Joint Committee on Taxation
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TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION CONCERNING TAX PENALTIES AND INTEREST BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE HOUSE COMMITTEE ON WAYS AND MEANS

January 27, 2000

My name is Lindy Paull. As Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") at this hearing concerning tax penalties and interest before the Subcommittee on Oversight of the House Committee on Ways and Means.[1]

A. Background

Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") directed the Joint Committee on Taxation and the Secretary of the Treasury to conduct separate studies of the present-law interest and penalty provisions of the Internal Revenue Code (the "Code") and to make any legislative or administrative recommendations they deem appropriate to simplify penalty and interest administration or reduce taxpayer burden. The studies were required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

In responding to this legislative mandate, the Joint Committee staff undertook an extensive study of the present-law system of penalties and interest. The Joint Committee staff reviewed each of the penalty and interest provisions in the Code. The Joint Committee staff economists analyzed the economic considerations that affect taxpayers' decisions with respect to compliance and the Federal government's decisions in setting enforcement parameters, including penalties. The Joint Committee staff met with representatives of the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS"), requested the General Accounting Office to investigate IRS practices regarding penalties and interest and, with the assistance of the Library of Congress, reviewed penalty and interest regimes in other countries. The Joint Committee staff solicited comments from taxpayers, tax practitioners, tax clinics serving low-

[1] This testimony may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Subcommittee on Oversight of the House Committee on Ways and Means, January 27, 2000* (JCX-2-00), January 26, 2000.

income individuals, and other interested parties, and met with representatives of major taxpayer groups and professional organizations to discuss their comments.

The Joint Committee staff study[2] includes a variety of recommendations to modify the present-law system of penalties and interest. These recommendations are designed to improve the overall administration of penalties and interest and to provide consistency in application with respect to similarly situated taxpayers.

B. Recommendations Relating to Interest

Equal treatment for all taxpayers

A single interest rate should be applied to all tax underpayments and overpayments for all taxpayers. The single interest rate should be set at the short-term applicable federal rate plus five percentage points ("AFR+5").

The Joint Committee staff recommendation is based on the concept that the Federal government and taxpayers, to the greatest extent possible, should be treated equally in the payment of interest. Equal treatment of interest would enhance perceptions of fairness and would simplify interest computations in situations involving overpayments and underpayments during overlapping periods of time. To achieve equal treatment, the same rate of interest should apply to payments by a taxpayer to the Federal government and to payments by the Federal government to a taxpayer, irrespective of whether the taxpayer is an individual or corporation, and without regard to the amount of the underpayment or overpayment of tax.

Present law does not embody this concept of equality. Corporations are required to pay higher interest rates on underpayments than the interest rates received on overpayments. Under certain circumstances, the rate of interest paid by a corporation on a large underpayment is four and one-half percentage points higher than the interest rate that would be paid by the Federal government on a large overpayment.[3]

The IRS Reform Act moved toward equal treatment with respect to interest by requiring that the same rate of interest apply to underpayments and overpayments of individual taxpayers.

[2] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999 (the "Joint Committee staff study").

[3] The current interest rate for a large corporate underpayment is 10 percent (so-called "hot" interest), compared with 5.5 percent paid by the Federal government on a large corporate overpayment (so-called "cold" interest). Rev. Rul. 99-53, 1999-50 I.R.B. 657 (December 13, 1999).

The IRS Reform Act also provided a net interest rate of zero for interest payable by and allowable to a taxpayer on equivalent amounts of underpayments and overpayments for the same period. However, the implementation of the zero net interest rate is expected to be complicated. The legislative history to the 1998 Act recognizes that implementation of the zero net interest rate may be dependent on taxpayer initiative while the IRS develops procedures for the automatic application of the zero net interest rate. The Joint Committee staff recommendation to apply a single interest rate to underpayments and overpayments of all taxpayers would eliminate most of the implementation issues for taxpayers and the IRS.

Equal treatment of interest for an individual taxpayer should be accomplished by excluding from income interest paid to an individual taxpayer on an overpayment of tax.

Interest paid by the Federal government to a taxpayer should be treated for federal income tax purposes in the same manner as interest paid by a taxpayer to the Federal government. Under present law, individual taxpayers are required to include in gross income interest received from the Federal government, but they are not allowed to deduct interest paid to the Federal government.[4] This inequality in treatment may cause individual taxpayers to believe that the federal income tax laws are not fair.

Prior to 1987, interest paid by an individual was generally deductible so long as it was not incurred as a cost of carrying tax-exempt bonds. However, as part of an effort to eliminate the deduction of various personal expenses, the Tax Reform Act of 1986 made most types of personal interest nondeductible. Treasury regulations take the position that nondeductible personal interest includes interest paid on underpayments of federal income tax, regardless of the source of the income generating the tax liability.[5]

It is noteworthy that no deduction is allowed under the Treasury regulations even if the interest relates to a deficiency in tax on business activities. Other interest incurred in the course of operating a business generally is deductible. The Tax Court has held the regulation position to be unreasonable, and therefore invalid.[6] However, the U.S. Courts of Appeals have consistently

[4] This disparity in treatment does not exist for corporations. Under present law, corporations generally are allowed to deduct interest paid to the Federal government and interest received from the Federal government is included in gross income.

[5] Treas. Reg. sec. 1.163-9T(b)(2).

[6] Redlark v. Commissioner, 106 T.C. 31 (1996), rev'd 141 F. 3d 936 (9th Cir., 1998).

upheld the validity of the regulation,[7] although these courts have expressed some reservations as to its wisdom.

The Joint Committee recommends excluding interest paid to an individual on an overpayment of tax to eliminate the inequality in treatment of individual taxpayers and the Federal government. Equal treatment of taxpayers and the IRS can be achieved so long as interest is either included and deductible, or excluded and nondeductible. Allowing individual taxpayers to exclude interest on overpayments, rather than deduct interest on underpayments, insures that individual taxpayers will be treated equally, whether or not they itemize deductions.

Abatement of interest

Under present law, the Secretary of the Treasury is authorized to abate interest in limited instances. Such circumstances include an unreasonable delay by the IRS in the performance of a managerial or ministerial act, a failure by the IRS to contact an individual taxpayer in a timely manner, an erroneous refund by the IRS of $50,000 or less, and during periods when the taxpayer is serving in a combat zone or is located in a designated disaster area.

Numerous situations arise in which the resolution of a taxpayer's case has been delayed as a result of events arising in their dealings with the IRS. By allowing for interest abatement only in specific situations that rarely occur, present law ties the hands of the IRS and prevents it from assisting taxpayers by abating the interest that accumulates during such delays. Thus, the circumstances in which the Secretary of the Treasury is authorized to abate interest should be expanded to cover additional situations where the collection of interest from the taxpayer is inappropriate.

The Secretary of the Treasury should be authorized to abate interest that is attributable to unreasonable IRS errors or delays, whether or not related to managerial or ministerial acts.

It is not appropriate to require taxpayers to pay interest for periods when the sole reason the taxpayer's case was not resolved in a timely manner relates to error or delay on the part of the IRS. The present-law rule prevents abatement in situations in which unreasonable delay on the part of the IRS is clearly present, but the reason for the delay does not meet the technical and limited definition of a managerial or ministerial act or the taxpayer cannot identify the specific act on the part of the IRS causing the delay. The present-law rule also serves as an excuse for IRS refusals to consider the abatement of interest. For example, a taxpayer's application for abatement would automatically be rejected under present law if the IRS spent excessive time due to obvious errors by a revenue agent in interpreting and applying the tax laws, the choice by an

[7] The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Sixth, Seventh, Eighth, and Ninth Circuits.

examining agent of which of his or her assigned cases to handle at a point in time, or the perceived need of the IRS to resolve other cases first.

The $50,000 limitation for abatement of interest on erroneous refunds should be removed.

Under present law, the Secretary is required to abate interest on erroneous refunds of $50,000 or less, provided the taxpayer has not in any way caused the erroneous refund. The Joint Committee staff recommends that the $50,000 limitation should be eliminated. If the taxpayer has done nothing to cause the erroneous refund, interest should not be charged until after the IRS requests the return of the money.

The Secretary should be allowed to abate interest on an underpayment if the underpayment is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity.

Under present law, penalties and additions to tax (but not interest) must be abated if they are attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. A taxpayer who follows the erroneous written advice of the IRS should not be charged interest for following that advice.

The Secretary should be granted the authority to abate interest if a gross injustice would result if interest is charged.

The Secretary should not be precluded from preventing a gross injustice solely because the particulars of a situation have not been provided for by law. It is anticipated that this authority would be used infrequently and only in situations in which the taxpayer has not materially contributed to the accrual of the interest.

Interest on disputed underpayments

Taxpayers should be allowed to establish interest-bearing accounts within the Treasury to stop the running of interest on taxes expected to be in dispute with the IRS.

Present law provides limited opportunities for a taxpayer to stop the accrual of interest prior to or during an IRS audit. A taxpayer may make a payment in the nature of a cash bond. However, such a cash bond does not earn interest and is ineffective to the extent the taxpayer recovers any portion of the deposit prior to final determination of the tax liability. Taxpayers and their representatives rarely consider this procedure for these reasons. As a result, taxpayers incur significant interest charges while waiting for their cases to be resolved.

The Joint Committee staff believes that tax administration would be benefitted by a mechanism that would allow taxpayers to manage exposure to underpayment interest without requiring the taxpayer to prepay tax on disputed items or to make a potentially indefinite-term investment in a non-interest bearing account. The Joint Committee recommends that taxpayers should be allowed to deposit amounts in a new "dispute reserve account." A dispute reserve account would be a special interest-bearing account within the U.S. Treasury that could be established by a taxpayer for any type of tax that is due for any period. Amounts could be withdrawn from a dispute reserve account at any time, and would earn interest from the date of deposit at a rate equal to the short term AFR. If an amount in the dispute reserve account is applied to pay an underpayment of tax, it is treated as a payment of tax on the original deposit date. The dispute reserve account could be especially helpful for lengthy audits with difficult issues or open audits of related passthrough entities.

C. Recommendations Relating to Accuracy-Related Return Standards for Taxpayers and Tax Preparers

The Joint Committee staff recommends (1) harmonizing the standards for taxpayers and tax preparers applicable under the accuracy-related penalties and (2) increasing the amount of the return preparer penalty. The Joint Committee staff believes that these recommendations will improve both the equity and administrability of the accuracy-related penalty system.

Undisclosed tax return positions

The minimum standard for each undisclosed position on a tax return should be that the taxpayer or tax preparer reasonably believes the return position is "more likely than not" the correct tax treatment under the Code.[8]

This standard, which would apply equally to taxpayers and tax preparers, would imply that, at the time the return was signed, there was a greater than 50 percent likelihood that all undisclosed positions would be sustained if challenged. The reasonable cause exception for the substantial understatement penalty would be eliminated.

Disclosed tax return positions

The minimum standard for each disclosed position taken or advised to be taken on a tax return should be that the taxpayer or tax preparer has "substantial authority" for such position.[9]

[8] Under the Joint Committee staff recommendations relating to corporate tax shelters, a higher standard would apply with respect to corporate tax shelter transactions.

[9] Under the Joint Committee staff recommendations relating to corporate tax shelters, a higher standard would apply with respect to corporate tax shelter transactions. For tax shelter

This standard, which would apply equally to taxpayers and tax preparers, would imply that, at the time the return was signed, there was a greater than 40 percent likelihood that all adequately disclosed positions would be sustained if challenged.

Revise tax preparer penalty amounts

The preparer penalty should be revised to better reflect the potential tax liabilities involved. The penalty for understatements due to unrealistic positions should be changed from a flat $250 to the greater of $250 or 50 percent of the tax preparer's fee. The penalty for willful or reckless conduct should be changed from a flat $1,000 to the greater of $1,000 or 100 percent of the preparer's fee.

The accuracy-related and tax preparer penalties are designed to delineate (1) when an erroneous position taken on a tax return should be considered innocent and not subject to penalty, (2) when taxpayers should specifically notify the IRS that they are adopting controversial positions, and (3) when taxpayers are taking unduly aggressive positions and should be penalized for any resulting tax deficiency regardless of disclosure. The flat $250 penalty of present law, for example, may have little deterrent effect if the tax preparer's fee is many times that amount.

Discussion of accuracy-related standards

Because federal tax law is complex and constantly evolving, it is unrealistic to expect taxpayers to file "perfect" returns, on which every position taken is unquestionably correct. Still, the U.S. Supreme Court has pointed out that "self assessment...is the basis of our American scheme of income taxation."[10] Self assessment requires a high degree of cooperation from the taxpayer to file an accurate tax return. A self-assessment system will work properly if taxpayers perceive the system to be fair and believe that the costs of noncompliance outweigh the benefits of such noncompliance.

Under present law, a taxpayer is not subject to an accuracy-related penalty for an undisclosed improper return position provided there is "substantial authority" for the position. The regulations describe substantial authority in terms of a spectrum,[11] with most practitioners assuming substantial authority implies a 40-percent chance of success if challenged by the IRS.

transactions not involving corporations, the present-law standard of "more likely than not" would continue to apply as a means to avoid an understatement penalty with respect to disclosed positions.

[10] Commissioner of Internal Revenue v. Lane Wells Co., 321 U.S. 219, 223 (1944).

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

In assessing whether a position is supported by substantial authority, certain specified sources of authority may be consulted.

Under present law, a taxpayer is not subject to the substantial understatement penalty for a disclosed improper return position provided there is a "reasonable basis" for the position. Most practitioners assume a reasonable basis exists for a position if there is at least a 20 percent likelihood of success if challenged by the IRS.

However, under present law, tax preparers are held to lower standards than taxpayers. For nondisclosed return positions, the tax preparer is not subject to the tax preparer penalty if the return position has a "realistic possibility of being sustained," which most practitioners believe falls between substantial authority and reasonable basis standards for taxpayers. If a return position is disclosed, a tax preparer need only ensure that the return position is "not frivolous." The "not frivolous" standard has been interpreted to mean there exists a five to ten percent chance of the return position being successful if challenged by the IRS.

The accuracy-related penalty generally is abated if the taxpayer can demonstrate there was a "reasonable cause" for the underpayment. Generally, if the taxpayer relies in good faith on the advice of a tax professional, the taxpayer would satisfy the reasonable cause requirement. Thus, the standards for taxpayers and tax preparers are interrelated and it is inappropriate for tax preparers to be held to a lower standard than taxpayers.

These present-law standards for imposition of accuracy-related penalties on taxpayers and return preparers arguably permit taxpayers to take positions on tax returns that have an inappropriately low chance of success if challenged by the IRS. These low standards have the effect of increasing perceptions of unfairness in our tax system because taxpayers who take aggressive positions on their returns and their advisors are unlikely to be penalized. If taxpayers and preparers are not held to standards which require them to believe information reported on tax returns is in fact correct, the IRS will have the impossible task of examining greater percentages of returns in order to maintain the fairness of our tax system.

D. Recommendations Relating to the Penalty for Failure to Pay Taxes

The failure to pay taxes penalty should be repealed. Interest would continue to apply to the underpaid amount, but at the single rate of AFR+5 discussed above. An annual late payment service charge would also apply to taxpayers who have not paid their taxes or have not entered into installment agreements in a timely manner.

Under the Joint Committee staff recommendation, the failure to pay taxes penalty would be repealed and taxpayers would be given four months after assessment[12] in which to pay their tax obligations and be charged interest only. At the end of that four-month period, if the taxpayer still has not fully paid the taxpayer's tax obligation, or entered into an installment agreement to pay such obligation, the taxpayer would be charged an annual 5-percent late payment service charge on the remaining outstanding balance. This service charge would be similar to late payment charges that are widely imposed in the private sector. Thus, taxpayers would easily understand the purpose of the charge--to encourage timely payment. To avoid the service charge, taxpayers would have a strong incentive to enter into an installment agreement in a timely fashion, rather than waiting for a long period of time and letting interest continue to mount without making further payments. The repeal of the penalty for failure to pay taxes and its replacement with the service charge would further a policy initiative to encourage the use of installment agreements that was begun by the IRS Reform Act, which reduced this penalty for taxpayers who enter into installment agreements.[13]

The late payment service charge would operate in the following way. If a taxpayer has not entered into an installment agreement by the fourth month after assessment, a 5-percent late payment service charge would be imposed on the balance remaining unpaid at the end of that four-month period. This 5-percent late payment service charge would also be imposed each year on the anniversary of its original imposition on the balance remaining unpaid at that anniversary date, unless the taxpayer has entered into an installment agreement with the IRS and has remained current on that agreement. For example, if an individual files an income tax return on April 15, but the full amount shown as due on that return is not paid with that return, the taxpayer must either pay the remaining taxes or enter into an installment agreement by August 15 to avoid paying the late payment service charge. A taxpayer could entirely avoid this service charge, however, by entering into an installment agreement with the IRS and remaining current on that agreement. Abrogation of the installment agreement by the taxpayer would result in the immediate imposition of the 5-percent late payment service charge.

Taxpayers who enter into installment agreements and who also agree to an automated withdrawal of each installment payment directly from their bank account would not be required to pay the present-law $43 fee for entering into an installment agreement.

The elimination of the $43 user fee for installment agreements for taxpayers who both enter into installment agreements and who agree to use automated mechanisms, such as automated debits from a bank account, to pay their installment payments is designed to increase the certainty of timely payment, simplify the payment process for taxpayers, decrease

[12] This provision would apply to self-assessments (amounts shown on an original return but not paid with that return) as well as assessments later made by the IRS.

[13] Code sec. 6651(h).

administrative costs of collection for the IRS, and eliminate what some taxpayers may view as a barrier to entering into an installment agreement.[14]

E. Recommendations Relating to Estimated Tax Penalties

The estimated tax penalty should be repealed and replaced with an interest charge using the single interest rate of AFR+5 discussed above. Many computational details also should be simplified. The threshold below which individuals are not subject to the estimated tax penalty (currently $1,000) should be increased to $2,000 and the calculation of this threshold would be modified to take into account certain estimated tax payments.[15]

Approximately 12 million individuals make estimated tax payments. Many of these individuals find that calculating the correct amount of estimated tax payments is complex and confusing. The Joint Committee staff recommendations would provide significant simplification for many of these individuals.

The Joint Committee staff recommends converting both the individual and the corporate estimated tax penalties into interest charges to more closely conform the titles and descriptions of those provisions with their effect. Because these penalties in fact are computed as an interest charge, conforming their title to the substance of their function may improve taxpayers' perceptions of the fairness of the tax system. The present-law penalties are essentially a time value of money computation which is not punitive in nature. The Joint Committee staff also recommends that no interest on underdeposits of estimated tax should be required for individual taxpayers if the balance due shown on the return is less than $2,000.[16] This would considerably simplify the computation of estimated tax payments and interest for many individuals, and eliminate the need for many of these individuals to calculate a penalty on underpayments of estimated tax altogether.

[14] The cost to the IRS of administering these automated payment mechanisms is less than one dollar per payment. See, Tax Notes, "OIC, Third-Party Contact Guidance Imminent, Ex Parte Guidance Soon," June 14, 1999, at 1544.

[15] In calculating the $2,000 threshold, amounts withheld (such as income tax withholding from wages) would be taken into account as under present law.

[16] No interest would be charged as a result of underpaid estimated taxes. However, if the full balance due shown on the return is not paid with the return, taxpayers would be charged interest from the due date of the return on the resulting underpayment.

In addition to the recommendations to convert the present-law estimated tax penalty into an interest provision and to increase the threshold from $1,000 to $2,000, the Joint Committee staff recommends making several specific changes to the estimated tax rules that would significantly reduce complexity in calculating the penalty for failure to pay estimated tax.

The modified safe harbor should be repealed.

Under present law, taxpayers with an adjusted gross income over $150,000 ($75,000 for married taxpayers filing separate returns) who make estimated tax payments based on the prior year's tax generally must do so based on 110 percent of the prior year's tax.[17] By repealing this rule, the same estimated tax safe harbor would apply to all individual taxpayers. Thus, to the extent that the special rule is eliminated, the estimated tax rules would be simplified, because all individual taxpayers would meet the estimated tax safe harbor if they made estimated payments equal to (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax.

Eliminate the need for numerous separate interest rate calculations.

Under present law, if interest rates change while an estimated tax underpayment is outstanding, taxpayers are required to make separate calculations of interest for the periods before and after the interest rate change. The Joint Committee staff recommends applying a single interest rate for any given estimated tax underpayment period. This would be the rate applicable to the first day of the quarter in which the pertinent estimated tax payment due date arises.

The definition of "underpayment" should be changed to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated tax payment periods.

Under the current estimated tax rules, underpayment balances are not cumulative, and each underpayment must be tracked separately in determining the penalty for underpayment of estimated tax. Thus, each underpayment balance runs from its respective estimated payment due date through the earlier of the date it is paid or the following April 15th. This often requires multiple interest calculations for each underpayment. Under the Joint Committee staff recommendation, taxpayers would calculate the cumulative estimated tax underpayment for each period or quarter and apply the appropriate interest rate as of that date. Thus, only one calculation would be needed for each underpayment period. This change would reduce

[17] The applicable 110 percent is modified when the prior taxable year begins in 1998 through 2001. The applicable percentage is 105 when the prior taxable year begins in 1998, 108.6 when the prior taxable year begins in 1999, 110 when the prior taxable year begins in 2000, and 112 when the prior taxable year begins in 2001.

complexity in calculating a penalty for underpayment of estimated tax by significantly reducing the number of calculations required to compute the penalty.

A 365-day year should be used for all estimated tax penalty calculations.

Under current IRS procedures, taxpayers with underpayment balances that extend between a leap year and a non-leap year are required to make separate calculations solely to account for the difference in the number of days during each year. By requiring a 365-day year for all estimated tax calculations, this extra calculation would be eliminated.

F. Other Recommendations

Pension-related penalties

The number of potential penalties for failure to file the Form 5500 series annual return should be reduced from six to one. The IRS should have the sole responsibility for enforcement of the Code and ERISA reporting requirements.

This reduction in the number of potential penalties would result from the consolidation of the ERISA and Code penalties for failure to file an annual return, and the repeal of the separate Code penalties for failure to file the required schedules and plan status change notification. The IRS should be designated as the agency responsible for enforcement of the Code and ERISA reporting requirements applicable to pension and deferred compensation plans, thereby reducing from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file the Form 5500 series annual return.

Under present law, the Code and ERISA require a plan administrator of a pension or other funded plan of deferred compensation to file a Form 5500 series annual return with the Secretary of the Treasury, the Department of Labor, and, for some plans, the Pension Benefit Guaranty Corporation ("PBGC"). For failure to file a timely and complete annual return, the Code imposes on the plan administrator a penalty equal to $25 per day, not to exceed $15,000 per return. In addition, ERISA provides that both the Secretary of Labor and the PBGC may impose on the plan administrator a penalty of up to $1,100 per day. The Secretary of the Treasury, the Secretary of Labor, and the PBGC may waive their respective penalties if the plan administrator demonstrates that the failure to file is due to reasonable cause. Separate Code penalties also apply if administrators fail to file Schedules SSA, Schedule B, or plan status change notification.

The separate Code and ERISA penalty provisions, and the separate Code penalty provisions for Schedule SSA, Schedule B, and notification of a plan status change, complicate the Form 5500 series annual return penalty structure and create the possibility that a plan administrator may face multiple penalties for a failure to file one return. A plan administrator that fails to file an annual return may be required to pay six different penalties to three different government agencies. A plan administrator who seeks abatement of the penalties may be required to demonstrate the existence of reasonable cause to three different government agencies and may receive a different determination from each agency as to the sufficiency of the demonstration.

Penalty for failure to file annual information returns for charitable remainder trusts

The penalty for failure to file annual trust information returns should expressly apply to the failure of a split-interest trust to file Form 5227. The penalty imposed on trusts for failure to file Form 5227 should be set at amounts comparable to the penalties imposed on tax-exempt organizations for failure to file annual information returns.

Under present law, it is not clear that the statute imposing a penalty for failure to file annual trust information returns applies to a split-interest trust's failure to file Form 5227. Form 5227, however, is critical to the enforcement efforts of the IRS as it provides detailed information regarding the financial activities of split-interest trusts[18] and possible liabilities for private foundation excise taxes to which these trusts are subject. Increasing the penalty imposed on trusts that fail to file required information returns and ensuring that all relevant returns are subject to such penalty would encourage voluntary compliance by delinquent filers and would assist the IRS in obtaining information about the activities of such trusts.

G. Conclusion

The Joint Committee staff recommendations on penalties and interest are intended to increase compliance and enhance the fairness and administrability of the federal tax laws. In many cases, the recommendations build on the provisions of, and policies embodied in, the IRS Reform Act. As stated in our published study, the Joint Committee staff believes that any legislative changes regarding penalties and interest should be undertaken only after careful and deliberative review by the Congress and the opportunity for input from the public, the Treasury Department, and the IRS. This hearing is an important step in that review process.

I thank the Subcommittee for the opportunity to present the Joint Committee staff recommendations on penalties and interest and I welcome the opportunity to answer any questions you may have now or in the future.

[18] Split-interest trusts are trusts in which some but not all of the interest is held for charitable purposes. Although these trusts are not private foundations, they are subject to some private foundation rules.