

[JOINT COMMITTEE PRINT]

**BACKGROUND ON
FEDERAL INCOME TAX COMPLIANCE**

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

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PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 23, 1983, on Federal income tax compliance issues.

This pamphlet, prepared in connection with the Committee's hearing, contains three parts. First, there is an overview of the income tax compliance provisions established in the Internal Revenue Code. Second, administrative efforts by the Internal Revenue Service to promote compliance are summarized. Third, different approaches toward increasing taxpayer compliance are identified and discussed.

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I. PROVISIONS OF PRESENT LAW RELATING TO COMPLIANCE WITH THE FEDERAL INCOME TAX LAWS

A. Overview

The internal revenue laws impose income taxes on individuals, estates, trusts, corporations and other organizations. These taxes are levied and collected under a system of self-assessment which requires taxpayers to file returns reporting income, deductions, credits, and other information necessary to compute tax liability. This system covers foreign as well as domestic transactions.

To assure compliance with the self-assessment system, the tax law imposes a variety of requirements both on taxpayers and on persons making payments to third parties. These include minimum filing requirements, recordkeeping requirements, withholding tax requirements, estimated tax payment requirements, and information reporting requirements. Taxpayers who fail to pay tax or who underpay their tax are subject to interest charges and may incur penalties. Third parties who contribute to the underpayment of tax by others may also be subject to penalties. Similarly, failure to file required information returns and statements may result in imposition of penalties. These requirements and the consequences of non-compliance are described below.

In addition, non-tax reporting requirements are imposed by the Bank Secrecy Act on financial institutions receiving large cash deposits from individuals, and on persons who bring large amounts of cash into or out of the United States.

B. Filing Requirements

Any person subject to any tax, or required to collect and pay over any tax, must make such returns, file such statements and provide such information as may be required by Treasury regulations. Such returns or statements must be according to the forms prescribed, and contain the information required by the Treasury including employer account numbers and employee identification numbers.

1. Individuals

As a general rule, every individual who is a United States citizen or resident who has gross income for the taxable year equal to or greater than the sum of the zero bracket amount applicable to that taxpayer plus the exemption amount (\$1,000 under present law, \$1,000 increased by a cost-of-living adjustment starting with taxable years beginning in 1985) must file an income tax return, even if the tax has been paid by installment or withholding payments. For example, individuals who are not married and not surviving spouses and who have gross income for the taxable year of \$3,300 or more (the sum of the exemption amount, \$1,000, plus the zero bracket amount applicable to such an individual, \$2,300) must file income tax returns. Similarly, filing is required of individuals entitled to file jointly with their spouses and whose gross income, when combined, is equal to \$5,400 (i.e., the zero bracket amount applicable to a joint return (\$3,400) plus twice the exemption amount (\$2,000)). However, married taxpayers filing separately or living apart have a filing threshold of \$1,000. If a taxpayer is entitled to an additional exemption amount for being 65 or over, for example, the filing threshold is increased accordingly. One effect of this exemption system is that in processing income information, the Internal Revenue Service cannot always identify exactly which taxpayers are required to file returns and which are not.

These filing thresholds for individuals do not apply to nonresident alien individuals, United States citizens entitled to the benefits of section 931 with respect to income from sources within United States possessions, individuals making short-year returns with respect to changes in accounting periods, and certain dependents who have unearned income. Such persons are subject to specialized filing rules or may not be required to file at all.

Minors are subject to the same filing requirements as are other individuals unless they could be claimed as a dependent on their parents' return and had unearned income of \$1,000 or more, in which case the filing threshold is \$1,000. The return of a minor must be made by the minor himself or by his guardian or the persons charged with the care of the minor's person or property.

A tax return may be made by the taxpayer's agent if, by reason of disease or infirmity, the person liable for the return is unable to

make it, or if the taxpayer is continuously absent from the United States (including Puerto Rico) for a period of at least 60 days prior to the return due date. The return may also be made by an agent if the district director determines that good cause exists for permitting the return to be made by an agent.

In general, every nonresident alien individual engaged in a trade or business in the United States at any time during the taxable year, or who has taxable income for the taxable year (unless fully paid by withholding) must make a return of income.

2. Corporations

Every domestic corporation (other than exempt corporations) in existence during any portion of a taxable year must file an income tax return. If a corporation is in existence for only part of a taxable year, it is required to make a return for that part of the taxable year. If an organization is otherwise exempt from tax under section 501(a) (dealing with certain exempt organizations), but is liable for the tax imposed on unrelated business income, it must nonetheless make a return.

In addition, every foreign corporation engaged in a trade or business in the United States at any time during the taxable year or which has income subject to tax for the taxable year (unless fully paid by withholding) must make a return of income.

3. Fiduciaries

The income tax return of taxable estates and trusts must be filed by the fiduciary responsible for the estate and trust. Tax returns are required if the estate or trust has \$600 or more of gross income during the taxable year or if any beneficiary of the estate or trust is a nonresident alien. Generally, no income tax return is required for a trust described in section 501(a), unless the trust is liable for the tax on unrelated business income. In addition, certain U.S. beneficiaries of foreign trusts are required to report their interests in the trust, and foreign trusts with U.S. beneficiaries must report.

4. Consequences of failure to file and pay tax, etc.

In general

The Secretary is required to make any inquiries and determinations necessary to assess all taxes imposed under the Internal Revenue Code. If a taxpayer fails to report and pay income, estate, gift, or certain excise taxes due, the Commissioner is authorized to send a notice of deficiency to the taxpayer and to proceed with the various steps preparatory to assessment and collection of the tax.

Various additions to tax, assessable civil penalties and criminal penalties also attend the failure to file a timely, accurate tax or information return or statement and to pay on time any tax due. These include penalties for failure to file or pay tax, for frivolous returns, substantial understatements, negligence and fraud, which are described below. (The separate penalties for failure to collect and pay over withholding taxes are described in Section C.2., below.)

Failure to file return or to pay tax

Any failure to file an income, estate, or gift tax return or to pay the amount shown as tax thereon on the due date (including extensions), may result in an addition to tax. Generally, the penalty for failure to file on time is an addition to tax equal to five percent of the amount of tax required to be shown on the return for each month or fraction thereof that the failure continues, but not in excess of 25 percent. In addition, in the case of a failure to file within 60 days of the date prescribed (with extensions), the minimum penalty for failure to file is not less than the lesser of the amount of tax required to be shown on the return or \$100. In 1982, the Senate Finance Committee adopted a minimum penalty on non-filers of \$100. This penalty was modified in conference to the form in which it appears in present law. A failure to timely pay the amount shown as tax on a return will result in an addition to tax equal to 0.5 percent of the amount of such tax for each month or a fraction thereof that the failure continues, not exceeding 25 percent. The failure to pay penalty reduces any addition to tax for failure to file. These additions to tax do not apply if the failure to file or pay is due to reasonable cause and not to willful neglect. These penalties do not apply to any failure to pay estimated tax. Those failures are subject to separate penalties. (See D., below.)

There is also an addition to tax for failure to file certain information returns. Any failure to file the information returns required with respect to, for example, interest or dividend payments generally will result in a \$50 penalty per failure not to exceed \$50,000 for the calendar year. There is a similar penalty for failure to provide a required information statement to the payee. Both penalties are subject to a reasonable cause defense. With respect to most information returns, if the failure to file is due to intentional disregard of the filing requirement, the penalty is not less than 10 percent of the amount not properly reported (5 percent of gross proceeds in the case of brokers) and the \$50,000 limitation does not apply.

Further, any person who is required by regulations to furnish his taxpayer identification number to another person, or to include in any return or other document filed with respect to another person the taxpayer identification number of such person, is subject to a \$50 penalty for each failure to do so. If a person fails to include his own taxpayer identification number in any return or other document, the penalty is \$5 per failure. In any event, the total penalties for all failures to include or provide taxpayer identification numbers cannot exceed \$50,000 in any calendar year. This penalty is subject to a reasonable cause exception.

Frivolous returns

An immediately assessable penalty of \$500 is imposed on any individual who files any document which purports to be a return of income tax if (1) the document fails to contain information from which the substantial correctness of the amount of tax shown on the return can be judged or contains information that on its face indicates that the amount of tax shown on the return is substantially incorrect, and (2) such conduct arises from a position taken

by the taxpayer on the purported return which is frivolous, or from a desire (which appears on the face of the purported return), to delay or impede the administration of the Federal income tax laws. This penalty is an addition to all other penalties provided by law.

Substantial understatement of tax liability

When there is a substantial understatement in income tax for any taxable year attributable to a filing position not disclosed by the taxpayer in the return, or for which the taxpayer did not have substantial authority, an addition to tax equal to 10 percent of the understatement is imposed.

For this purpose, an understatement of income tax is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. An understatement of income tax is substantial if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for the taxable year or \$5,000 (\$10,000 for corporations other than S-corporations and personal holding companies.)

In determining whether an understatement is substantial, the amount of the understatement is reduced by any portion of the understatement attributable to the treatment of any item if (1) the treatment of the item on the return is or was supported by substantial authority or (2) in non-tax shelter cases, all of the facts relevant to the tax treatment of the item were disclosed on the return or in a statement attached to the return.

With respect to tax shelter items, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. For this purpose, a tax shelter is a partnership or other entity, plan or arrangement the principal purpose of which, based on objective evidence, is the avoidance or evasion of Federal income tax.

In 1982, the Senate Finance Committee provision relating to substantial understatements did not contain the substantial authority defense. Thus, the taxpayer would have been required to have a reasonable belief that his position was more likely than not correct in all cases. This substantial authority defense in non-tax shelter cases was adopted on the Senate floor.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Finally, this penalty applies only to that portion of the substantial understatement attributable to items on which the overvaluation penalty under section 6659 is not imposed.

Addition to tax for valuation overstatements

A penalty, as a percentage of the underpayment, is imposed (on individuals and certain corporations), with respect to any underpayment of income tax attributable to a valuation overstatement. A valuation overstatement for this purpose is any valuation of property (or the adjusted basis of property) claimed on a return which is 150 percent or more of the correct value or adjusted basis

of the property. The percentage penalty ranges from 10 percent of the underpayment attributable to the overstatement for valuation overstatements from 150 percent to 200 percent, to 30 percent of the underpayment for valuation overstatements in excess of 250 percent.

The penalty is not imposed if the property has been held by the taxpayer for over five years or the underpayment attributable to the valuation overstatement is less than 1,000.

This penalty is, in effect, a strict liability penalty. The Secretary may waive the penalty on a showing by the taxpayer that there was a reasonable basis for the value claimed and that such claim was made in good faith.

Negligence

If any part of an underpayment of income, gift, or windfall profit tax is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there is added to the tax an amount equal to 5 percent of the total underpayment. In addition, there is added to the tax an amount equal to 50 percent of the interest payable with respect to that portion of the underpayment attributable to negligence or intentional disregard of rules and regulations for the period from the last day prescribed for payment of the tax (without regard to extensions), to the earlier of assessment or payment of the tax.

Fraud

If any part of an underpayment of any tax is due to fraud, there is added to the tax an amount equal to the sum of 50 percent of the entire underpayment plus 50 percent of the interest payable on the portion of the underpayment attributable to fraud for the period beginning on the last day prescribed for payment of the tax (without regard to any extension), and ending on the earlier of the date of assessment or the date of payment of the tax. In the case of any income, gift or windfall profit tax, the negligence penalty does not apply if the fraud penalty applies. In addition, if a fraud penalty is assessed for any underpayment, no penalty for failure to file or pay tax will be assessed for that underpayment. In addition to the 50-percent civil fraud penalty, criminal penalties may apply. (See below.)

Recordkeeping requirements

Taxpayers are required to keep such records as the Secretary may from time to time require including such records as may be necessary to allow the taxpayer to make an accurate return of income.

With respect to the amount of tips paid to a particular employee, the only records of charged tips which an employer can be required to keep under section 6001 are charge receipts and copies of statements furnished by employees under section 6053(a). Accordingly, an employer is required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but is not presently required to record on such charge receipts, or otherwise keep records of the name of any particular em-

ployee to whom the charge tip amount is paid over by the employer.

This recordkeeping limitation relates to records of amount of such tips paid over to a particular employee and does not affect any other recordkeeping requirements which may be applicable to the employer under section 6001 (e.g., for purposes of determining the employer's own income tax liabilities). Nor does it affect any recordkeeping, reporting, or return requirements imposed on employers pursuant to section 6051 with respect to tips included in statements furnished by employees to the employer pursuant to section 6053(a).

Failure to comply with such recordkeeping requirements may, in the event of an underpayment of tax, subject the taxpayer to a five percent penalty.

Jeopardy and termination assessments

In addition to the normal deficiency procedure which is available to the Internal Revenue Service for the collection of underpayments, the Internal Revenue Service has other tools at its disposal for the collection of tax, including the jeopardy and termination assessment procedures.

The Secretary may make a jeopardy assessment of income, estate, gift, and certain excise taxes if he determines that there is a tax deficiency the collection of which would be jeopardized by delay. In the case of a jeopardy assessment, the Secretary may immediately assess and collect such deficiency, together with all interest, additional amounts, and additions to tax provided for by law. A jeopardy assessment may be made at any time prior to the earlier of a final decision of the Tax Court or the appeal of a Tax Court decision. There are provisions for the abatement of any jeopardy assessment and for review of the assessment.

The Secretary may make a termination assessment if he finds that a taxpayer intends to do any act tending to render proceedings to collect the income tax for the current or immediately preceding taxable year ineffectual. When a termination assessment is made with respect to the current taxable year, the Secretary must treat the taxable year as terminated as of the date of the determination and treat that portion of the taxable year as if it were an entire taxable year. The amount assessed is due and payable immediately. Both jeopardy and termination assessments are subject to review by the Tax Court. The Secretary may not make a termination assessment for the taxpayer's preceding taxable year after the due date for that year's return.

The Secretary can presume that the collection of an amount of income tax is in jeopardy when an individual in physical possession of more than \$10,000 of cash or of an equivalent medium of exchange denies ownership of the cash and does not claim that such cash belongs to another person the identity of whom is readily ascertainable by the Secretary (and who acknowledges ownership). In such a case, the Secretary may presume, for purposes of the jeopardy or termination assessment provisions (1) that such cash represents gross income to a single individual for the taxable year of possession taxable at a 50 percent rate, and (2) that the collection

of the tax on such cash would be jeopardized by delay. The Internal Revenue Service cannot assess on the same cash twice.

Criminal penalties

There are certain criminal penalties which may attend a failure to file an income tax return as required or to pay a tax when due. For example, any person who willfully attempts to evade or defeat any tax is guilty of a felony and is subject to a fine of not more than \$100,000 (\$500,000 for corporations), or imprisonment for not more than 5 years, or both. If a person is required to pay a tax, to make a return, to keep any records, or to supply any information and that person willfully fails to do so, then that person generally is guilty of a misdemeanor and is subject to a fine of not more than \$25,000 (\$100,000 for corporations), or imprisonment for not more than one year, or both. The penalty for perjury on a tax return is a fine of not more than \$100,000 (\$500,000 for corporations), or imprisonment for not more than 3 years, or both. A person who willfully aids, counsels or advises the preparation of a fraudulent return or other document, is guilty of a felony and may be subject to a fine of not more than \$100,000 (\$500,000 for corporations) or imprisonment for not more than three years, or both.

C. Withholding and Withholding Noncompliance

1. Withholding requirements

Under present law, an employer who pays wages to individual employees must withhold a portion of such wages to satisfy all, or part, of the employee's Federal income and social security tax liability. The term "wages" generally is defined as all remuneration, unless specifically excluded, paid for services performed by an employee for an employer, including the cash value of all remuneration paid in any medium other than cash. The amount to be withheld from the wages of a particular employee is determined in accordance with tables prescribed by the Secretary.

Besides the obligation on employers to withhold the employee's income and social security taxes from wages paid to the employee, present law contains a variety of other withholding requirements. These include withholding on certain items of income to foreign persons where the items are not effectively connected with a U.S. trade or business or are compensation for personal services; gambling winnings; payments of interest, dividends, or patronage dividends; and backup withholding payments where no taxpayer identification number (TIN) is received (or an erroneous TIN is not corrected).

Wage withholding exemptions

Individuals whose wages are subject to withholding may be entitled to exempt them from withholding in \$1,000 increments (exemptions). The exemptions allowed include (1) one exemption for the taxpayer; (2) one additional exemption for the taxpayer who has attained, or will attain, age 65 during the taxable year; (3) one additional exemption if the taxpayer is blind; (4) an exemption for the taxpayer's spouse (and additional exemptions for age or blindness of the spouse) unless the spouse is claiming such exemptions on a separate return; (5) one additional exemption for each dependent of the taxpayer; and (6) a zero bracket amount allowance, unless the taxpayer is married and the spouse receives wages subject to withholding or the taxpayer has withholding exemption certificates in effect with respect to more than one employer. In addition to these withholding exemptions, taxpayers may be entitled to claim additional withholding exemptions for excess itemized deductions, tax credits and additional items specified in Treasury Regulations.

An individual subject to withholding may reduce or increase the number of exemptions claimed (under procedures set forth in the regulations) so that withheld taxes will more closely equal his or her anticipated tax liability. Employees who incurred no income tax liability for the preceding taxable year and expect to have no

income tax liability for the current taxable year may claim total exemption from wage withholding.

Wage withholding exemption certificates

An individual may claim withholding exemptions by furnishing his or her employer with a withholding exemption certificate (Form W-4). In the case of new employment, this certificate must be furnished when or before employment begins. If no exemption certificate is furnished, the employee is considered as unmarried and claiming no exemptions.

When a change occurs which decreases the number of withholding exemptions which an employee is entitled to claim, the employee must furnish the employer with a new exemption certificate reflecting the correct number of exemptions. Such new certificate must be furnished within ten days after the change occurs. In addition, a new certificate is required when an employee who has claimed complete exemption from withholding can no longer reasonably anticipate a zero income tax liability for the current taxable year.

An employer is required to submit to the Internal Revenue Service a copy of a withholding exemption certificate received from an employee during the reporting period if (1) on the last day of the reporting period, the employee is employed by that employer and claims more than fourteen withholding exemptions, or (2) the employee claims complete exemption from withholding unless the employer reasonably expects that the employee's wages from the employer will not usually exceed \$200 a week.

Withholding from pensions, annuities, and certain other deferred income

In general, withholding is required under section 3405 from the taxable portion of any distribution or payment (*i.e.*, any designated distribution) from or under an employer deferred compensation plan, an individual retirement plan (as defined in section 7701(a)(37)), or a commercial annuity, unless the payee elects, in writing, not to have withholding applied to the designated distribution. The payor of a designated distribution is required to provide a payee with notice of the right to elect not to have the withholding rules apply. This notice must contain a statement that the payee may be subject to penalties if he elects out of withholding and fails to make sufficient estimated tax payments during the year.

The amount required to be withheld depends upon whether a designated distribution is a periodic payment, a nonperiodic distribution, or a qualified total distribution. Periodic payments are subject to withholding based on the tables for withholding from wages, treating the payee as a married individual claiming three withholding allowances (unless the payee has filed a withholding certificate (Form W-4P) claiming different status). Nonperiodic distributions are subject to withholding at a 10 percent rate. The amount to be withheld from a qualified total distribution is determined under tables prescribed by the Secretary.

Withholding on gambling winnings

In certain circumstances, proceeds from wagers are subject to withholding at a rate of 20 percent. In general, gambling winnings are subject to withholding if the proceeds exceed \$1,000 and are at least 300 times as large as the amount wagered. However, special rules apply to winnings from State-conducted lotteries and winnings from sweepstakes, wagering pools, certain parimutuel pools, jai alai, and other lotteries.

The payor of gambling winnings that are subject to withholding is required to file Form W-2G with the Internal Revenue Service center serving the district in which the principal place of business of the person filing the return is located.

Withholding on foreign investors

In general, the United States taxes U.S. source income of a non-resident alien or foreign corporation which is not effectively connected with the conduct of a trade or business in the United States (or which is compensation for personal services) at a flat rate of 30 percent (or a lower treaty rate) of the gross amount paid. This tax is collected through withholding by the person making the payment to the foreign recipient. Income effectively connected with a U.S. trade or business is not subject to the flat 30-percent withholding tax, but instead is includable in the U.S. income tax return of the business and is taxed at the regular graduated rates.

Certain noneffectively connected U.S. source income is exempt from U.S. tax, and therefore from withholding. For example, interest from bank deposits is generally exempt from U.S. tax. Banks have only a minor burden in policing the identify of persons who claim foreign status, however, there is no requirement that payors of interest to persons claiming foreign status report such payments to the Internal Revenue Service. Also, the income of foreign governments from investments in the United States in bonds, stocks, and other securities, or from interest on bank deposits, is exempt from U.S. tax.

Withholding on interest, dividends, and patronage dividends

In general, withholding at a rate of 10 percent is required on any payment of interest, dividends, or patronage dividends paid or credited after June 30, 1983, unless an exception to withholding applies. Exceptions are made with respect to payments to exempt individuals (certain low-income or elderly individuals, and certain simple trusts), exempt recipients (e.g., corporations, tax-exempt organizations, etc.), minimal interest payments (payments of interest which do not exceed \$150 if annualized), and qualified consumer cooperative payments.

In general, exemption certificates must be filed by exempt individuals or exempt recipients receiving payments of interest, dividends, or patronage dividends who wish such payments to be exempted from withholding. However, payors may treat certain payees as exempt even though no exemption certificate for that payee has been filed. For example, if the name of the payee contains an unambiguous expression of corporate form, the payor may treat that person as exempt.

In May 1983, the House of Representatives passed H.R. 2973, which would repeal mandatory withholding on interest and dividends. On June 16, 1983, the Senate passed H.R. 2973 with an amendment which would repeal mandatory withholding on interest and dividends and apply special backup withholding rules to such payments. In light of these developments, on June 16, 1983, the Treasury Department announced a one-month moratorium in enforcing the present law mandatory withholding provisions.

Backup withholding

Under present law, backup withholding at a rate of 15 percent of the amount of the payment may be imposed on a wide range of payments (including payments of interest, dividends, and patronage dividends to payments to nonemployees and certain payments in the course of a trade or business). Backup withholding may be imposed with respect to any such payment if the payee of such payment fails to furnish his taxpayer identification number to his payor, or furnishes an incorrect number and the payor is notified to withhold by the Secretary. Withholding may be required with respect to a payment even though that payment is less than the reporting threshold for such payments.

2. Consequences of withholding noncompliance

Any person liable to withhold out of wages or payments of interest, dividends, or patronage dividends who fails to do so, is liable for the amount of tax not withheld. However, in the case of withholding on interest, dividends, or patronage dividends, the payor is not so liable if the tax is paid by the payee. In addition, any person required to collect and pay over any tax who willfully fails to do so or who willfully attempts to evade or defeat the tax is liable for a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over.

Any person required to deposit a tax by a prescribed date who fails to do so, or any person who makes an overstated deposit claim, is subject to a penalty equal to 5 percent of underpayment or 25 percent of the overstatement, as the case may be, unless the failure or overstatement was due to reasonable cause and not willful neglect.

Any person who is required to furnish certain information to employees with respect to withholding of tax, and who willfully fails to do so or furnishes a false or fraudulent statement, is liable for a penalty of \$50 for each failure. In addition, such a person may be subject to a criminal penalty of up to \$1,000 or may be imprisoned for not more than one year, or both.

Further, any individual who makes a false withholding statement (with respect to wage withholding, or interest, dividend, or patronage dividend withholding) may be subject to civil penalty of \$500, (1) if such statement results in a decrease in the amount deducted and withheld, and (2) if at the time the statement was made there was no reasonable basis for such statement. The Secretary may waive this penalty (in whole or in part) if the taxes imposed on the individual are equal to or less than the sum of his credits against taxes and payments of estimated taxes. Such individual may also be subject to a criminal penalty of not more than \$1,000

(in the case of wage withholding), or \$500 (in the case of interest, dividend, or patronage dividend withholding), or imprisonment of not more than 1 year, or both.

D. Estimated Tax

1. Corporations

Any corporation subject to tax is required to make payments of estimated tax if it reasonably expects to have a tax liability for the taxable year of \$40 or more. The estimated tax is payable in up to four installments over the taxable year. In general, if the estimated tax payments for the taxable year are not at least 90 percent of the actual tax due, then a penalty is imposed as an addition to tax. This penalty equals the amount of interest which would accrue on the amount of the underpayment of estimated tax during the period of the underpayment. Generally, this addition to tax does not apply with respect to any installment if, on or before the date prescribed for such installment, the corporation pays the amount which would have been due on that date if the estimated tax were the lesser of:

- (1) The corporation's prior year tax liability;
- (2) the corporation's tax liability on prior year's income computed using tax rates for the current year; or
- (3) 90 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been computed on an annualized basis.

In addition, a special exception applies with respect to corporations (including large corporations) having recurring seasonal income. If a corporation pays 80 percent of the total tax due instead of 90 percent, the penalty is reduced by 25 percent.

In 1983, large corporations (those with taxable income of \$1,000,000 or more during any of the three previous taxable years) otherwise qualifying under either of the first two safe harbors will not be subject to the addition to tax if their estimated tax payments for the taxable year are at least 75 percent of the tax shown on their returns for the taxable year. In taxable years beginning in 1984 and thereafter a large corporation must generally pay at least 90 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been computed on an annualized basis to avoid penalty.

2. Individuals

Individuals must also pay estimated tax. In general, a single person, or a married couple with one wage earner, whose gross income is expected to exceed \$20,000 for the taxable year is required to pay estimated tax. A married individual entitled to file a joint return with his spouse, whose gross income is expected to exceed \$10,000 for the taxable year, and whose spouse also receives wages is also liable to pay such tax. Finally, a married individual not entitled to file a joint return with his or her spouse, whose gross income is expected to exceed \$5,000, must pay estimated tax.

In any event, an individual who expects to receive more than \$500 from sources other than wages during the year must pay estimated tax. Regardless of the taxpayer's estimated income, however, no payment of estimated tax is required if it is anticipated that the taxpayer's estimate tax liability for the year will be less than \$300 (\$400 for 1984, and \$500 for 1985 and thereafter).

An individual who fails to pay an amount of estimated tax due on or before the due date may be subject to a penalty. The penalty is equal to the amount of interest which would accrue on the underpayment during the period of the underpayment. In general, an underpayment for this purpose is equal to the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been paid. The penalty is not subject to a reasonable cause defense.

There are four exceptions to the general penalty for underpayment of estimated tax which also operate to define the amount of estimated taxes due for the taxable year. No additional estimated tax payment is required and no underpayment penalty is imposed upon a taxpayer if total payments on or before any installment due date equal or exceed: (1) the amount due if the current year's tax equaled the tax shown on the preceding year's return, or the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year and such year was a full taxable year of 12 months; (2) 80 percent (or 66½ percent for farming or fishing income) of the taxes which would be due if the income already received during the current year were placed on an annual basis; (3) 90 percent of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) the amount due at current year's rates and exemptions, but otherwise based on the preceding taxable year's law and income.

For taxable years beginning in 1985 and subsequent years, no penalty will be imposed upon an individual for failure to pay estimated tax if the tax shown on the individual's return (or, if no return is filed, the tax) is less than \$500 (without regard to the credit for wages withheld). This exception to the penalty for failure to pay estimated taxes is phased in in the same manner as the increase in the tax liability threshold described above.

E. Information Reporting

1. Information at source generally

Under present law, persons engaged in a trade or business, and the United States, must generally file information returns with respect to payments aggregating \$600 or more in any taxable year. These returns are intended to inform the Internal Revenue Service that specified items have been disbursed by the payor so that the Service can determine whether the recipient of the item has treated it properly for tax purposes.¹ This reporting requirement, subject to certain exceptions, applies to various payments including rent, salaries, wages, or other forms of compensation for services, and other fixed or determinable gains, profits, and income, regardless of medium in which payment is made.

These information returns are required to be filed annually and generally must contain the name, address, and tax identification number of the recipient of the payment. Likewise, the payor must furnish the recipient with a written statement showing the payor's name, address, and taxpayer identification number, and the aggregate amount of payments shown on the return. Such statement must be furnished to the recipient on or before January 31 of the year following the calendar year for which the return was made.

If, in the course of a trade or business, any person for whom services are performed pays an aggregate of \$600 or more to any person for such services in any calendar year, the payor must file an information return with the Secretary. Such information return must state the aggregate amount of such payments to any recipient and the name and address of such recipient. If any person, (1) sells (in the course of a trade or business), consumer products to any buyer on a buy-sell, deposit-commission, or similar basis for resale in the home (or otherwise than in a permanent retail establishment), and (2) the aggregate sales to any buyer during the calendar year equals or exceeds \$5,000, the seller must file an information return with the Secretary. Such returns must set forth the name and address of the buyer, and such other information as may be required by regulations. In either case, information statements with respect to such payments or sales must be furnished to each person with respect to whom a return is filed. (See also 7. below.)

Generally, amounts paid to employees, regardless of whether they are subject to withholding, are not reportable on the usual information return (Form 1099). Instead, those amounts are reportable on information returns (Forms W-2) which relate to payments to employees.

¹ The Internal Revenue Service's Information Returns Program (IRP) matches the information returns filed with respect to payments to some individuals with their income tax returns to detect nonfiling or underreporting of income.

Partnerships are required to file returns for each taxable year stating such items as the Secretary may prescribe, including items of gross income and deductions, and the name and addresses of each individual partner and the amount of that partner's distributive share. If the partnership fails to file such a return, or files an incomplete return, it is liable for a penalty equal to \$50 per partner per month (for not more than 5 months) that the failure continues, unless the failure is due to reasonable cause. In addition, a criminal penalty may apply.

Various reporting requirements are also imposed upon the other entities, including custodians of common trust funds, exempt organizations, officers of foreign personal holding companies, and S-corporations.

2. Payments of dividends

In general, every person who makes dividend payments to another person which aggregate \$10 or more in a calendar year, who receives dividend payments as a nominee and who makes payments aggregating \$10 or more during any calendar year to any other person with respect to the dividends so received, or who is required to withhold tax on any payment of dividends, must file information returns with the Secretary. In the case of the payment of dividends aggregating less than \$10, the requirement of information reporting (other than with respect to amounts withheld), is discretionary with the Secretary.

Dividend information returns must be filed with the Internal Revenue Service after September 30 for any calendar year (but not before the payor's final dividend payment for that year), and on or before February 28 of the following year. The returns must set forth the aggregate amount of dividend payments, the amount of withholding (if any), and the name, address and taxpayer identification number of the person to whom paid.

In addition to filing information returns with the Internal Revenue Service, payors of dividends (or nominees) making payments of dividends (or payments with respect to dividends) aggregating \$10 or more during any calendar year also must furnish statements to recipients of the dividends. These statements must set forth the name and address of the payor of the dividends and the aggregate amount of payments made to the dividend recipient. Such a statement must be furnished to a dividend recipient no later than January 31 of the year following the dividend payment.

For purposes of this information reporting requirement, the term "dividend" means any distribution made by a corporation which is a dividend under section 316 of the Code. The term dividend also includes any payment made by a stockbroker to any person as a substitute for a dividend, for example, a payment made to the lender of stock in connection with a short sale.

The dividend reporting requirements generally do not apply to distributions or payments made by foreign corporations, or to distributions or payments made to foreign corporations, nonresident aliens, or partnerships not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens.

If the payor is unable to determine what portion of a payment represents a dividend or is paid with respect to a dividend, then, for purposes of the information return requirements, the entire amount of the payment is considered to be a dividend or a payment with respect to a dividend.

3. Payments of interest

Under present law, every person making a payment of interest, including deemed payments of original issue discount, aggregating \$10 or more in any calendar year, who receives a payment of interest as a nominee and who makes payments with respect to such interest aggregating \$10 or more in any calendar year, or who withholds tax on any payment of interest, must file an information return with the Secretary. Such return must set forth the aggregate amount of such payments, the amounts withheld, if any, and the name and address of the person to whom paid or from whom withheld.

Under present law, original issue discount is treated as a payment of interest at the time the discount is includable in income, without regard (in the case of a long-term obligation) to any reduction in the amount of original issue discount actually includable in income which results from a purchase of the obligation at a price in excess of the issue price plus accrued original issue discount. In the case of original issue discount on a bearer obligation issued before January 1, 1983, and original issue discount which is not includable in the income of a holder periodically (because, for example, the obligation has a maturity of one year or less), the original issue discount is treated as paid on the earlier of redemption or maturity of the obligation. Similarly, acquisition discount on short-term government obligations (which is also treated as interest for tax purposes) is treated as paid at the earlier of redemption or maturity of the obligation. Under these rules, the amounts reported with respect to holders of original issue discount obligations could be different from the amount, in fact, includable in the payee's income.

Reportable interest includes (1) interest on any obligation (other than any obligation with a maturity at the time of issue of not more than 1 year which is held by a corporation) which is issued in registered form or which is of a type offered to the public; (2) interest on deposits with persons carrying on the banking business; (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) interest on deposits with brokers as defined in section 6045(c); (6) interest paid on amounts held by investment companies and on amounts invested in other pooled funds or trusts; and (7) to the extent provided in regulations prescribed by the Secretary, any other interest (which is not specifically excluded from the definition of interest).

Interest subject to reporting does not include interest on obligations issued by natural persons; interest on exempt governmental

obligations; and, except to the extent otherwise provided in regulations, generally any amount paid to a person who qualifies as an exempt recipient for purposes of the withholding provisions.

4. Employee tips

Under present law (sec. 6053(a)), an employee who receives and retains tips of \$20 or more in a month, including charge tips paid over to the employee by the employer, must report such tips to his or her employer by the tenth day of the following month. In turn, employers are required to report as wages subject to income tax withholding and social security withholding only the tips actually reported to them by their employees pursuant to section 6053(a).² If an employee fails to report any amount of such tips which are wages or compensation to his or her employer, a penalty is imposed on the employee equal to 50 percent of the social security or railroad retirement tax, as the case may be, imposed with respect to the amount of the tips which he failed to report.

Section 6041 (which requires every employer of an employee earning \$600.00 or more yearly to report the total of that employee's earnings to the Internal Revenue Service) specifically provides that the information reporting requirements of that provision do not apply to tips reportable under section 6053(a). Accordingly, the only employee tips which an employer must report to the Internal Revenue Service are those reported to the employer by employees on statements furnished pursuant to section 6053(a).

As a result of changes enacted in 1982, each large food or beverage establishment also is required to report annually to the Internal Revenue Service (1) the gross receipts of the establishment from food or beverage sales (other than receipts from carryout sales and mandatory 10-percent or greater service charge sales), (2) the amount of aggregate charge receipts (other than receipts from carryout sales and 10-percent or greater service charge sales), (3) the aggregate amount of tips shown on such charge receipts, (4) reported tip income together with mandatory service charges of less than 10 percent to the extent paid to employees as wages, and (5) any amount allocated to tipped employees under the 8 percent rule described below.

If tipped employees of large food or beverage establishments voluntarily report tips aggregating 8 percent or more of gross receipts (defined as gross receipts from the sale of food or beverages less carryout sales, less 10-percent or greater service charge sales), then no tip allocation needs to be made. However, if this 8-percent reporting threshold is not met, the employer must allocate (as tips for reporting purposes) an amount equal to the difference between 8 percent of gross receipts and the amounts reported by employees for the year to all tipped employees pursuant to either an agreement between the employer and employees or, in the absence of such an agreement, according to Treasury regulations. The employ-

² If, because of tip-splitting or tip pooling, the amount of charged tips reported by an employee on his or her Federal income tax return differs from the amount of charged tips reported by the employer for that employee on Form W-2, the IRS rulings permit the employee to attach an explanation of the difference to his or her income tax return.

er has no liability to employees in connection with any dispute regarding allocations of amounts under this rule.

Regulations under the 8-percent provision provide procedures under which a particular establishment, or type of establishment, can show that its tipped employee's average tip rate is less than 8 percent (but not less than 5 percent) of gross receipts. Subject to the Secretary's discretion, such establishments may allocate based on such lower amount as the Secretary may prescribe.

The allocation of the excess of the 8-percent amount over reported tips among tipped employees is solely an information reporting device designed to detect underpayments of tax. This reporting requirement cannot increase or decrease the employer's FICA, FUTA, or income tax withholding responsibilities or the employee's income tax liability.

5. Pensions, IRAs, and annuities

General rules

An information return generally is required with respect to a distribution made to an employee or the employee's beneficiary under a pension, profit-sharing, or stock bonus plan (whether or not tax sheltered annuity program), or a tax-shelter annuity program maintained by an eligible tax-exempt organization or educational institution, if the amount of the distribution which is includable in the recipient's income totals \$600 or more for the calendar year (sec. 6041(a)).³ However, a separate reporting requirement applies to distributions from a tax-qualified plan which benefits an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent). An information return is required with respect to any owner-employee (or beneficiary of an owner-employee) to whom distributions totaling \$10 or more are made during the calendar year, without regard to the amount includable in the recipient's income (sec. 6047).

The trustee or custodian of an individual retirement account or the issuer of an individual retirement annuity (IRA) is required to provide the individual on whose behalf the account or annuity is established (or the individual's beneficiary) an annual report with regard to the status of the account or annuity, including the amount contributed for the years. For 1983 and later years, a copy of this report is required to be furnished to the IRS. Distributions from an IRA are required to be reported by information return to the Internal Revenue Service without regard to the amount of the distribution (sec. 408(i)).

When a United States retirement bond purchased for an employee under a tax-qualified bond purchase plan (sec. 405) is redeemed by the employee or the employee's beneficiary, the Bureau of the Public Debt reports the payment of the redemption proceeds to the Internal Revenue Service. Similarly, when a United States individ-

³ In the case of a tax-qualified plan, this requirement for an information return applies not only with respect to amounts actually distributed, but also to any amount includable in the income of an employee as an amount paid to provide the employee current life insurance protection (sec. 72(m)(3)). In addition, an employer who provides group-term life insurance for employees is required to separately report any part of the cost of such insurance which is included in an employee's income (sec. 6052). Generally, the cost of the first \$50,000 of group-term life insurance provided by an employer is excluded from the employee's income (sec. 79).

ual retirement bond (sec. 409) is redeemed, the Bureau reports the payments of the redemption proceeds to the Internal Revenue Service.

The issuer of a life insurance or annuity contract not purchased for an employee under a tax-qualified plan or tax-sheltered annuity program generally is required to file an information return with respect to amounts paid to an individual under the contract, if the payments to the individual total \$600 or more for the calendar year (sec. 6041(a)). This reporting requirement does not apply, however, to amounts paid by reason of the death of the insured or to amounts paid upon the contract's surrender.

Amounts subject to pension or annuity withholding

The Tax Equity and Fiscal Responsibility Act of 1982 added additional reporting requirements for all designated distributions (*i.e.*, the taxable part of payments made from or under a pension, profit-sharing, stock bonus, or annuity plan, an employer deferred compensation plan if the payments are not otherwise considered wages, an IRA, or a commercial annuity contract). Under regulations prescribed by the Secretary of the Treasury, (1) the employer maintaining, or the plan administrator of, a plan or (2) the issuer of a contract from which a designated distribution may be made shall provide certain information to the Secretary, to the plan participants and beneficiaries, and to any other persons the Secretary requires. In addition to the name, address, and social security number of the participant or payee (and spouse or other beneficiary if applicable), this information includes such items as the total amount of the distribution, the amount of accumulated deductible employee contributions, the amount of nondeductible employee contributions, the amount eligible for capital gains treatment, the amount subject to ordinary income treatment, and the cost basis of any employer securities included in a distribution. This reporting requirement applies without regard to the amount of the distribution.

In the case of an insurance or annuity contract, the reporting requirement applies to amounts paid by reason of the death of the insured and to amounts paid upon surrender of the contract. In addition, an exchange of insurance contracts under which a designated distribution may be made (including a section 1035 tax-free exchange) is a reportable event even though no designated distribution occurs in the particular transaction. The issuer of the contract to be exchanged must, therefore, provide the required information to the policyholder and to the issuer of the new contract.

6. Transactions by brokers

Under present law (sec. 6045), every person doing business as a broker (including a barter exchange) must, when required by regulations, make a return showing customer's names, together with details regarding the customer's gross proceeds and such other information as may be required by forms or regulations. Under TEFRA, the Secretary was required to issue regulations requiring reporting to brokers with respect to securities and commodities. These regulations, which were promulgated in final form on March

3, 1983, apply to transactions by brokers occurring after July 1, 1983.

7. Independent contractors

In general, individuals receiving compensation must be classified as either employees or independent contractors. The classification of individuals as either employees or independent contractors is important because a certain amount of wages paid to employees is generally subject to (1) social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and (2) unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). In addition, Federal income tax must be withheld from compensation paid to employees while payments to independent contractors are not subject to such withholding. On the other hand, compensation paid to independent contractors is subject to the tax on self-employment income (SECA).

The information reporting and withholding rules applicable to employees are reviewed above. A service-recipient (*i.e.*, a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return reporting such payments (and the name, address, and identification number of the recipient) if the remuneration paid to the person during the calendar year is \$600 or more. Also, the service-recipient must furnish to the person receiving such payments a statement setting forth the name, address, and identification number of the service-recipient, and the aggregate amount of payments made to the payee during the year.

In addition, any person engaged in a trade or business who in the course of such trade or business sells consumer products on a buy-sell basis, deposit-commission basis, or any similar basis for sale in the home or otherwise than in a permanent retail establishment must report with respect to gross purchases by any buyer of \$5,000 or more of such products in any calendar year. Any return filed under this reporting requirement must set forth the name, address, and identification number of the buyer. The seller also must furnish the buyer with a statement setting forth the name, address, and identification number of the seller. In either of those two cases, the service-recipient or seller is also required to report commissions and other remuneration under the reporting provisions generally applicable to such payments.

Because there is no Federal income tax withholding with respect to nonwage income, independent contractors may be required to pay estimated income tax under the rules discussed above.

8. Currency transactions

In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary to require reporting of certain financial transactions.

Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than \$10,000. The Treasury regulations pro-

vide a number of exceptions to this reporting requirement. Also, persons who bring or send more than \$5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other foreign financial account that he controls or in which he has an interest. If the amount in the account is over \$1,000 then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department, and made available to agents of the Internal Revenue Service.

9. Penalties relating to information reporting

As indicated earlier, the Code requires the filing of a variety of information returns with the Internal Revenue Service. Generally, these returns relate to payments to, and transactions with, other persons. The penalty for failure to file most information returns is \$50 per return, subject to a maximum of \$50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect.

If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the \$50,000 limitation will not apply. In the case of an information return required to be filed by a broker under section 6045, the penalty is not less than 5 percent of gross proceeds required to be reported, without regard to the \$50,000 limitation.

Also, a person required to file an information return generally must furnish a written information statement to the person to whom the payment was made showing certain information. For example, written statements must be furnished to recipients of payments that are reported under section 6041(a) (information at source), section 6041A (remuneration for services), section 6042(c) (payments of dividends), section 6045 (return by brokers), and section 6049(a)(1) (payment of interest aggregating \$10 or more). Failure to furnish such statements to payees as required subjects the payor to a penalty of \$50 for each failure, up to a maximum penalty of \$50,000 for any calendar year. This penalty is not applicable if the payor's failure is due to reasonable cause and not to willful neglect.

Information returns must generally show the name, address and taxpayer identification number (TIN) of the payor and payee. If any person (1) required by regulation to include his TIN in any return, statement, or other document, (2) to furnish his TIN to another person, or (3) to include in any return, statement, or other document made with respect to another person the TIN of such other person, fails to do so at the time prescribed, such person is liable for a penalty of \$50 (\$5 in case (1)) for each failure up to \$50,000 in any calendar year. The penalty does not apply if the failure is due to reasonable cause.

Failure to comply with the Bank Secrecy Act reporting requirements can result in criminal sanctions. Fines of up to \$500,000 and

imprisonment for up to five years are provided for long-term patterns of significant violations, and violations in furtherance of certain other Federal crimes. It is also a felony to make a false or fraudulent statement in any of the required reports. Currency and monetary instruments can be seized if they are not reported, or if the report omits material facts. Additional civil penalties are also provided.

F. Penalty Provisions Relating to Third Parties

1. 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 and who makes or furnishes (in connection with such organization or sale), (1) a statement with respect to the allowability of any tax benefit by reason of participating in the entity, plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or (2) a gross valuation overstatement with respect to any matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed, is subject to a civil penalty. Thus, persons subject to the penalty may include not only the promoter of a tax shelter partnership but also any other person who organizes or sells a plan or arrangement with respect to which there are material misrepresentations or valuation errors affecting the tax benefits to be derived from participation in the arrangement.

A matter is material to the arrangement if it would have a substantial impact on the decision making process of a reasonably prudent investor. A gross valuation overstatement is any statement or representation of the value of services or property which exceeds 200 percent of the correct value of the property or services and which is directly related to the amount of any income tax deduction or credit allowable to any participant.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of \$1,000 or 10 percent of the gross income derived, or to be derived, from the activity. There need not be reliance by the purchasing taxpayer or actual underreporting of tax.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

2. Understatement of tax liability by income tax return preparer

An income tax preparer is subject to certain penalties for the negligent or willful understatement of a client's tax. An income tax return preparer is subject to a \$100 penalty for each return or claim on which an understatement of tax liability results from the tax preparer's negligent or intentional disregard of rulings or regulations. A \$500 penalty applies in the case of each return or claim on which an understatement of tax liability results from the tax return preparer's willful attempt to understate his client's tax liability. If an understatement results from both the negligent and willful actions of a tax return preparer, both the negligence and

willful understatement penalties apply and the amount of the willful understatement penalty is reduced by an amount equal to the negligence penalty.

The negligent and willful understatement penalties are both assessable penalties. However, certain procedural rules apply which allow a tax return preparer against whom either penalty is imposed an opportunity for district court review of the Secretary's notice and demand for the penalty on payment of 15 percent of the amount claimed, the filing of a claim for refund, and pursuit of the claim in the district court. If there is, at any time, a final administrative determination or final judicial decision that imposition of the penalty was incorrect, the penalty will be abated and any amounts paid refunded.

3. Aiding and abetting the understatement of tax liability

Any person who aids, assists in, procures, or advises the preparation or presentation of any portion of a return, affidavit, claim or other document under the internal revenue laws which the person knows will be used in connection with any material matter arising under the tax laws, and which portion the person knows will (if used) result in an understatement of the tax liability of another person, is subject to a penalty.

The penalty applies as a civil counterpart to the criminal penalty on aiding or assisting in the preparation or presentation of false or fraudulent statements, returns or other documents. The penalty does not apply to persons who aid or assist with respect to any preparation or presentation of documents in a manner that is merely negligent.

No person is subject to the penalty unless that person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document that will be used under the tax laws, or "procures" a subordinate to do any act punishable under this provision. The penalty does not apply to any person who merely furnishes typing, reproducing or other mechanical assistance in the preparation of the return, etc.

The term "procures" includes ordering or otherwise causing a subordinate to do an act subject to this penalty, or knowing of and not attempting to prevent participation of a subordinate in an act subject to this penalty. Thus, the penalty imposes an affirmative duty on supervisors to act to prevent the conduct proscribed by the provision when he knows it is occurring. The term "advises" includes acts of independent contractors such as attorneys and accountants in counseling a particular course of action. A "subordinate" is any individual, including an agent, over which the person has direction, supervision, or control. Direction, supervision, or control for this purpose includes only direct and immediate direction, supervision, and control.

This penalty, which is \$1,000 for each return or other document (\$10,000 in the case of returns and documents relating to the tax of a corporation), can be imposed whether or not the taxpayer knows of the understatements. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to documents relating to any one person.

G. Standards for Imposition of Penalties

Under present law, taxpayers may be subject to various additions to tax or civil penalties for failure to comply with filing or payment requirements of the internal revenue laws. With the exception of the addition to tax for failure to pay estimated income tax or for overvaluations, or for substantial understatements, additions and penalties are generally subject to the taxpayer's defense of "reasonable cause," or the Government is required to prove negligence, fraud, or that the noncompliance was willful.

1. Strict liability

The addition to tax for failure to pay estimated tax and the two overvaluation penalties are assessed on a strict liability standard. The Secretary may waive the addition to tax for overvaluations in the case of good faith errors if the taxpayer had a reasonable basis for the valuation claimed. A standard similar to strict liability applies under the substantial understatement penalty in the absence of substantial authority or disclosure or, in the case of tax shelters, the taxpayer's reasonable belief that he was more likely than not to prevail.

2. Reasonable cause

Whether a taxpayer's noncompliance is "due to reasonable cause and not due to willful neglect" depends on the facts and circumstances of each case. For example, for purposes of the addition to tax for failure to file a return or pay tax, if a taxpayer has an honest belief that he need not file a return or pay an amount of tax, his failure to file or pay may be due to reasonable cause and not willful neglect. On the other hand, ignorance of the law requiring such filing has generally not been viewed by the courts as reasonable cause for failing to comply with filing requirements. Although a taxpayer's uninformed and unsupported belief that he need not file or pay tax is not reasonable cause, a taxpayer's limited education and business experience, together with reliance on the advice of an attorney or certified public accountant, has been held to be reasonable cause for a failure to file a return.

Also, a taxpayer's failure to file has been found due to reasonable cause when the taxpayer was mentally incompetent, or when illness prevented the taxpayer from obtaining the necessary records for filing. A taxpayer's incarceration or lack of funds does not, however, constitute reasonable cause.

3. Negligence and civil fraud

If any part of an underpayment of tax is due to "negligence or intentional disregard of rules and regulations (but without intent to defraud)" an addition to tax equal to 5 percent of the entire underpayment may be imposed. In addition, an amount equal to one-

half the interest due on the underpayment attributable to negligence will be added to the tax. Similarly, if any part of an underpayment is due to fraud an addition to tax equal to 50 percent of the entire underpayment may be imposed together with an amount equal to one-half the interest due on the underpayment attributable to fraud.

Whether the taxpayer has been negligent is a question of fact. Ordinarily, the negligence addition to tax will not be imposed where a taxpayer relied on his attorney or certified public accountant and such agent erred in the preparation of the taxpayer's return. But the taxpayer may be found negligent if he carefully reviewed his return and should have noticed the error, or if he failed to supply his agent with complete information for the return.

Also, if a taxpayer intentionally disregards rules and regulations, he or she may be considered negligent. Likewise the taxpayer's own conviction that the relevant rules or regulations misinterpret the law in a certain instance, if used as a reason for his subsequent disregard thereof, will not necessarily prevent the negligence penalty from being imposed. Generally, the Internal Revenue Service has ruled that when an error is made due to an honest misunderstanding of the facts or the law, the addition for negligence should not be asserted.

For the fraud addition to tax to apply it is necessary to show that there was fraudulent intent to evade tax and an underpayment of tax. Mere negligence, or ignorance of the law, does not constitute fraud. Generally, a corporation is responsible for the fraudulent acts of its officers committed on its behalf, and an individual taxpayer cannot escape the penalty for fraud by delegating the preparation of his return to another. Although, ordinarily, a taxpayer will not be held liable for the fraud addition to tax if he acts upon advice of counsel, he must show that he gave complete and accurate information to his attorney, that he relied on the attorney's advice, and did not have knowledge that the advice of the attorney was incorrect. Finally, a voluntary disclosure after the fact (for example, by the filing of an amended return) will not necessarily relieve a taxpayer of the civil fraud penalty, nor of criminal prosecution therefor.

4. Willful noncompliance

Willful noncompliance with the internal revenue laws is a fact question. Although "willfulness" is most often associated with criminal penalties, it can also arise in the civil penalty area.

The concept of willfulness is exemplified by its use in the section 6672 penalty for failure to collect, account for, and pay over taxes. The standard of willfulness applied by the courts under that section does not require any bad motive or evil intent on the part of the responsible party. Rather, an intent to do the proscribed act itself is sufficient to render the act "willful." For example, if it is shown that an employer knowingly and intentionally used withheld payroll taxes to pay operating expenses or other debts of the business the act will be deemed willful for purposes of this penalty. Most courts reject the contention that reasonable cause or justifiable excuse plays a part in determining whether the responsible party's actions are willful.

H. Injunctive Authority

In addition to its general authority to seek appropriate remedies in the courts of the United States, the Justice Department is specifically authorized to seek injunctions against income tax return preparers who engage in certain prescribed conduct or otherwise engaged in fraudulent or deceptive conduct. Income tax return preparers may, in certain circumstances, post a bond to avoid such injunctions. The Justice Department is also authorized to seek injunctions against fraudulent tax-shelter promoters to prevent further fraudulent activity.

I. Interest on Underpayments or Overpayments of Tax

1. Underpayments

Under present law, if a tax is not paid on or before the last date prescribed for payment, interest must be paid by the taxpayer on the unpaid amount for the period from the last date prescribed for payment to the date of payment at an annual rate established under section 6621.

In general, the last date prescribed for payment is the due date of the return determined without regard to any extension of time for payment and without regard to any notice and demand for payment issued by reason of a jeopardy assessment (but not later than the date notice and demand for the tax is made by the Secretary). Certain taxes, other than the income tax, may be paid in installments. If an election to pay such taxes in installments is made, the date prescribed for payment of each installment of tax is generally the date from which interest runs.

If the amount of any underpayment of income tax is reduced by reason of a net operating, or net capital, loss carryback, such reduction does not effect the computation of the interest payable on such underpayment prior to the due date (without extensions) of the income tax return for the loss year. Similar rules apply with respect to credit carrybacks.

2. Overpayments

Under present law, interest is paid by the United States on the overpayment of any tax at the annual rate established under section 6621. Generally, interest is paid with respect to a credit from the date of overpayment (generally the due date of the return) to the due date of the amount against which the credit is taken. In the case of a refund, interest is generally paid from the date of overpayment to the date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days. However, if the credit or refund is claimed in a late return, no interest is allowed or paid for the period before the date the return is filed. No interest is allowed on an overpayment of income tax if such overpayment is refunded within 45 days after the last date prescribed for filing the return of such tax (without regard to any filing extensions) or, if later, within 45 days after the date the return is filed. Finally, no interest is allowed unless the return is in processable form.

An overpayment resulting from a net operating loss carryback, a net capital loss carryback, or credit carryback is treated as occurring on the due date (without extensions) of the return for the year in which the carryback arises. In the case of a refund, the return for the loss year is treated as not filed prior to the time the claim for refund therefore is filed. Therefore, no interest would be paid

on a refund claimed on a late return if the refund is made within 45 days after the return is filed. For purposes of the payment of interest on overpayments, a return is not treated as filed until filed in processible form.

3. Rate of interest

Both the taxpayer and the United States must pay interest compounded at the annual rate established under section 6621. Under present law interest rates are redetermined twice a year on the basis of the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year).

II. IRS ADMINISTRATIVE EFFORTS TO IMPROVE TAXPAYER COMPLIANCE

A. Taxpayer Services Provided by the Internal Revenue Service

1. *Programs under the Associate Commissioner (Data Processing)*

In general

The IRS conducts a year-round tax information program in each of its 7 regions, 60 internal revenue districts, 10 internal revenue service centers, and in various foreign countries (through the Foreign Operations District (FOD). The basic assistance part of the program is operated by the Associate Commissioner (Data Processing) through the Assistant Commissioner (Returns and Information Processing). Assistance ranges from interpreting technical provisions of the tax law to answering questions on tax account status and furnishing forms requested by taxpayers. In addition, since 1977, the Service has operated a special Problem Resolution Program (discussed below) to handle situations in which normal procedures are considered inadequate.

Taxpayer assistance is provided by three principal methods: telephone assistance, assistance to taxpayers who walk into an Internal Revenue Service office, and taxpayer information and education programs, including programs directed at special groups.

Telephone assistance

A toll-free telephone network allows taxpayers to call IRS personnel for tax assistance. This service covers all of the United States, Puerto Rico, and the Virgin Islands. In addition, assistance is provided without cost to deaf and hearing-impaired taxpayers through a television/telephone/teletypewriter system.

Walk-in taxpayer assistance

The walk-in taxpayer assistance program is available both at permanent and temporary (during the filing season) sites located throughout the country. This is basically a self-help program which includes answering taxpayers' questions and furnishing tax forms and publications. The IRS does not provide direct return preparation assistance on a general basis.

Taxpayer information and education

In addition to its telephone and walk-in assistance programs, the IRS presently conducts a year-round public information program with special emphasis on the filing period (January through April). This program includes training participants in several volunteer programs and supervising the programs, directing educational programs for taxpayers, and preparing media efforts for targeted groups and the general public.

The Volunteer Income Tax Assistance Program (VITA), begun in 1969, provides assistance in completing tax returns to low-income, elderly, and non-English speaking persons who would have difficulty obtaining assistance from paid tax return preparers or IRS walk-in assistance personnel. Community volunteers are trained by the IRS in simple tax return preparation skills. These individuals then offer free tax return preparation assistance in neighborhood locations throughout the country.

Tax Counseling for the Elderly, a similar volunteer program, was established by the Revenue Act of 1978, to help meet the special tax needs of persons aged 60 and older. Under this program, the IRS enters into agreements with selected nonprofit organizations which provide volunteers to furnish tax assistance to the elderly. The volunteers are reimbursed by the IRS, through the sponsoring organizations, for out-of-pocket expenses incurred in providing the assistance.

The Student Tax Clinic Program is conducted at 13 colleges and universities across the country. Under this program, law and graduate accounting students represent low-income taxpayers before the IRS in examination and appeal proceedings.

Small Business Workshops and Tax Practitioner Institutes are conducted in each internal revenue district to educate small businessmen and tax practitioners on recent tax developments which may affect them.

Disaster and Emergency Assistance Programs are conducted by IRS in cooperation with other government agencies to provide specialized tax information to victims of major disasters and emergencies.

The Understanding Taxes and Fundamentals of Tax Preparation Programs provide free student publications to high schools and colleges. Additionally, under this program, IRS employees may meet with teachers to explain these publications and answer questions on tax laws and procedures.

2. Problem Resolution Program and Office of the Taxpayer Ombudsman

In 1977, the Internal Revenue Service implemented a taxpayer complaint response system, known as the Problem Resolution Program (PRP), in each of its districts. Under this program, there is a Problem Resolution Officer in each district who reports directly to the district director. In 1979, this program was expanded to cover all Internal Revenue Service centers, as well as districts.

PRP was established to handle taxpayers' problems and complaints not promptly or properly resolved through normal procedures, or those problems which taxpayers believe have not received appropriate attention. In addition, the program provides for the analysis of problems resolved by it to determine their underlying causes so corrective action can be taken to prevent their recurrence.

In 1979, the IRS established a Taxpayer Ombudsman in the Office of the Commissioner of Internal Revenue. The responsibilities of the Ombudsman include the administration of the Problem Resolution Program; representation of taxpayer interests and concerns within the IRS decisionmaking process; review of IRS policies

and procedures for possible adverse effects on taxpayers; proposal of ideas on tax administration that will benefit taxpayers; and representation of taxpayer views in the design of tax forms and instructions.

In 1982, 256,496 individual taxpayer problems were resolved by the Problem Resolution Program.

B. Internal Revenue Service Collection and Enforcement Efforts

The major function of the IRS is to collect revenue and enforce the tax laws. The enforcement efforts complement IRS collection efforts both by assisting directly in those collection efforts and by encouraging voluntary compliance with the tax laws.

The following is a summary of the major IRS collection and enforcement efforts in fiscal year 1982.¹

1. Collection efforts

Returns received

During 1982, the IRS received and processed 170.4 million returns and supplemental documents. Of these, 95.5 million (56.0 percent) were individual income tax returns.

Tax receipts

Gross tax receipts in fiscal year 1982 were \$632.2 billion. Income taxes accounted for more than two-thirds of this amount. Individual income tax receipts were \$352.6 billion and corporation income tax receipts were \$66.0 billion.

Social security, self-employment, Federal unemployment, and railroad retirement taxes accounted for \$168.7 billion. In addition, excise tax revenue was \$36.7 billion. Finally, receipts from estate and gift taxes were \$8.1 billion.

Refunds

In 1982, the IRS paid \$75.2 billion in refunds to 74.5 million taxpayers. Of this amount, \$55.1 billion went to filers of Forms 1040 and 1040A.

Penalties

During 1982, the IRS assessed 26.3 million civil penalties, amounting to about \$5.1 billion (about \$100 million in penalties was abated). These penalties were assessed primarily for failure to pay tax, pay estimated tax, late filing, and negligence and fraud.

Combined annual wage reporting

Combined annual wage reporting is a system that is designed to reduce the reporting burden for employers while still satisfying the reporting requirements of both the IRS and the Social Security Administration.

In January 1980, the IRS began a program to ensure that amounts reported on employment tax returns filed with the IRS agree with Forms W-2 filed with the Social Security Administra-

¹The information in this section was derived from the 1982 Annual Report of the Commissioner of Internal Revenue.

tion. This reconciliation is designed to assure that the correct wages have been reported and that employees have received the correct social security coverage. As a result of this program, \$218.1 million in additional tax was assessed in 1982.

2. Enforcement efforts

Examination and correction results

The IRS examined 1,732,232 returns in 1982. Examination coverage of income, estate, and gift tax returns was 1.63 percent.

The IRS examination program resulted in recommendations for additional tax and penalties of \$11.7 billion. Of that amount, individual and fiduciary income tax returns accounted for \$3 billion, corporate income tax returns for \$7.2 billion, estate and gift returns for \$0.8 billion, and employment and excise returns for \$0.2 billion. This program also disclosed overassessments on 114,602 returns, resulting in refunds of \$0.5 billion.

In addition to the IRS examination program, 716,193 returns were verified or corrected through correspondence from IRS service centers. This type of examination resulted in recommended additional tax and penalties of \$268 million.

Information returns program

The Internal Revenue Service received 664 million information documents in its tax year 1981 information returns program including over 178 million Forms W-2 processed by the Social Security Administration and 50 million pre-1974 Series E savings bonds from the Bureau of Public Debt. There were also 435 million information returns received from businesses and organizations reporting interest dividends and other payments. More than 354 million of these documents were submitted on magnetic media. The Internal Revenue Service matches almost all of the information returns submitted on magnetic media to verify that correct amounts are reported on taxpayers' returns. About 21 percent of the information returns submitted on paper are processed, and 82 percent of the combined magnetic media and paper receipts are processed. In 1981, the Internal Revenue Service began associating information returns with cases of taxpayers who filed income tax returns in previous years but failed to do so for the current year.

As a result of its information returns program, the Internal Revenue Service notified over 2.9 million taxpayers in 1982 of potential discrepancies between income reported on their tax returns and income reported on information returns. Furthermore, 2.1 million taxpayers were sent notices of apparent failure to file tax returns based on information returns.

Windfall profit tax

In 1982, the IRS completed examination of more than 507 windfall profit tax returns. Windfall profit tax liabilities reported on returns processed through September 30, 1982, amounted to about \$2.2 billion.

In the 1982 examination program for the windfall profit tax, over 500 examinations, resulting in \$0.5 billion in recommended additional tax and penalties were completed.

Coordinated examination program

The coordinated examination program (CEP) includes the largest taxpayers in the country. There are 9 criteria (including assets, receipts and operating entities) which are used to identify a CEP taxpayer. The CEP is a two-tiered program involving a National and Regional CEP. The most complicated cases are assigned to the National program.

At the end of fiscal year 1982, there were 1,438 large corporation cases in the CEP. Recommended tax deficiencies and penalties for the 12-month period ending September 30, 1982 were \$5.77 billion.

Tax shelters

As of September 30, 1982, there were 284,828 returns with tax shelter issues in the examination process. During 1982, 71,793 returns were closed with recommended tax and penalties of \$954.2 million.

In 1981, the IRS established special examination groups for commodity shelters.

W-4 program (withholding allowance certificates)

The W-4 program was established in 1980 to check abuses by employees who file incorrect withholding allowance certificates with employers to avoid having high income tax withheld from wages.

During 1981, the IRS expanded the monitoring of employer compliance with the withholding requirements. Furthermore, the IRS has developed a computer system to detect employers who have not submitted required Forms W-4 to the IRS. In addition, a program has been established to follow up automatically on W-4 filers who failed to file 1980 tax returns.

Unreported income program

The IRS currently is working to develop the capability to identify potential unreported income on filed returns through its discriminant function (DIF) scoring system.

International enforcement

Examinations of business operations outside the U.S. are handled by approximately 290 international examiners located in 15 key districts. In 1982, these examiners participated in the examination of 2,976 returns and recommended adjustments and penalties of \$3.7 billion.

The Foreign Operations District (FOD) has jurisdiction to audit foreign based taxpayers with books and records in another country who are subject to U.S. income tax. It has foreign posts located in 16 key cities around the world. These foreign posts are headed by revenue service representatives who manage the examination, collection, and taxpayer service programs at those posts. In addition, FOD and its overseas representatives are responsible for the exchange of information with U.S. treaty partners, and for other overseas tax information gathering. In 1982, FOD examined over 18,000 returns and recommended additional tax and penalty assessments of about \$160 million.

Criminal investigation

The general enforcement program of the Criminal Investigation Division of the IRS (CID) identifies income tax evasion cases with prosecution potential. The program also attempts to provide balanced criminal tax enforcement and geographical and occupational coverage of various types of alleged tax law violations. During 1982, priority enforcement efforts included investigating individuals who filed multiple claims for tax refunds, illegal tax protesters, and promoters of fraudulent tax shelters.

The special enforcement program of the CID identifies and investigates individuals who derive substantial income from illegal activities and violate the tax laws. The program also includes such projects as the Federal strike force program against organized crime, the high-level drug dealers project, wagering tax enforcement, and other efforts against racketeers. CID initiated 6,498 investigations in 1982 and completed 5,831 investigations. Prosecution was recommended in 2,297 of the completed investigations.

Cooperation with other agencies

The IRS is involved in the Federal strike force program against organized crime. The Department of Justice coordinates investigations in 15 strike forces located in 25 cities. The CID also participates in financial investigative task forces established by U.S. attorneys to coordinate the various Federal law enforcement agencies' efforts against major narcotics organizations. Furthermore, IRS special agents are detailed to the drug enforcement administration to identify narcotics traffickers subject to the internal revenue laws.

Narcotics traffickers

Since 1980, the IRS has more than doubled the number of staff years involved in investigations of high-level drug traffickers, financiers, and money launderers in its special enforcement program. As of September 30, 1982, there were 807 such cases under investigation and another 262 undergoing IRS and Department of Justice review before indictment.

Tax protesters program

The IRS had 30,956 protest returns under examination and had closed 10,378 returns as of September 30, 1982. This was a 12.1 percent increase over 1981.

Collection of delinquent accounts

During 1982, the IRS disposed of 2.4 million delinquent accounts and collected \$7.4 billion in overdue taxes. Of that amount, \$3.1 billion was collected in response to computer notices sent to taxpayers and \$4 billion was collected on delinquent accounts. In addition, \$331 million were collected when 1.7 million delinquent returns, involving \$2.4 billion in additional assessments, were secured.

IRS service center collection branches handle computer delinquency notices. This is the first step in communication with taxpayers who have not filed returns or paid taxes. The service centers also perform such procedures as associating taxpayer corre-

spondence, screening cases to determine that a final notice has been sent. In addition, many procedures that were previously performed in the districts have been absorbed by the service center collection branches, including the monitoring of employers' monthly tax returns, insolvency case processing and the control, maintenance and monitoring of 100-percent penalty cases.

If taxpayers do not resolve delinquent accounts or delinquent return investigations in response to notices from service centers, their cases are transferred to district offices. Most of these transferred cases are worked first by clerical and paraprofessional employees in the collection office function. However, the more difficult delinquent accounts and return investigations are referred to the collection field function to be handled by revenue officers.

Nonfilers and delinquent returns

The Internal Revenue Service has special programs to deal with the problems of nonfilers and delinquent return filers. New procedures for early identification and contact of income tax nonfilers were established in 1980 and further refined in 1981. In addition, in 1981, changes were made in the delinquent returns programs to place greater emphasis on matching information documents and tax returns.

In 1982, the IRS began a research project to determine whether revenue yield can be increased if the accounts of identifiable groups of taxpayers are handled differently. A total of 50,000 individual income delinquent accounts are being handled in six different ways. The IRS also conducted approximately 22,000 taxpayer compliance measurement program investigations of potential non-filers of tax year 1979 income tax returns.

III. POSSIBLE APPROACHES TO IMPROVING TAX COMPLIANCE

This part discusses a broad range of approaches to improving taxpayer compliance which could be considered by the Congress. Many of these approaches are the product of work done not only by the tax-writing committees but also by the American Bar Association, the American Institute of Certified Public Accountants, the New York State Bar Association, the Department of the Treasury, the U.S. General Accounting Office, and the Department of Revenue of the State of Minnesota. In particular, attention is called to the report of the *Invitational Conference on Income Tax Compliance*, prepared by the Section of Taxation of the American Bar Association; *Comments on the Tax Compliance Act of 1982*, New York State Bar Association, Tax Section, Committee on Unreported Income; and *Unreported Taxable Income: The Problem and Possible Solutions*, by the Federal Tax Division of the American Institute of Certified Public Accountants.

The precise reasons for the decline in voluntary compliance cannot be easily identified. However, a number of factors may contribute to the problem. For example, the complexity of the tax code and frequent changes in its provisions may contribute to higher levels of taxpayer misunderstanding than existed in earlier times. This higher level of misunderstanding would lead to an increase in inadvertent noncompliance. Noncompliance may be due to inadequacies in the information reporting and withholding systems. If a taxpayer is not informed of items which should be included on his tax return or if incorrect amounts are reported, both the Internal Revenue Service and the taxpayer may have difficulty determining the proper treatment of that item. In addition, the Internal Revenue Service is less able to detect noncompliance in the case of an inaccurately reported item. Further, if the penalties provided under present law are insubstantial in amount or uncertain in their applications taxpayers may consider the cost of noncompliance as relatively low. Similarly, the number of times the Internal Revenue Service contacts taxpayers and the number of returns selected for audit may directly affect the public perception of the risks associated with noncompliance. The growth in international business, and the increased sophistication of taxpayers also opens new opportunities for noncompliance. A number of approaches could lead to increased voluntary compliance either through better understanding of the internal revenue laws or through increasing the risks associated with noncompliance.

Education

To comply with the internal revenue laws, taxpayers must have a general awareness of the requirements imposed on them and an ability to obtain accurate information when they seek to comply

with these requirements. For example, many believe that the frequent failure of taxpayers to pay estimated tax is the result of a relatively low level of awareness with respect to the estimated tax payment requirements. Similarly, a significant number of the individuals who fail to file the required income tax returns are subject to wage withholding and may incorrectly believe that payment of tax through the withholding system relieves them of the obligation to file an annual return. It has been suggested that the relatively low level of compliance with respect to pension payments may result from the belief by many taxpayers that retirement income is not subject to Federal income taxation. A broad-based program of public education or an increase in the Internal Revenue Service's taxpayer assistance program might have a positive effect in reducing noncompliance in these and similar areas. There are, however, no data which suggest whether such an educational program would be more or less effective in reducing noncompliance than greater information reporting requirements, broader withholding requirements, or increased sanctions for failure to comply.

Simplification

The complexity of the tax laws and the frequency with which they are modified may adversely affect the ability and willingness of taxpayers to comply with the requirements of those laws. For example, a taxpayer who believes that the required returns cannot be understood or filed properly may be less likely to file a return than one who fully understands the requirements. Similarly, because of the law's complexity a taxpayer may have the impression that the law does not equitably distribute the tax burden, which may contribute to a reduction in the voluntary self-assessment. In addition, complexity may place added burdens on the Internal Revenue Service and reduce the likelihood that any particular item will be examined.

Similarly, certain deductions and credits present special challenges to a system of tax administration which audits only a small percentage of all returns. For example, under prior law, approximately one-third of all casualty loss deductions claimed were improper. Substantial examination resources of the Internal Revenue Service are allocated to insuring compliance with limitations on travel and entertainment expenditure deductions. Provisions that require records and computations based on multiple years, such as income averaging and carryovers of losses or unused credits, require extensive use of the data processing capacities of the Internal Revenue Service.

Others argue that reducing the number of taxpayers claiming itemized deductions could be reduced more simply by increasing the zero bracket amount. Any such change, however, could result in substantial revenue loss which would not be offset by increased receipts from improved compliance. Proponents of tax simplification or broad-based, low rate tax systems argue that greater compliance can be achieved by reducing the complexity of the tax laws. On the other hand, such simplification may entail substantive tax changes which may not be perceived by many as desirable. Additionally, the change to a substantially different system could result

in temporarily lower compliance rates as taxpayers adjust to the new rules.

Information reporting

The information reporting requirements of the Code are intended to serve two purposes. First, they remind taxpayers of their obligation to report amounts on their tax returns and provide them with the information needed to report the amounts. Second, they provide the Internal Revenue Service with the information necessary to detect noncompliance. The information reporting system can fail to accomplish these results in several circumstances. For example, if information returns are not filed or are filed in an incomplete or unprocessable form, their value in detecting noncompliance is lost or substantially diminished. Similarly, if the Internal Revenue Service does not have sufficient resources to pursue all detected non-compliance the value of the reporting system is eroded. In addition, if information reports are available on only some of the elements of a taxpayer's income, then the Internal Revenue Service will have greater difficulty detecting noncompliance since its information will be incomplete. Thus, if a taxpayer has income of \$10,000 but processable reports are filed on only \$5,000, the Internal Revenue Service will not readily detect any underreporting while processing the return as long as at least \$5,000 is reported, unless matching is done on an item-by-item basis. As the information reporting system is expanded and made more accurate, this problem becomes less serious.

The quality of information reporting can be improved by requiring more returns to be in machine processable form, by increasing the penalties for failure to report or failure to provide accurate and complete reports (including removing limitations on the penalties) and by expanding the number and variety of transactions subject to such reporting.

An expansion of information reporting could take one or more directions. For example, the broker reporting regulations could require reporting of a broader range of income-related items such as gross proceeds on sales of antiques and collectibles. Amounts of tip income (both in the food and beverage industry and in other industries) that are not now subject to reporting could be brought into the system. For example, tips in excess of 8 percent in establishments with high tip rates (e.g., establishments with high charge tip rates) could be subjected to information reporting. Expansion of information reporting to deduction items or to further income-related items might be criticized as imposing disproportionate burdens in small businesses.

Another approach would be to require information reporting designed to enable the Internal Revenue Service to cross-check deductions or credits claimed by taxpayers. This type of reporting requirement could be criticized as shifting costs which should be borne by the Internal Revenue Service audit function to the private sector. In addition, to be effective, some reporting of this type might require taxpayers to provide greater detailed information on tax returns. This could be viewed as an inappropriate increase in paperwork burdens on the private sector. Finally, many individual taxpayers do not itemize their deductions; therefore, reporting on

deduction items could entail reporting of many transactions which are of little interest to the Internal Revenue Service.

A third approach would be to require reporting of information designed to assist the Internal Revenue Service in identifying non-filers and underreporters. For example, a number of States have used information on professional licensing and on large purchases (e.g. luxury cars) to identify nonfilers. Several bar and accounting professional groups have suggested reporting of large cash purchases. This might enable the Internal Revenue Service to identify taxpayers with unreported cash income. On the other hand, such reports might impose substantial burdens on small business taxpayers and may be questioned as imposing too high a cost relative to the benefits to be derived in tax collections.

A fourth approach would be to impose stricter standards on the format in which information is reported to the Internal Revenue Service. Increased use of magnetic media and other machine readable formats might improve the usefulness of the information reported. Information reporting format requirements might impose new costs on reporting taxpayers. Simplifying returns, where appropriate, could also increase the quality of information reporting.

Detection of noncompliance can also be improved through strengthening the ability of the Internal Revenue Service to obtain relevant information. For example, tax treaties could provide for increased information exchanges between taxing authorities and enlarged U.S. access to records held by third parties overseas.

With respect to any of these possible expansions of information reporting, it is not clear that the current data processing capacity of the Internal Revenue Service can effectively absorb the increased input. Further, many of the potential deficiencies detected by the present information reporting system are not pursued because of resource constraints. Imposing information reporting costs on the private sector would be difficult to justify if the Internal Revenue Service could make only limited use of the information.

Withholding

The most recent Internal Revenue Service compliance data indicates that 99 percent of all wages subject to withholding are reported on tax returns. This high compliance rate is generally attributed to the fact that tax is withheld before the taxpayer receives payments, to the high degree of accuracy in information reported with respect to withheld amounts, and to the ability of the Internal Revenue Service to detect noncompliance effectively. In addition, persons entitled to credits or refunds arising from wage withholding have a strong incentive to file returns and claim those credits or refunds. Although withholding appears to result in higher compliance rates, some people may question whether withholding requirements should be expanded, without first requiring the Internal Revenue Service to make full use of the information reporting system. An expansion of the backup withholding system of present law may offer a means of targeting withholding to noncompliant taxpayers.

Recordkeeping

Taxpayers are currently required to maintain books and records. Failure to maintain such books and records leads to penalties only in the case that the taxpayer has underpaid his tax. The current recordkeeping requirements could be expanded by requiring certain large business taxpayers to have their tax returns or financial statements prepared by third parties or otherwise audited. The recordkeeping requirements could also be expanded to require syndicators of tax-oriented investments to maintain records identifying their investors. Such requirements, however, may unnecessarily add to the cost for and burden on honest taxpayers. A penalty might be imposed for a failure to maintain and present minimal records regardless of whether any tax were owed.

Tax professionals and other third parties

Present law imposes certain responsibilities on income tax return preparers and other tax professionals. These responsibilities (other than for tax return preparers) were substantially increased in 1982. The General Accounting Office issued a report cite critical of the Internal Revenue Service implementation of the income tax return preparer system. In general, the tax return preparer regulatory system has not been reviewed since it was created in 1976. Further review of the tax return preparer system and other professionals may reveal legislative changes which may lead such professionals to play a more constructive role in improving taxpayer compliance. Some have even suggested the creation of a private auditing system to complement auditing by the Internal Revenue Service.

In addition, some insurance companies are now prepared to offer insurance against the risk that if a return is audited, the Internal Revenue Service will require the payment of additional taxes, interest, and perhaps even penalties. Such insurance may be viewed by some as contrary to sound public policy in that it encourages taxpayers to underestimate their tax liability without bearing the full risk of that decision.

Increased Internal Revenue Service enforcement efforts

The ultimate deterrents to noncompliance are Internal Revenue Service enforcement efforts and the penalties and interest charges imposed on taxpayers who fail to comply. Thus, an increase in compliance could be expected from increased spending on Internal Revenue Service enforcement activities. For example, the Internal Revenue Service audits only a very small percentage of all filed returns. Moreover, the percentage of returns examined has declined substantially in recent years because of reductions in the IRS budget. There are many more returns which could be expected to require adjustments if audits were conducted. Similarly, a significant percentage of the discrepancies and non-filings detected by the information returns program are not pursued because of resource constraints on the Internal Revenue Service. Finally, even when tax deficiencies are determined to exist, the resources are not available to take collection action with respect to many of these delinquent accounts. Suggestions to address the Internal Revenue Service's resource constraints have included (1) modest funding in-

creases of the sort enacted for fiscal year 1983, (2) large increases in particular functions and (3) treating Internal Revenue Service spending as an offsetting entry relative to tax receipts which would, in effect, place Internal Revenue Service spending outside the unified budget.

Another approach to encouraging compliance would be to increase the interest charged on tax deficiencies based on the view that most individuals borrow at higher interest rates than the rate of interest now charged by the Internal Revenue Service. Increasing the current interest rate, however, could create an incentive for taxpayers to overpay their income tax liability and thereby invest at a rate of return above prime rate. Thus, it could be necessary to consider denying interest in some refund cases, or providing a lower rate of interest on refunds than on deficiencies.

Although the penalty structure under the Internal Revenue Code was reviewed in 1982, several suggestions for increases or expanded coverage have been made with respect to present law. For example, the Senate has adopted amendments removing the limitations on payor penalties for failure to comply with information reporting requirements in certain cases. Last year, the Senate Committee on Finance reported a penalty on substantial underpayments which would have applied unless the taxpayer reasonably believed that the position taken was more likely than not to prevail. Another suggestion has been that a no-fault penalty could apply to any failure to report certain classes of income such as gross receipts from a business or cash income. Finally, some tax-shelter promoters have characterized the promoter penalty enacted last year as an empty threat because of its perceived low level.

Reliance solely on enforcement activities, interest charges, and penalties to increase compliance could reduce voluntary compliance if taxpayers were to develop a strongly negative attitude toward the Internal Revenue Service as a result of increased intrusions by the Internal Revenue Service into their lives. Some have suggested that too heavy an emphasis on penalties could create a "catch-me-if-you-can" mentality which would erode compliance.

The Internal Revenue Service enforcement efforts could also be bolstered by providing alternatives, such as backup withholding or increased withholding on noncompliant taxpayers, to enhance collections.

Non-tax amendments

It has been suggested that tax compliance might also be improved through a variety of non-tax amendments such as an expansion of audits by outside auditors under the securities laws, elimination of large denomination currency, and extension of the currency reporting rules to other recipients of cash. Prompter notification under the currency transaction provisions and an opportunity for action by the Treasury might be provided, particularly if the currency is to be transferred into jurisdictions who do not provide adequately for exchange of information.

Federal-State cooperation

The Internal Revenue Service presently has tax information exchange agreements with forty-eight States, the District of Colum-

bia, Guam and American Samoa. These agreements assist the Internal Revenue Service and State taxing authorities in identifying persons who have failed to file Federal or State tax returns by providing for cooperative inspection of tax records.

Expanding the scope of Federal-State cooperation is a potentially effective and cost-efficient means for both the Internal Revenue Service and State taxing authorities to improve taxpayer compliance. The Internal Revenue Service and State taxing authorities face similar budgetary and practical constraints in the enforcement and collection areas. Expanded information exchange and other forms of cooperation may eliminate wasteful duplication of effort. For example, expanded information exchange could permit taxpayer data required by both Federal and State authorities to be collected only once. In addition, in some situations, the Internal Revenue Service may have readier access or the only access to data required by the States, and vice-versa. For example, Data exists outside conventional tax administration channels at both the Federal and State levels that could assist the Internal Revenue Service and the States in identifying nonfilers and underreporters. Records of such Federal agencies as the Departments of Labor and Agriculture, which contain taxpayer identification numbers could be used by both the Internal Revenue Service and the States; however, the Internal Revenue Service can more easily aggregate such Federal agency data than can the States. State licensing (for example, law practice licensing) and county property tax records, which can also be an effective tool in detecting nonfilers and underreporters, are, on the other hand, most readily available to the respective State taxing authorities. The gathering and exchange by the Internal Revenue Service and the States of such types of information could be of special benefit to the Internal Revenue Service because, under current exchange agreements, the Internal Revenue Service receives, the results of all State audits that produce increases in Federal tax liability. To encourage States to participate, "seed money" could be provided by the Federal government for specific projects or the Federal government might simply purchase important data from the States. Significant expansion of the kind of information exchange would raise privacy concerns.

With respect to the conduct of audits, a few States presently work with District Offices on various projects to coordinate and, improve their respective efforts. State and District Office participation in such projects could be expanded and different types of projects established. In other areas, the Internal Revenue Service and State departments of revenue have targeted for audit specific industries that have serious noncompliance rates and then divided the audit responsibility to avoid duplicative efforts. Other States have supplemented the Internal Revenue Service's audit program for organizers of abusive tax shelters by auditing tax shelter participants.

One State has developed a computerized levy source that the Internal Revenue Service is now sharing to improve the collectibility of delinquent accounts. Other States could be encouraged to share their levy sources with the Internal Revenue Service, particularly if the Internal Revenue Service were to share their levy sources with the States. In addition, States could be permitted to intercept Federal refunds to apply against State tax liabilities, and vice versa.



