

DESCRIPTION OF H.R. 2528

(IMPROVED PENALTY ADMINISTRATION AND COMPLIANCE TAX ACT OF 1989)

Scheduled for a Hearing  
Before the  
SUBCOMMITTEE ON OVERSIGHT  
of the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on June 6, 1989

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION

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## INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a hearing on June 6, 1989, on H.R. 2528 (introduced by Subcommittee Chairman Pickle and Messrs. Schulze, Anthony, Flipppo, Dorgan of North Dakota, Ford of Tennessee, and Shaw on June 1, 1989).<sup>1</sup> H.R. 2528 ("Improved Penalty Administration and Compliance Tax Act of 1989") would revise several major groups of civil penalties in the Internal Revenue Code: (A) information reporting penalties; (B) accuracy penalties; (C) preparer, promoter, and protester penalties; and (D) delinquency penalties.

This document,<sup>2</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the bill, including present law, provisions of the bill, and effective dates.

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<sup>1</sup> See 135 Congressional Record H 2267-2272 (June 1, 1989). This document is identical to the Summary Explanation of the bill's provisions printed in the Record.

<sup>2</sup> This document may be cited as follows: Joint Committee on Taxation, Description of H.R. 2528 (Improved Penalty Administration and Compliance Tax Act of 1989) (JCX-11-89), June 5, 1989.

DESCRIPTION OF H.R. 2528(IMPROVED PENALTY ADMINISTRATION AND COMPLIANCE TAX ACT OF 1989)

## A. Information Reporting Penalties

Present Law

Any person that fails to file an information return with the Internal Revenue Service on or before the prescribed filing date is subject to a \$50 penalty for each failure, with a maximum penalty of \$100,000 per calendar year. In addition, any person that fails to provide a copy of an information return (a "payee statement") to a taxpayer on or before the prescribed due date is subject to a penalty of \$50 for each failure, with a maximum penalty of \$100,000 per calendar year. If a person fails to include all of the information required to be shown on an information return or a payee statement or includes incorrect information, then a penalty of \$5 may be imposed with respect to each such failure, with a maximum penalty of \$20,000 per calendar year. Stricter penalty provisions apply in the case of interest and dividend returns and in the case of intentional failures to comply with the information return requirements.

A penalty may also be imposed for each failure to include a correct taxpayer identification number on a return or statement and for each failure to furnish a correct taxpayer identification number to another person. The amount of the penalty that may be imposed is either \$5 or \$50 for each failure, depending on the nature of the failure.

Explanation of ProvisionsFailure to file correct information returns

The bill modifies the information return penalties provided under present law in order to encourage persons to file correct information returns even though such returns are filed after the prescribed filing date.

Under the bill, any person that fails to file a correct information return with the Internal Revenue Service on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, a correct information return is filed. If a person files a correct return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is \$15 per return, with a maximum penalty of \$75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is \$30 per return, with a

maximum penalty of \$150,000 per calendar year. If a correct return is not filed on or before August 1 of any year, the amount of the penalty is \$50 per return, with a maximum penalty of \$250,000 per calendar year.

The bill also provides a de minimis exception that applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all of the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

The bill maintains the present-law rules for failures that are due to intentional disregard of the filing requirement.

#### Failure to furnish correct payee statements

Under the bill, any person that fails to furnish a correct payee statement to a taxpayer on or before the prescribed due date is subject to a penalty of \$50 per statement, with a maximum penalty of \$100,000 per calendar year. If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, the bill generally provides a penalty of \$100 per statement or, if greater, 10 percent of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

#### Failure to comply with other information reporting requirements

Under the bill, any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of \$50 for each failure, with a maximum penalty of \$100,000 per calendar year. The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person.

#### Waiver, definitions and special rules

The bill provides that any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect. The subcommittee intends that for this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has a history of complying with the

information reporting requirements.

The bill also repeals the special information reporting requirements that apply to payments of interest and dividends; the bill makes those payments subject to the same general rules applicable to other types of information returns.

#### Uniform requirements for returns on magnetic media

The bill provides that uniform magnetic media requirements apply to all information returns filed during any calendar year. The bill accomplishes this by making statutory the requirement currently contained in IRS regulations that persons filing more than 250 information returns file those returns on magnetic media. The bill makes this requirement applicable to all types of information reports. Thus, the bill repeals the provision of present law that requires persons filing more than 50 information returns relating to payments of interest, dividends, and patronage dividends to file all such returns on magnetic media.

#### Study of procedures to prevent mismatching

The bill requires the General Accounting Office, in consultation with the Treasury Department, to conduct a study on whether the Internal Revenue Service should be permitted to disclose taxpayer identity information to a person that has filed an information return. The study should consider whether, if the name and taxpayer identification number of any person that is set forth on an information return do not correspond to the name and taxpayer identification number of such person contained on the records of the Internal Revenue Service, the Internal Revenue Service should be permitted to disclose to the person that has filed such information return such information as may be necessary to determine the correct name and taxpayer identification number. The study should also consider alternative means of correcting the mismatch between names and taxpayer identification numbers that involve the least amount of disclosure of confidential taxpayer identity information. A report on the study, together with any recommendations, is to be submitted to the Congress by June 1, 1990.

#### Study of service bureaus

The bill requires the General Accounting Office, in consultation with the Treasury Department, to conduct a study of whether persons engaged in the business of transmitting information returns or other documents to the Internal Revenue Service on behalf of other persons should be subject to registration or other regulation. A report on the study, together with any recommendations, is to be submitted to the Congress not later than July 1, 1990.

Effective Dates

The information reporting provisions of the bill generally apply to information returns and payee statements the due date for which (determined without regard to extensions) is after December 31, 1989.

## B. Accuracy Penalties

### Present Law

#### Negligence penalty

If any part of an underpayment of tax required to be shown on a return is due to negligence or disregard of rules or regulations, a penalty may be imposed equal to 5 percent of the total amount of the underpayment. An underpayment of tax that is attributable to a failure to include on an income tax return an amount shown on an information return is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

#### Fraud penalty

If any part of an underpayment of tax required to be shown on a return is due to fraud, a penalty may be imposed equal to 75 percent of the portion of the underpayment that is attributable to fraud.

#### Substantial understatement penalty

If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 25 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return. Special rules apply to tax shelters.

#### Valuation penalties

If an individual, personal service corporation, or closely held corporation underpays income tax for any taxable year by \$1,000 or more as a result of a valuation overstatement, then a penalty may be imposed with respect to the amount of the underpayment that is attributable to the valuation overstatement. A valuation overstatement exists if the valuation or adjusted basis of any property claimed on a return is 150 percent or more of the correct value or adjusted basis. The amount of the penalty that may be imposed varies between 10, 20 and 30 percent of the underpayment attributable to the valuation overstatement depending on the percentage by which the valuation claimed exceeds the correct valuation. Similar



penalties may be imposed with respect to (1) an underpayment of income tax that is attributable to an overstatement of pension liabilities and (2) an underpayment of estate or gift tax that is attributable to a valuation understatement.

### Explanation of Provisions

#### Eliminate overlap

The bill reorganizes the accuracy penalties into a new structure that operates to eliminate any overlap of the penalties.

#### Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence; (2) any substantial understatement of income tax; (3) any substantial valuation overstatement; (4) any substantial overstatement of pension liabilities; and (5) any substantial estate or gift tax valuation understatement.

##### 1. Negligence

If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence rather than, as under present law, to the entire underpayment of tax. Negligence includes any careless, reckless, or intentional disregard of rules or regulations. In addition, the bill repeals the present-law presumption under which an underpayment is treated as attributable to negligence if the underpayment is due to a failure to include on an income tax return an amount shown on an information return.

##### 2. Substantial understatement of income tax

The accuracy-related penalty that applies to the portion of an underpayment that is attributable to a substantial understatement of income tax is the same as the substantial understatement penalty provided under present law with three principal modifications. First, the rate is lowered to 20 percent. Second, the subcommittee intends that the list of authorities upon which taxpayers may rely is to be expanded to include proposed regulations, private letter ratings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices, and any other similar documents published by the Internal Revenue Service in the Internal Revenue Bulletin. In addition, the list of authorities is to include General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book"). Third, the bill requires the Internal Revenue Service to publish not less frequently than annually a list of

positions for which the Internal Revenue Service believes there is no substantial authority. The purpose of this list is to assist taxpayers in determining whether a position should be disclosed in order to avoid the substantial understatement penalty.

3. Substantial valuation overstatement, substantial overstatement of pension liabilities, and substantial estate or gift tax valuation understatement

The penalty that applies to the portion of an underpayment that is attributable to a substantial valuation overstatement is generally the same as the valuation overstatement penalty provided under present law with five principal modifications. First, the bill extends the penalty to all taxpayers. Second, a substantial valuation overstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. Third, the penalty is to apply only if the amount of the underpayment attributable to a valuation overstatement exceeds \$5,000 (\$10,000 in the case of most corporations). Fourth, the amount of the penalty for a substantial valuation overstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. Fifth, the bill provides that this penalty is doubled if the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis. The bill also provides similar modifications to the penalty for overstatements of pension liabilities and the penalty for estate or gift tax valuation understatements.

Fraud penalty

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud.

Definitions and special rules

The bill provides special rules that apply to each of the penalties imposed under the new structure. First, the bill provides that no penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. The enactment of this standardized waiver criteria is designed to permit the courts to review the assertion of penalties under the same standards that apply in reviewing additional tax that the Internal Revenue Service asserts is due.

The bill also provides that an accuracy-related or fraud penalty is to be imposed only if a return has been filed. This is intended to improve the coordination between these penalties. Under present law, a negligence or fraud penalty may be imposed

in the case of a failure to file a return.

Finally, the bill repeals the higher interest rate that applies to substantial underpayments that are attributable to tax-motivated transactions.

#### Effective Date

The accuracy provisions of the bill generally apply to returns the due date for which (determined without regard to extensions) is after December 31, 1989.

## C. Preparer, Promoter, and Protester Penalties

### Present Law

#### Return preparer penalties

An income tax return preparer is subject to a penalty of \$100 if any part of an understatement of tax on a return or claim for refund is due to the return preparer's negligent or intentional disregard of rules and regulations. In addition, an income tax return preparer is subject to a penalty of \$500 if any part of an understatement of tax on a return or claim for refund is due to the return preparer's willful attempt in any manner to understate tax. An income tax return preparer is also subject to a penalty of \$25 for each failure to (1) furnish a copy of a return or claim for refund to the taxpayer; (2) sign the return or claim for refund; or (3) furnish his or her identifying number.

#### Penalty for promoting abusive tax shelters

Any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, is subject to a penalty if in connection with such activity the person makes or furnishes a false or fraudulent statement or a gross valuation overstatement. The amount of the penalty equals the greater of \$1,000 or 20 percent of the gross income derived or to be derived by the person from the activity. It is unclear under present law whether the term "activity" refers to each sale of an interest in a tax shelter or whether the term activity refers to the overall activity of promoting an abusive tax shelter.

#### Penalty for aiding and abetting the understatement of tax liability

Any person who aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document under the tax laws which (1) the person knows will be used in connection with any material matter arising under the tax laws, and (2) the person knows will (if so used) result in an understatement of the tax liability of another person is subject to a penalty equal to \$1,000 for each return or other document (\$10,000 in the case of returns and documents relating to the tax of a corporation).

#### Frivolous income tax return penalty

Any individual who files a frivolous income tax return is subject to a penalty of \$500.

Sanctions and costs awarded by courts

If it appears to the Tax Court that (1) proceedings before it have been instituted or maintained primarily for delay, (2) the taxpayer's position is frivolous, or (3) the taxpayer has unreasonably failed to pursue administrative remedies, the Court may award damages not to exceed \$5,000 to the United States.

Explanation of ProvisionsReturn preparer penalties

The bill revises the present-law penalties that apply in the case of an understatement of tax that is caused by an income tax return preparer. First, the bill provides that if any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits and if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position, then that return preparer is subject to a penalty of \$250. The subcommittee intends that imposition of this penalty not lead to an automatic referral to the Internal Revenue Service Director of Practice. The subcommittee believes that the Internal Revenue Service should exercise discretion in selecting the specific cases that are referred to the Director of Practice. In addition, the bill provides that if any part of an understatement of tax on a return or claim for refund is attributable to a willful attempt by an income tax return preparer to understate the tax liability of another person or to any reckless or intentional disregard of the income tax law by an income tax return preparer, then the income tax return preparer is subject to a penalty of \$1,000.

The return preparer penalties that apply to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, and (3) furnish his or her identifying number are increased to \$50 and the total penalties imposed for any type of failure for any calendar year is limited to \$25,000.

Penalty for promoting abusive tax shelters

Under the bill, the amount of the penalty imposed for promoting abusive tax shelters equals the lesser of \$1,000 or 100 percent of the gross receipts derived or to be derived by the person from such activity. In calculating the amount of the penalty, the organization of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitutes a separate activity.

Penalty for aiding and abetting the understatement of tax liability

The bill amends the penalty for aiding and abetting the understatement of tax liability by imposing the penalty in cases where the person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document is so used, an understatement of the tax liability of another person would result. In addition, the bill provides that a penalty for promoting abusive tax shelters is not to be imposed on any person with respect to any document if an aiding and abetting penalty is imposed on such person with respect to such document.

#### Frivolous income tax return penalty

The bill increases the penalty for filing frivolous income tax returns from \$500 per return to \$1,000 per return.

#### Sanctions and costs awarded by courts

The bill authorizes the Tax Court to impose a penalty not to exceed \$25,000 if a taxpayer (1) institutes or maintains a proceeding primarily for delay, (2) takes a position that is frivolous, or (3) unreasonably fails to pursue available administrative remedies. The subcommittee intends that the increased penalty (above \$5,000) apply primarily (but not exclusively) to tax shelter cases, where the \$5,000 maximum provided under present law appears to be ineffective in deterring taxpayers from taking frivolous positions.

The bill also authorizes the Tax Court to require any attorney or other person permitted to practice before the Court to pay excess costs, expenses, and attorney's fees that are incurred because the attorney or other person unreasonably and vexatiously multiplied any proceeding before the Court.

#### Effective Dates

The modifications to the return preparer penalties apply to documents prepared after December 31, 1989. The modifications to the penalty for promoting abusive tax shelters and the aiding and abetting penalty apply to activities after December 31, 1989. The modification to the frivolous income tax return penalty applies to returns filed after December 31, 1989. The modifications to the court-awarded sanctions apply to proceedings pending on, or commenced after, December 31, 1989.

## D. Delinquency Penalties

### Present Law

#### Failure to file

A taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 25 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

#### Failure to make timely deposits of tax

If any person who is required to deposit taxes imposed by the Internal Revenue Code with a government depository fails to deposit such taxes on or before the prescribed date, a penalty may be imposed equal to 10 percent of the amount of the underpayment, unless it is shown that such failure is due to reasonable cause and not willful neglect. The amount of the underpayment for this purpose is the excess of the amount of the tax required to be deposited over the amount of the tax, if any, deposited on or before the prescribed date.

### Explanation of Provisions

#### Failure to file

The bill modifies present law by providing that the fraud and negligence penalties are not to apply in the case of a negligent or fraudulent failure to file a return. Instead, the bill provides that in the case of a fraudulent or intentional failure to file a return, the failure to file penalty is to be increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 75 percent.

#### Failure to make timely deposits of tax

The bill also modifies the penalty for the failure to make timely deposits of tax in order to encourage depositors to correct their failures. Under the bill, a depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is 5 days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. Finally, a depositor is subject to a penalty equal to 10 percent of the

amount of the underpayment if the failure is not corrected on or before the date that is 15 days after the due date. As under present law, no penalty is to be imposed if the failure to make a timely deposit is due to reasonable cause and not willful neglect. The bill also repeals the present-law 25 percent penalty on overstated deposit claims.

#### Effective Dates

The modification to the failure to file penalty applies to returns the due date for which (determined without regard to extensions) is after December 31, 1989. The modification to the penalty for the failure to make timely deposits of tax applies to deposits that are required to be made after December 31, 1989.