	1,491	446	365	2,326	1,445	500	362	2,346	1,636	513	573
Estimated Tax	5,878	1,094	232	86	6,413	1,215	231	84	6,842	1,391	228	107
Failure to Pay	13,110	1,228	969	108	12,875	1,311	1,028	103	12,768	1,329	1,301	150
Bad Check	233	9	11	2	248	10	15	2	243	11	16	3
Fraud	6	141	1	24	6	159	1	37	4	109	1	27
Other	38	114	34	59	22	111	23	57	11	43	16	32
Corporate Income Tax	**797**	**1,414**	**148**	**890**	**831**	**1,258**	**142**	**347**	**845**	**911**	**145**	**483**
Failure to File	140	456	26	439	154	421	27	153	142	275	24	192
Estimated Tax	311	274	22	114	319	243	22	96	339	355	24	173
Failure to Pay	336	405	100	333	346	339	93	81	355	142	97	86
Fraud	1	59	0	1	1	119	0	2	0	28	0	1
Other	10	220	0	3	12	137	0	14	9	110	1	31
Employment	**10,185**	**5,402**	**1,884**	**2,755**	**9,678**	**4,485**	**1,798**	**2,520**	**9,853**	**4,122**	**1,844**	**1,681**
Failure to File	1,838	663	250	189	1,697	750	234	261	1,728	649	238	231
Failure to Pay	4,378	387	826	90	4,213	451	800	150	4,176	384	859	109
Federal Tax Deposits	3,874	4,339	806	2,469	3,661	3,255	760	2,104	3,838	3,057	739	1,332
Bad Check	89	5	1	0	100	9	2	1	107	12	7	5
Other	6	8	1	7	6	20	1	4	4	20	1	3
Excise	408	168	103	95	426	273	111	109	461	291	133	142
Estate and Gift	21	154	12	133	24	203	14	155	28	227	17	201
Other (3)	515	272	286	198	512	514	226	443	458	408	150	308
Non-Return (4)	349	1,719	89	1,015	125	2,169	17	867	298	1,634	76	920
TOTAL	**33,985**	**13,205**	**4,214**	**5,729**	**33,486**	**13,154**	**4,107**	**5,086**	**34,157**	**12,112**	**4,441**	**4,626**

(1) FY 1998 data are preliminary and subject to change. Number of assessments and abatements in thousands. Amounts in millions of dollars.
(2) Does not include civil trust fund penalty abatements (approximately $685 million FY 1996, $710 million FY 1997, $675 million in FY 1998. Source: General Accounting Office).
(3) Includes forms 1041, 1065 and IRAs.
(4) Includes failure to file proper information returns, failure to file a W-2 and other.
Source: IRS Databook, Table 15, various years.

Table 4

Tax, Penalty and Interest Abatements, FY 1998
Individual Income Tax (1)

Return Tax Year	Total Abatements (2) Number	Total Abatements (2) Amount	Tax Abatements Number	Tax Abatements Amount	Penalty Abatements (3) Number	Penalty Abatements (3) Amount	Interest Abatements (4) Number	Interest Abatements (4) Amount
Pre 1980	2.0	27	0.2	5	1.1	3	0.7	19
1980 to 1984	39.1	197	4.3	43	26.0	40	8.9	114
1985 to 1989	310.9	630	33.9	240	219.9	210	57.1	180
1990	132.5	255	17.8	118	86.1	82	28.6	55
1991	164.3	330	25.0	168	102.1	107	37.1	55
1992	240.1	444	41.3	263	134.4	118	64.4	63
1993	364.3	898	81.9	655	174.2	150	108.1	93
1994	470.8	1,044	160.8	835	175.9	146	134.1	63
1995	828.5	891	277.6	701	285.0	150	265.9	40
1996	2,028.5	1,356	685.9	1,063	682.4	238	660.2	55
1997	2,505.5	1,604	1,219.7	1,377	484.5	208	801.3	19
1998	2.6	1	0.0	1	1.8	-	0.8	-
Total	7,088.9	7,677	2,549.6	4,699	2,372.2	1,452 (5)	2,167.1	756

(1) Number of abatements in thousands. Amount of abatements in millions of dollars. Does not include reductions due to offers-in-compromise or bankruptcies.
(2) Source: IRS' Abatement of Assessments in Fiscal Years 1995-98, Table 2.3, General Accounting Office.
(3) Source: IRS' Abatement of Assessments in Fiscal Years 1995-98, Table 4.11, General Accounting Office.
(4) Source: IRS' Abatement of Assessments in Fiscal Years 1995-98, Table 4.13, General Accounting Office.
(5) Includes $675 million in trust fund penalty abatements that were not included in tabulations from IRS Databook.

Table 5

Penalty and Interest Write Offs and Unpaid Assessments
All Tax Sources
(billions of dollars)

	Penalty and Interest Data (1)					
	FY 1997			FY 1998		
Category	Penalties	Interest	Total	Penalties	Interest	Total
Assessments	13.2	13.1	26.2	12.1	11.9	24.0
Abatements	4.1	2.8	6.9	4.4	2.1	6.5
Collections	5.6	6.9	12.5	5.6	7.3	12.9
Written Off, Assessed	1.8	1.7	3.5	1.7	1.7	3.4
Written Off, Accrued (2)	1.4	6.7	8.1	1.0	6.8	7.8

	Unpaid Assessments (3)			
Category	FY 1997 Amount	Penalty and Interest	FY 1998 Amount	Penalty and Interest
Receivables, Collectible	28		26	
Receivables, Uncollectible	62		55	
Write Offs	76	53	119	83
Compliance Assessments	48		22	
Total	214	136	222	140

(1) Source: Office of the Chief Financial Officer, IRS. Penalties assessed and abated from IRS Databook, Table 15. Amounts refer to activities during the fiscal year noted.

(2) 1997 figures are estimates. 1997 and 1998 figures apportioned between penalty and interest based on the stock of accrued penalties and interest for unpaid assessment accounts categorized as write-offs in FY 1998.

(3) Source: IRS Custodial Financial Statements, FY 1997 and FY 1998. Amounts shown refer to unpaid assessments as of the end of the fiscal year noted.

Table 6

Tax, Penalty and Interest Payments for Accounts Receivable
Collections in FY 1996
(millions of dollars)

Individual Income Tax

	Taxpayer Returns		FY 1996	Total Payments			Tax Payments		Penalty Payments		Interest Payments	
Number of Years Return a Receivable	Number (1)	Percent of Total	Imputed Balance (2)	Amount	Percent of Total	Percent of Balance	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
More Than Ten Years	109	0.8%	3,647	57	0.4%	1.6%	17	0.2%	5	0.3%	35	1.6%
Five to Ten Years	2,271	16.6%	22,514	719	5.0%	3.2%	290	2.7%	100	6.4%	329	15.1%
Two to Five Years	4,120	30.2%	25,974	2,345	16.2%	9.0%	1,304	12.2%	384	24.4%	656	30.1%
One to Two Years	2,527	18.5%	12,806	2,141	14.8%	16.7%	1,493	13.9%	296	18.8%	352	16.2%
Less Than One Year	4,626	33.9%	23,377	9,205	63.6%	39.4%	7,611	71.0%	787	50.1%	807	37.0%
Total	13,653	100.0%	88,318	14,467	100.0%	16.4%	10,716	100.0%	1,572	100.0%	2,179	100.0%

Corporate Income Tax

	Taxpayer Returns		FY 1996	Total Payments			Tax Payments		Penalty Payments		Interest Payments	
Number of Years Return a Receivable	Number (1)	Percent of Total	Imputed Balance (2)	Amount	Percent of Total	Percent of Balance	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
More Than Ten Years	2	1.1%	467	12	0.4%	2.5%	12	0.5%	0	0.0%	0	0.0%
Five to Ten Years	54	30.7%	5,477	17	0.6%	0.3%	11	0.5%	1	0.7%	5	0.8%
Two to Five Years	39	22.4%	12,904	180	5.9%	1.4%	120	5.2%	12	8.7%	48	7.7%
One to Two Years	19	10.6%	12,810	126	4.1%	1.0%	95	4.1%	6	4.2%	25	4.0%
Less Than One Year	62	35.2%	6,924	2,733	89.1%	39.5%	2,071	89.7%	117	86.4%	545	87.4%
Total	175	100.0%	38,582	3,068	100.0%	8.0%	2,309	100.0%	135	100.0%	624	100.0%

Employment Taxes

	Taxpayer Returns		FY 1996	Total Payments			Tax Payments		Penalty Payments		Interest Payments	
Number of Years Return a Receivable	Number (1)	Percent of Total	Imputed Balance (2)	Amount	Percent of Total	Percent of Balance	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
More Than Ten Years	121	2.4%	2,801	13	0.2%	0.4%	5	0.1%	1	0.1%	6	1.3%
Five to Ten Years	1,944	38.3%	20,543	133	1.8%	0.6%	67	1.3%	23	1.4%	43	9.8%
Two to Five Years	1,297	25.5%	10,493	438	5.9%	4.2%	247	4.7%	118	7.0%	73	16.5%
One to Two Years	476	9.4%	3,396	538	7.3%	15.9%	339	6.4%	149	8.8%	51	11.6%
Less Than One Year	1,238	24.4%	11,582	6,254	84.8%	54.0%	4,598	87.5%	1,389	82.7%	267	60.7%
Total	5,076	100.0%	48,815	7,376	100.0%	15.1%	5,256	100.0%	1,680	100.0%	440	100.0%

(1) Thousands.
(2) Imputed balance at beginning of fiscal year. Equal to year-end balance plus all payments. Write-offs occuring during fiscal year excluded from imputed balance.
Source: Treasury tabulations of payments from Accounts Receivable database for FY 1996.

SEC. 6651. FAILURE TO FILE TAX RETURN OR TO PAY TAX.

Subsec. (a) ADDITION TO THE TAX.--

In case of failure--

6651(a)(1) to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes) or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

6651(a)(2) to pay the amount shown as tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate; or

6651(a)(3) to pay any amount in respect of any tax required to be shown on a return specified in paragraph (1) which is not so shown (including an assessment made pursuant to section 6213(b)) within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which such notice and demand is made equals or exceeds $100,000), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount of tax stated in such notice and demand 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

In the case of a failure to file a return of tax imposed by chapter 1 within 60 days of the date prescribed for filing of such return (determined with regard to any extensions of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, the addition to tax under paragraph (1) shall not be less than the lesser of $100 or 100 percent of the amount required to be shown as tax on such return.

SEC. 6652. FAILURE TO FILE CERTAIN INFORMATION RETURNS, REGISTRATION STATEMENTS, ETC.

Subsec. (a) RETURNS WITH RESPECT TO CERTAIN PAYMENTS AGGREGATING LESS THAN $10.-- In the case of each failure to file a statement of a payment to another person required under the authority of--

> **6652(a)(1)** section 6042(a)(2) (relating to payments of dividends aggregating less than $10), or
>
> **6652(a)(2)** section 6044(a)(2) (relating to payments of patronage dividends aggregating less than $10),

on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary and in the same manner as tax) by the person failing to so file the statement, $1 for each such statement not so filed, but the total amount imposed on the delinquent person for all such failures during the calendar year shall not exceed $1,000.

Subsec. (b) FAILURE TO REPORT TIPS.--

> In the case of failure by an employee to report to his employer on the date and in the manner prescribed therefor any amount of tips required to be so reported by section 6053(a) which are wages (as defined in section 3121(a)) or which are compensation (as defined in section 3231(e)), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be paid by the employee, in addition to the tax imposed by section 3101 or section 3201 (as the case may be) with respect to the amount of tips which he so failed to report, an amount equal to 50 percent of such tax.

Subsec. (c) RETURNS BY EXEMPT ORGANIZATIONS AND BY CERTAIN TRUSTS.--

6652(c)(1) ANNUAL RETURNS UNDER NLCITE]SECTION 6033NL/CITE].--

> **6652(c)(1)(A)** PENALTY ON ORGANIZATION.--In the case of--
>
> > **6652(c)(1)(A)(i)** a failure to file a return required under section 6033 (relating to returns by exempt organizations) on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), or
> >
> > **6652(c)(1)(A)(ii)** a failure to include any of the information required to be shown on a return filed under section 6033 or to show the correct information,
>
> there shall be paid by the exempt organization $20 for each day during which such failure continues. The maximum penalty under this subparagraph on failures with respect to any 1 return shall not exceed the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year. In the case of an organization having gross receipts exceeding $1,000,000 for any year, with respect to the return required under section 6033 for such year, the first sentence of this subparagraph shall be applied by substituting “$100” for

"$20" and, in lieu of applying the second sentence of this subparagraph, the maximum penalty under this subparagraph shall not exceed $50,000.

6652(c)(1)(B) MANAGERS.--

6652(c)(1)(B)(i) IN GENERAL.--The Secretary may make a written demand on any organization subject to penalty under subparagraph (A) specifying therein a reasonable future date by which the return shall be filed (or the information furnished) for purposes of this subparagraph.

6652(c)(1)(B)(ii) FAILURE TO COMPLY WITH DEMAND.--If any person fails to comply with any demand under clause (i) on or before the date specified in such demand, there shall be paid by the person failing to so comply $10 for each day after the expiration of the time specified in such demand during which such failure continues. The maximum penalty imposed under this subparagraph on all persons for failures with respect to any 1 return shall not exceed $5,000.

6652(c)(1)(C) PUBLIC INSPECTION OF ANNUAL RETURNS.--In the case of a failure to comply with the requirements of subsection (d) or (e)(1) of section 6104 (relating to public inspection of annual returns) on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), there shall be paid by the person failing to meet such requirements $10 for each day during which such failure continues. The maximum penalty imposed under this subparagraph on all persons for failures with respect to any 1 return shall not exceed $5,000.

6652(c)(1)(D) PUBLIC INSPECTION OF APPLICATIONS FOR EXEMPTION.--In the case of a failure to comply with the requirements of section 6104(e)(2) (relating to public inspection of applications for exemption) on the date and in the manner prescribed therefor, there shall be paid by the person failing to meet such requirements $10 for each day during which such failure continues.

6652(c)(2) RETURNS UNDER section 6034 or 6043(b)--

6652(c)(2)(A) PENALTY ON ORGANIZATION OR TRUST.--In the case of a failure to file a return required under section 6034 (relating to returns by certain trusts) or section 6043(b) (relating to terminations, etc., of exempt organizations), on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), there shall be paid by the exempt organization or trust failing so to file $10 for each day during which such failure continues, but the total amount imposed under this subparagraph on any organization or trust for failure to file any 1 return shall not exceed $5,000.

6652(c)(2)(B) MANAGERS.--The Secretary may make written demand on an organization or trust failing to file under subparagraph (A) specifying therein a reasonable future date by which such filing shall be made for purposes of this subparagraph. If such filing is not made on or before such date, there shall be paid by the person failing so to file $10 for each day after the expiration of the time specified in the written demand during which such failure continues, but the total amount imposed under this subparagraph on all persons for failure to file any 1 return shall not exceed $5,000.

Subsec. (d) ANNUAL REGISTRATION AND OTHER NOTIFICATION BY PENSION PLAN.--

6652(d)(1) REGISTRATION.--In the case of any failure to file a registration statement required under section 6057(a) (relating to annual registration of certain plans) which includes all participants required to be included in such statement, on the date prescribed therefor (determined without regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing so to file, an amount equal to $1 for each participant with respect to whom there is a failure to file, multiplied by the number of days during which such failure continues, but the total amount imposed under this paragraph on any person for any failure to file with respect to any plan year shall not exceed $5,000.

6652(d)(2) NOTIFICATION OF CHANGE OF STATUS.--In the case of failure to file a notification required under section 6057(b) (relating to notification of change of status) on the date prescribed therefor (determined without regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing so to file, $1 for each day during which such failure continues, but the total amounts imposed under this paragraph on any person for failure to file any notification shall not exceed $1,000.

Subsec. (e) INFORMATION REQUIRED IN CONNECTION WITH CERTAIN PLANS OF DEFERRED COMPENSATION; ETC.--

In the case of failure to file a return or statement required under section 6058 (relating to information required in connection with certain plans of deferred compensation), 6047 (relating to information relating to certain trusts and annuity and bond purchase plans), or 6039D (relating to returns and records with respect to certain fringe benefit plans) on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing so to file, $25 for each day during which such failure continues, but the total amount imposed under this subsection on any person for failure to file any return shall not exceed $15,000. This subsection shall not apply to any return or statement which is an information return described in section 6724(d)(1)(C)(ii) or a payee statement described in section 6724(d)(2)(Y).

Subsec. (f) RETURNS REQUIRED UNDER SECTION 6039C.--

6652(f)(1) IN GENERAL.--In the case of each failure to make a return by section 6039C which contains the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, the amount determined under paragraph (2) shall be paid (upon notice and demand by the Secretary and in the same manner as tax) by the person failing to make such return.

6652(f)(2) AMOUNT OF PENALTY.--For purposes of paragraph (1), the amount determined under this paragraph with respect to any failure shall be $25 for each day during which such failure continues.

6652(f)(3) LIMITATION.--The amount determined under paragraph (2) with respect to any person for failing to meet the requirements of section 6039C for any calendar year shall not exceed the lesser of--

6652(f)(3)(A) $25,000, or

6652(f)(3)(B) 5 percent of the aggregate of the fair market value of the United States real property interests owned by such person at any time during such year.

For purposes of the preceding sentence, fair market value shall be determined as of the end of the calendar year (or, in the case of any property disposed of during the calendar year, as of the date of such disposition).

Subsec. (g) INFORMATION REQUIRED IN CONNECTION WITH DEDUCTIBLE EMPLOYEE CONTRIBUTIONS.-

In the case of failure to make a report required by section 219(f)(4) which contains the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing so to file, an amount equal to $25 for each participant with respect to whom there was a failure to file such information, multiplied by the number of years during which such failure continues, but the total amount imposed under this subsection on any person for failure to file shall not exceed $10,000. No penalty shall be imposed under this subsection on any failure which is shown to be due to reasonable cause and not willful neglect.

Subsec. (h) FAILURE TO GIVE NOTICE TO RECIPIENTS OF CERTAIN PENSION, ETC., DISTRIBUTIONS.--

In the case of each failure to provide notice as required by section 3405(e)(10)(B), at the time prescribed therefor, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid, on notice and demand of the Secretary and in the same manner as tax, by the person failing to provide such notice, an amount equal to $10 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $5,000.

Subsec. (i) FAILURE TO GIVE WRITTEN EXPLANATION TO RECIPIENTS OF CERTAIN QUALIFYING ROLLOVER DISTRIBUTIONS.--

In the case of each failure to provide a written explanation as required by section 402(f), at the time prescribed therefor, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid, on notice and demand of the Secretary and in the same manner as tax, by the person failing to provide such written explanation, an amount equal to $100 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $50,000.

Subsec. (j) FAILURE TO FILE CERTIFICATION WITH RESPECT TO CERTAIN RESIDENTIAL RENTAL PROJECTS.--
In the case of each failure to provide a certification as required by section 142(d)(7) at the time prescribed therefor, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid, on notice and demand of the Secretary and in the same manner as tax, by the person failing to provide such certification, an amount equal to $100 for each such failure.

Subsec. (k) FAILURE TO MAKE REPORTS REQUIRED UNDER SECTION 1202.--
In the case of a failure to make a report required under section 1202(d)(1)(C) which contains the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing to make such report, an amount equal to $50 for each report with respect to which there was such a failure. In the case of any failure due to negligence or intentional disregard, the preceding sentence shall be applied by substituting “$100” for “$50”. In the case of a report covering periods in 2 or more years, the penalty determined under preceding provisions of this subsection shall be multiplied by the number of such years. No penalty shall be imposed under this subsection on any failure which is shown to be due to reasonable cause and not willful neglect.

Subsec. (l) FAILURE TO FILE RETURN WITH RESPECT TO CERTAIN CORPORATE TRANSACTIONS.--
In the case of any failure to make a return required under section 6043(c) containing the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing to file such return, an amount equal to $500 for each day during which such failure continues, but the total amount imposed under this subsection with respect to any return shall not exceed $100,000.

SEC. 6654. FAILURE BY INDIVIDUAL TO PAY ESTIMATED INCOME TAX. Subsec. (a) ADDITION TO THE TAX.--
Except as otherwise provided in this section, in the case of any underpayment of estimated tax by an individual, there shall be added to the tax under chapter 1 and the tax under chapter 2 for the taxable year an amount determined by applying--

6654(a)(1) the underpayment rate established under section 6621,
6654(a)(2) to the amount of the underpayment,
6654(a)(3) for the period of the underpayment.

SEC. 6656. FAILURE TO MAKE DEPOSIT OF TAXES.

Subsec. (a) UNDERPAYMENT OF DEPOSITS.--

In the case of any failure by any person to deposit (as required by this title or by regulations of the Secretary under this title) on the date prescribed therefor any amount of tax imposed by this title in such government depository as is authorized under section 6302(c) to receive such deposit, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be imposed upon such person a penalty equal to the applicable percentage of the amount of the underpayment.

Subsec. (b) DEFINITIONS.--

For purposes of subsection (a)--

6656(b)(1) APPLICABLE PERCENTAGE.--

6656(b)(1)(A) IN GENERAL.--Except as provided in subparagraph (B), the term "applicable percentage" means--

6656(b)(1)(A)(i) 2 percent if the failure is for not more than 5 days,

6656(b)(1)(A)(ii) 5 percent if the failure is for more than 5 days but not more than 15 days, and

6656(b)(1)(A)(iii) 10 percent if the failure is for more than 15 days.

6656(b)(1)(B) SPECIAL RULE.--In any case where the tax is not deposited on or before the earlier of--

6656(b)(1)(B)(i) the day 10 days after the date of the first delinquency notice to the taxpayer under section 6303 , or

6656(b)(1)(B)(ii) the day on which notice and demand for immediate payment is given under section 6861 or 6862 or the last sentence of section 6331(a) ,

the applicable percentage shall be 15 percent.

6656(b)(2) UNDERPAYMENT.--The term "underpayment" means the excess of the amount of the tax required to be deposited over the amount, if any, thereof deposited on or before the date prescribed therefor.

SEC. 6662. IMPOSITION OF ACCURACY-RELATED PENALTY.

Subsec. (a) IMPOSITION OF PENALTY.--

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

Subsec. (b) PORTION OF UNDERPAYMENT TO WHICH SECTION APPLIES.--

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

6662(b)(1) Negligence or disregard of rules or regulations.

6662(b)(2) Any substantial understatement of income tax.

6662(b)(3) Any substantial valuation misstatement under chapter 1.

6662(b)(4) Any substantial overstatement of pension liabilities.

6662(b)(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663 .

SEC. 6663. IMPOSITION OF FRAUD PENALTY.

Subsec. (a) IMPOSITION OF PENALTY.--

If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

Subsec. (b) DETERMINATION OF PORTION ATTRIBUTABLE TO FRAUD.--

If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

Subsec. (c) SPECIAL RULE FOR JOINT RETURNS.--

In the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

SEC. 6672. FAILURE TO COLLECT AND PAY OVER TAX, OR ATTEMPT TO EVADE OR DEFEAT TAX.

Subsec. (a) GENERAL RULE.--

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 or part II of subchapter A of chapter 68 for any offense to which this section is applicable.

SEC. 6684. ASSESSABLE PENALTIES WITH RESPECT TO LIABILITY FOR TAX UNDER CHAPTER 42.

If any person becomes liable for tax under any section of chapter 42 (relating to private foundations and certain other tax-exempt organizations) by reason of any act or failure to act which is not due to reasonable cause and either--

6684(1) such person has theretofore been liable for tax under such chapter, or

6684(2) such act or failure to act is both willful and flagrant,

then such person shall be liable for a penalty equal to the amount of such tax.

SEC. 6694. UNDERSTATEMENT OF TAXPAYER'S LIABILITY BY INCOME TAX RETURN PREPARER.

Subsec. (a) UNDERSTATEMENTS DUE TO UNREALISTIC POSITIONS.--

If--

6694(a)(1) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits,

6694(a)(2) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and

6694(a)(3) such position was not disclosed as provided in section 6662(d)(2)(B)(ii) or was frivolous,

such person shall pay a penalty of $250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

Subsec. (b) WILLFUL OR RECKLESS CONDUCT.--

If any part of any understatement of liability with respect to any return or claim for refund is due--

6694(b)(1) to a willful attempt in any manner to understate the liability for tax by a person who is an income tax return preparer with respect to such return or claim, or

6694(b)(2) to any reckless or intentional disregard of rules or regulations by any such person,

such person shall pay a penalty of $1,000 with respect to such return or claim. With respect to any return or claim, the amount of the penalty payable by any person by reason of this subsection shall be reduced by the amount of the penalty paid by such person by reason of subsection (a).

SEC. 6695. OTHER ASSESSABLE PENALTIES WITH RESPECT TO THE PREPARATION OF INCOME TAX RETURNS FOR OTHER PERSONS.

Subsec. (a) FAILURE TO FURNISH COPY TO TAXPAYER.--

Any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with section 6107(a) with respect to such return or claim shall pay a penalty of $50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000.

Subsec. (b) FAILURE TO SIGN RETURN.--

Any person who is an income tax return preparer with respect to any return or claim for refund, who is required by regulations prescribed by the Secretary to sign such return or claim, and who fails to comply with such regulations with respect to such return or claim shall pay a penalty of $50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000.

Subsec. (c) FAILURE TO FURNISH IDENTIFYING NUMBER.--
Any person who is an income tax return preparer with respect to any return or claim for refund and who fails to comply with section 6109(a)(4) with respect to such return or claim shall pay a penalty of $50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000.

Subsec. (d) FAILURE TO RETAIN COPY OR LIST.--
Any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with section 6107(b) with respect to such return or claim shall pay a penalty of $50 for each such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to any return period shall not exceed $25,000.

Subsec. (e) FAILURE TO FILE CORRECT INFORMATION RETURNS.--
Any person required to make a return under section 6060 who fails to comply with the requirements of such section shall pay a penalty of $50 for--

6695(e)(1) each failure to file a return as required under such section, and

6695(e)(2) each failure to set forth an item in the return as required under [such] section,

unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to any return period shall not exceed $25,000.

Subsec. (f) NEGOTIATION OF CHECK.--
Any person who is an income tax return preparer who endorses or otherwise negotiates (directly or through an agent) any check made in respect of the taxes imposed by subtitle A which is issued to a taxpayer (other than the income tax return preparer) shall pay a penalty of $500 with respect to each such check. The preceding sentence shall not apply with respect to the deposit by a bank (within the meaning of section 581) of the full amount of the check in the taxpayer's account in such bank for the benefit of the taxpayer.

Subsec. (g) FAILURE TO BE DILIGENT IN DETERMINING ELIGIBILITY FOR EARNED INCOME CREDIT.--
Any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of $100 for each such failure.

SEC. 6698. FAILURE TO FILE PARTNERSHIP RETURN.

Subsec. (a) GENERAL RULE.--
In addition to the penalty imposed by section 7203 (relating to willful failure to file return, supply information, or pay tax), if any partnership required to file a return under section 6031 for any taxable year--

6698(a)(1) fails to file such return at the time prescribed therefor (determined with regard to any extension of time for filing), or

6698(a)(2) files a return which fails to show the information required under section 6031
,

such partnership shall be liable for a penalty determined under subsection (b) for each month (or fraction thereof) during which such failure continues (but not to exceed 5 months), unless it is shown that such failure is due to reasonable cause.

Subsec. (b) AMOUNT PER MONTH.--
For purposes of subsection (a), the amount determined under this subsection for any month is the product of--

6698(b)(1) $50, multiplied by

6698(b)(2) the number of persons who were partners in the partnership during any part of the taxable year.

SEC. 6702. FRIVOLOUS INCOME TAX RETURN.

Subsec. (a) CIVIL PENALTY.--
If--

6702(a)(1) any individual files what purports to be a return of the tax imposed by subtitle A but which--

6702(a)(1)(A) does not contain information on which the substantial correctness of the self-assessment may be judged, or

6702(a)(1)(B) contains information that on its face indicates that the self-assessment is substantially incorrect; and

6702(a)(2) the conduct referred to in paragraph (1) is due to--

6702(a)(2)(A) a position which is frivolous, or

6702(a)(2)(B) a desire (which appears on the purported return) to delay or impede the administration of Federal income tax laws,

then such individual shall pay a penalty of $500.

Subsec. (b) PENALTY IN ADDITION TO OTHER PENALTIES.--
The penalty imposed by subsection (a) shall be in addition to any other penalty provided by law.

SEC. 6721. FAILURE TO FILE CORRECT INFORMATION RETURNS.

Subsec. (a) IMPOSITION OF PENALTY.--

6721(a)(1) IN GENERAL.--In the case of a failure described in paragraph (2) by any person with respect to an information return, such person shall pay a penalty of $50 for each return with respect to which such a failure occurs, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $250,000.

6721(a)(2) FAILURES SUBJECT TO PENALTY.--For purposes of paragraph (1), the failures described in this paragraph are--

6721(a)(2)(A) any failure to file an information return with the Secretary on or before the required filing date, and

6721(a)(2)(B) any failure to include all of the information required to be shown on the return or the inclusion of incorrect information.

Subsec. (b) REDUCTION WHERE CORRECTION IN SPECIFIED PERIOD.--

6721(b)(1) CORRECTION WITHIN 30 DAYS.--If any failure described in subsection (a)(2) is corrected on or before the day 30 days after the required filing date--

6721(b)(1)(A) the penalty imposed by subsection (a) shall be $15 in lieu of $50, and

6721(b)(1)(B) the total amount imposed on the person for all such failures during any calendar year which are so corrected shall not exceed $75,000.

6721(b)(2) FAILURES CORRECTED ON OR BEFORE AUGUST 1.--If any failure described in subsection (a)(2) is corrected after the 30th day referred to in paragraph (1) but on or before August 1 of the calendar year in which the required filing date occurs--

6721(b)(2)(A) the penalty imposed by subsection (a) shall be $30 in lieu of $50, and

6721(b)(2)(B) the total amount imposed on the person for all such failures during the calendar year which are so corrected shall not exceed $150,000.

Subsec. (e) PENALTY IN CASE OF INTENTIONAL DISREGARD.--

If 1 or more failures described in subsection (a)(2) are due to intentional disregard of the filing requirement (or the correct information reporting requirement), then, with respect to each such failure--

6721(e)(1) subsections (b), (c), and (d) shall not apply,

6721(e)(2) the penalty imposed under subsection (a) shall be $100, or, if greater--

6721(e)(2)(A) in the case of a return other than a return required under section 6045(a) , 6041A(b) , 6050H , 6050I , 6050J , 6050K , or 6050L , 10 percent of the aggregate amount of the items required to be reported correctly,

6721(e)(2)(B) in the case of a return required to be filed by section 6045(a) , 6050K , or 6050L , 5 percent of the aggregate amount of the items required to be reported correctly, or

6721(e)(2)(C) in the case of a return required to be filed under section 6050 I(a) with respect to any transaction (or related transactions), the greater of--

6721(e)(2)(C)(i) $25,000, or

6721(e)(2)(C)(ii) the amount of cash (within the meaning of section 6050 I(d)) received in such transaction (or related transactions) to the extent the amount of such cash does not exceed $100,000, and

6721(e)(3) in the case of any penalty determined under paragraph (2)--

6721(e)(3)(A) the $250,000 limitation under subsection (a) shall not apply, and

6721(e)(3)(B) such penalty shall not be taken into account in applying such limitation (or any similar limitation under subsection (b)) to penalties not determined under paragraph (2).

SEC. 6722. FAILURE TO FURNISH CORRECT PAYEE STATEMENTS.

Subsec. (a) GENERAL RULE.--

In the case of each failure described in subsection (b) by any person with respect to a payee statement, such person shall pay a penalty of $50 for each statement with respect to which such a failure occurs, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $100,000.

Subsec. (c) PENALTY IN CASE OF INTENTIONAL DISREGARD.--

If 1 or more failures to which subsection (a) applies are due to intentional disregard of the requirement to furnish a payee statement (or the correct information reporting requirement), then, with respect to each failure--

- **6722(c)(1)** the penalty imposed under subsection (a) shall be $100, or, if greater--
  - **6722(c)(1)(A)** in the case of a payee statement other than a statement required under section 6045(b) , 6041A(e) (in respect of a return required under section 6041A(b)), 6050H(d) , 6050J(e) , 6050K(b) , or 6050L(c) , 10 percent of the aggregate amount of the items required to be reported correctly, or
  - **6722(c)(1)(B)** in the case of a payee statement required under section 6045(b) , 6050K(b) , or 6050L(c) , 5 percent of the aggregate amount of the items required to be reported correctly, and
- **6722(c)(2)** in the case of any penalty determined under paragraph (1)--
  - **6722(c)(2)(A)** the $100,000 limitation under subsection (a) shall not apply, and
  - **6722(c)(2)(B)** such penalty shall not be taken into account in applying such limitation to penalties not determined under paragraph (1).

SEC. 6723. FAILURE TO COMPLY WITH OTHER INFORMATION REPORTING REQUIREMENTS.

In the case of a failure by any person to comply with a specified information reporting requirement on or before the time prescribed therefor, such person shall pay a penalty of $50 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $100,000.

STATE	FAILURE TO FILE	FAILURE TO PAY	NEGLIGENCE	FAILURE TO FURNISH INFO.	FAILURE TO PAY TAX REQUIRED ON RETURN	SUBSTANTIAL UNDER-STATEMENT	INTEREST ON UNDERPAYMENTS (u) / OVERPAYMENTS (o)
AZ**	4.5% per mo. up to 25%*	1/2% per mo. up to 10%*					(u) & (o): AFR + 3%** (effective 10-1-99)
CA**	5% per mo. up to 25%.* If more than 60 days late penalty is lesser of $100 or 100% of tax.	5% per mo. up to 40 mo.* Adjusted if fail to file penalty applies	Same as 6662.	25% of tax.*			(u): 6621(a)(2) (o): Same as 6621(a)(2) Higher rates for corporate underpayments.
CO**	Greater of $5 or 5% of tax due plus 1\2% per mo not to exceed 12%.*	Same as fail to file only the greater penalty applies.*	Up to 25% of the deficiency.*				(u) & (o): Prime rate, per WSJournal + 3%, rounded up to nearest full percent.
NY**	5% per mo. up to 25%.*	1/2% per mo. up to 25%.*	5% of deficiency + 50% of the interest.		1/2% per mo. up to 25%.*	10%	(u): Federal short-term rate (AFR) + 3% (o): AFR + 2%
PA**	5% per mo. Up to 25%	NONE	5% of u/p up to 25% max if omission > 25%				(u): “rate established by the ... IRC of 1954" (o): “same rate as is prescribed for underpayments”
VA**	6% per mo. up to 36%.*	6% per mo. up to 36%.*					(u) & (o): 6621
VT**	5% per mo. up to 25%.*	5% per mo. up to 25%.*	Up to 25% of up attrib. to negl.				(u) & (o): “average prime rate charged by banks during the immediately preceding 12 months” Set in December & rounded up to whole percent.

* Reasonable Cause exception applies. ** As of October 1, 1999