

**BACKGROUND ON  
FEDERAL INCOME TAX COMPLIANCE AND  
DESCRIPTION OF S. 2198  
(TAXPAYER COMPLIANCE IMPROVEMENT  
ACT OF 1982)**

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE  
INTERNAL REVENUE SERVICE

OF THE

SENATE COMMITTEE ON FINANCE

ON

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PREPARED BY THE STAFF

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## INTRODUCTION

The Senate Finance Subcommittee on Oversight of the Internal Revenue Service has scheduled a public hearing on March 22, 1982, on Federal income tax compliance and on S. 2198 (Senators Dole, Grassley, Chafee, Domenici, Danforth, Stafford, and Andrews) which would address certain taxpayer compliance shortcomings.

This pamphlet, prepared in connection with the Subcommittee's hearing, contains five parts. First, there is an overview of the income tax compliance scheme established in the Internal Revenue Code. Secondly, administrative efforts by the Internal Revenue Service to promote compliance are summarized. Thirdly, current and historical data are presented on the level of voluntary compliance for different segments of the taxpaying population. Fourthly, different approaches toward increasing taxpayer compliance are identified and discussed. Finally, a section-by-section description of the bill, S. 2198 (the Taxpayer Compliance Improvement Act of 1982) is provided.



# 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 domestic as well as foreign 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. Similarly, failure to file required information returns and statements may result in imposition of penalties. These requirements and the consequences of noncompliance 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) 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)). If a taxpayer is entitled to an additional exemption amount for being 65 or over, for example, the filing threshold is increased accordingly.

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. 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**

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, and 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 and criminal penalties also attend the failure to file a timely, an 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, 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 (sec. 6651). 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. A failure to timely pay the amount shown as tax on the 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. These additions to tax do not apply if the failure to file or pay is due to reasonable cause and not to willful neglect. In either case the penalty is computed on the net amount due the Treasury. Thus, there is no penalty for failure to file if no tax is owed in excess of amounts withheld or paid as estimated tax. These penalties do not apply to any failure to file a declaration of estimated tax or to pay any estimated tax. Those failures are subject to separate penalties. (See D., below.) The failure to pay penalty reduces any addition to tax for failure to file.

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 and dividends will result in a \$10 penalty per failure not to exceed \$25,000 for the calendar year (sec. 6652). 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.

Further, any person who is required to provide a taxpayer identification number to the Secretary or another person and who fails to do so is subject to a \$5 penalty for each failure, subject to a reasonable cause exception.

### *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 interest payable with respect to that portion of the underpayment attributable to negligence or intentional disregard of rules and regulations (sec. 6653(a)).

### *Fraud*

If any part of an underpayment of any tax is due to fraud, there is added to the tax an amount equal to 50 percent of the entire underpayment (sec. 6653(b)). In the case of any income or gift 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 paragraph (e) below.)

### *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 of income taxes.

The Secretary may make a jeopardy assessment of income, estate, gift, and certain excise taxes if he determines that there is a 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 without

prior notice (sec. 6861). 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.

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 (sec. 6851). When a termination assessment is made with respect to the current taxable year, the Secretary must treat that 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. 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.

### *Criminal penalties*

There are certain criminal penalties which 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 \$10,000 or imprisonment for not more than 5 years, or both (sec. 7201). If a person is required to pay a tax, including estimated 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 is guilty of a misdemeanor and is subject to a fine of not more than \$10,000 or imprisonment for not more than one year, or both (sec. 7203). The penalty for perjury on a tax return is a fine of not more than \$5,000 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 \$5,000 or prison for not more than three years, or both (sec. 7206).

## C. Withholding and Withholding Noncompliance

### *1. Withholding requirements*

Under present law, an employer who pays wages to individual employees (or has employees who report tips) must withhold a portion of such wages to satisfy all, or part, of the employee's Federal income tax liability (sec. 3402). 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 (sec. 3401(a)).

The amount to be withheld from the wages of a particular employee is determined in accordance with tables prescribed by the Secretary. Except in the case of certain foreign persons, there is no requirement under present law for withholding on payment other than wages.

### *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 the 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.

### *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 on or before employment begins. If no exemption cer-

tificate 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.

### *Voluntary withholding*

Under present law, annuity or pension payments are subject to withholding to the extent includible in gross income if the payee so requests (sec. 3402(o)(1)(B)). Such request must be made in writing to the payor of the annuity or pension.

The amount requested to be withheld from a pension or annuity must be at least \$5 per month and must not reduce the net amount of any pension or annuity payment below \$10.

### *Withholding on gambling winnings*

In certain circumstances, proceeds from wagers are subject to withholding at a rate of 20 percent (sec. 3402(q)). 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 pari-mutuel 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 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 (and is not subject to withholding at source).

Certain noneffectively connected U.S. source income is exempt from U.S. tax, and therefore withholding. For example, interest from bank deposits, and original issue discount on obligations maturing in six months or less. 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.

## *2. Consequences of withholding noncompliance*

In general, 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 (sec. 6672).

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. (sec. 6656).

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 (sec. 6674). 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 (sec. 7204).

In addition, any individual who makes a false withholding statement 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 (sec. 6682). Such individual may also be subject to a criminal penalty of not more than \$1,000 or imprisonment of not more than 1 year, or both (sec. 7205).

## 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 80 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) 80 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 1982 and 1983, large corporations (those with taxable income of \$1,000,000 or more during any of the three previous taxable years) otherwise qualifying for treatment 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 65 percent (in 1982) or 75 percent (in 1983) of the tax shown on their returns for that taxable year. In 1984 and thereafter, the first two safe harbor rules are not available to large corporations. In 1984 and thereafter, therefore, a large corporation must either pay at least 80 percent of the amount of tax shown on its return for the taxable year, or 80 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.

### 2. Individuals

Individuals must also declare and 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 liable to declare and 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 declare and 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 declare and pay estimated tax. However, an individual who

expects to receive more than \$500 from sources other than wages during the year must declare and pay estimated tax. Regardless of the taxpayer's estimated income, however, no declaration of estimated tax is required if it is anticipated that the taxpayer's estimated tax liability for the year will be less than \$200 (or \$300 for 1983, \$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 underpayment penalty. No underpayment penalty is imposed upon a taxpayer if: (1) total tax payments for the current year equal or exceed the amount due if the current year's tax equaled the tax shown in the preceding year's return, or the preceding year's tax liability, if no return showing a liability for tax was filed for the preceding year; (2) total tax payments equal or exceed 80 percent of the taxes which would be due if the income already received during the current year were placed on an annual basis; or (3) total tax payments equal or exceed 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) total estimated tax payments equal or exceed the amount due at current year's rates and exemptions, but otherwise based on the preceding taxable year's law and income.

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. 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.

## E. Information Reporting

### 1. Information at source generally

Under present law, persons (other than corporations) 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 (sec. 6041(a)). 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.<sup>1</sup> This reporting requirement, subject to various exceptions, applies to various payments including rent, salaries, wages, commissions, fees, or other forms of compensation for services, and other fixed or determinable gains, profits, or 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 (secs. 6041(a) and 6109(a)). 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 (sec. 6041(d)).

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 (Form W-2) which relate to payments to employees.

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 names and addresses of each individual partner and the amount of that partner's distributive share (sec. 6031). If the partnership fails to file such a return, or files an incomplete return, it will be liable for a penalty equal to \$50 per partner per month (for not more than 5 months) that the failure continues (sec. 6698). In addition, a criminal penalty may apply (sec. 7203).

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 subchapter-S corporations.

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<sup>1</sup> 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. Under this program, most information returns filed for individuals on magnetic tape, and some of those filed on paper forms, are included in the IRS document matching program.

## *2. Payments of dividends*

Present law imposes information reporting requirements with respect to payments of dividends (sec. 6042). In general, every person who makes dividend payments aggregating \$10 or more to any other person in a calendar year, including dividends received as nominee, must file information returns with the Secretary. In the case of the payment of dividends aggregating less than \$10, the requirement of information reporting 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 and the name and address of the person to whom paid.

In addition to filing information returns with the Internal Revenue Service, payors of dividends 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 on a short sale.

The dividend reporting requirements generally do not apply to distributions or payments made by foreign corporations, 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. Also excluded from the reporting requirements is the undistributed taxable income of electing small business corporations.

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*

The information reporting requirements for interest payments are similar to the requirements imposed on dividend payments (sec. 6049). In general, every person who makes interest payments, whether as a principal or nominee, aggregating \$10 or more to any other person during the calendar year must file an information return. In addition, a corporation which issues a bond or other evidence of indebtedness in registered form after May 27, 1969 (unless issued pursuant to a written commitment binding on and after that date), must file an information return if, during the calendar year, an amount of original issue discount aggregating \$10 or more is includible in the gross income of any holder. In the case of the inter-

est payment aggregating less than \$10, the information reporting requirement is discretionary with the Secretary. The Secretary also has discretion to require information reporting with respect to corporate interest payments such as on bearer instruments.

Information returns for the payment of interest must be filed with the Internal Revenue Service after September 30 for the calendar year, but not before the payor's final payment for the year, and on or before February 28 of the following year. These returns must set forth the aggregate amount of the interest payments to any taxpayer and the name and address of the person to whom paid.

Information returns required with respect to original issue discount must be filed with the Service after December 31 for the calendar year in which the original issue discount accrues, and on or before February 28 of the following year. In general, these returns must set forth various information, including the aggregate amount includible in income by each holder of a discount obligation for the period during the calendar year in which the obligation was held; the ratable monthly portion of original issue discount; the issue price of the obligation; and the stated redemption price at maturity.

Payors of interest and persons who are required to file information returns with respect to original issue discount must furnish statements to recipients setting forth the aggregate amount of interest payments or original issue discount includible in income. Statements to recipients of interest must be furnished after November 30 (but not before the final interest payment for the year) of the calendar year and on or before January 31 of the following year. These statements may be furnished at any time after April 30 of the calendar year of payment if furnished with the final interest payment for the calendar year. Statements for original issue discount must be furnished after December 31 and on or before January 31.

Included in the term "interest," for purposes of these reporting requirements are: (1) interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation in registered form and, to the extent prescribed by regulations, interest on other corporate indebtedness issued to the public (e.g., bearer bonds); (2) interest on bank deposits; (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, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchaseable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; and (5) interest on deposits with stockbrokers and dealers in securities.

#### *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. If an employee fails to report any amount of such tips 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 (sec. 6652(c)).

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).<sup>2</sup> The present law for both income tax withholding and social security withholding refers to the amount of tips reported by the employee to the employer under section 6053(a) as the amount of tips which constitute wages for purposes of the withholding requirements.

Section 6041(e) specifically provides that the information reporting requirements do not apply to tips that are reportable under section 6053(a). This provision, enacted by the Revenue Act of 1978, nullified revenue rulings that any charge account tips actually paid over by the employer to the employee must be reported to the Internal Revenue Service by the employer under section 6041(a) (assuming the aggregate \$600 test was met) whether or not the tips were reported to the employer by the employee.<sup>3</sup> 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).

In enacting section 6041(e), the 1978 Act also provided that, 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 will be required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but may not be required to record on such charge receipts, or otherwise keep records of (except copies of sec. 6053(a) statements), the name of any particular employee to whom the charge tip amount is paid over by the employer.

This recordkeeping limitation relates to records of amounts 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).

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

<sup>3</sup>Section 6041(a) requires every employer of an employee earning \$600 or more yearly to report the total of that employee's earnings to the IRS. The regulations specify that any employee's earnings which are not wages subject to withholding are nonetheless required to be reported to the IRS on the Form W-2 for the employee.

## 5. Pensions

### *Pensions, IRAs, and annuities*

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-qualified), or a tax-sheltered annuity program maintained by an eligible tax-exempt organization or educational institution, if the amount of the distribution which is includible in the recipient's income totals \$600 or more for the calendar year (sec. 6041(a)).<sup>4</sup> 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 includible 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 year. The report is not now required to be provided to the Internal Revenue Service (sec. 408(i)).<sup>5</sup> 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 individual retirement bond (sec. 409) is redeemed, the Bureau reports the payment 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.

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<sup>4</sup> 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 includible 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).

<sup>5</sup> The Commissioner may, however, require that the annual report for an IRA be filed with the Internal Revenue Service.

## **6. Transactions by brokers**

Under present law (sec. 6045), every person doing business as a broker must, when required by regulation, make a return showing customer's names, together with details regarding the customer's profits and losses and such other information as may be required by form and regulation. Currently, however, there are no regulations promulgated under this section by which the Secretary exercises this authority. The last regulation dealing with broker returns, Regulation 103, § 19.149-1, was revoked by T.D. 5218, February 1, 1943 (1943 C.B. 470), which provided that no return of information was required to be filed under the precursor of section 6045 for any calendar year subsequent to calendar year 1941.

## **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. The only information return requirement applicable to independent contractors is that contained in the general information at source section (sec. 6041). Thus, as discussed above, persons engaged in a trade or business must file information returns with respect to certain payments to another person of \$600 or more in any taxable year (sec. 6041(a)). This reporting obligation, subject to limited exceptions, applies to payments of commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income, paid to independent contractors. These information returns must generally contain the name, address and tax identification number of the recipient of the payment.

Further, because there is no Federal income tax withholding with respect to nonwage income, independent contractors may be required to file a declaration of 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 of the Treasury 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 provide 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 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 \$10 per return, subject to a maximum of \$25,000 for any calendar year (sec. 6652(a)). The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect.

Also, a person required to file an information return generally must furnish a written 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 6042(a)(1) (payment of dividends aggregating \$10 or more), 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 \$10 for each failure, up to a maximum penalty of \$25,000 for any calendar year. This penalty is also 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 \$5 for each failure (sec. 6676). The broad language of this penalty makes it applicable to both the payor and the payee. However, it does not apply if the failure is due to reasonable cause.

Failure to comply with the Bank Secrecy Act reporting requirements can result in severe 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. 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, additions and penalties are 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. Reasonable cause

The question of whether or not 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 (sec. 6651), 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. See, *Dexter v. U.S.*, 306 F. Supp. 415 (D. Miss. 1970).

Also, a taxpayer's failure to file has been found due to reasonable cause where the taxpayer was mentally incompetent, or where 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.

### 2. 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.

Whether the taxpayer has been negligent is a question of fact. Ordinarily, the negligence addition to tax will not be imposed where a taxpayer placed complete reliance on his attorney or certified public accountant for filing tax returns and such agent erred on 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 where an error is made due to an honest misunderstanding of the facts or the law, the addition for negligence should not be asserted.

In order 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 returns 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. 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 (sec. 7203).

### *3. 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.

## **G. Interest on Underpayments or Overpayments of Tax**

### ***1. Underpayments***

Under present law (sec. 6601(a)), 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 of the underpayment at an annual rate established under section 6621.

Under section 6601(b), the last date prescribed for payment is 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. If an election to pay the tax in installments is made, the date prescribed for payment of each installment of tax is generally the date from which interest runs. In cases in which the last date for payment is not otherwise prescribed, the last date of payment generally is deemed to be the date the return of tax is due.

### ***2. Overpayments***

Under present law (sec. 6611), interest is allowed and paid by the United States on the overpayment of any tax at the annual rate established under section 6621. Under section 6611(b), interest must be allowed and paid with respect to a credit from the date of overpayment (the due date of the return) to the due date of the amount against which the credit is taken; with respect to a refund, it is 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. No interest is allowed on an overpayment of income tax if it is refunded within 45 days after the last date prescribed for filing the return of such tax (but without regard to any filing extensions) or, if later, within 45 days after the date the return is filed (sec. 6611(e)).

In addition, there is a special rule for computing interest on an overpayment that results from a carryback of a net operating loss or net capital loss, or from certain credit carrybacks. In general such overpayment is deemed not to have been made prior to the close of the taxable year in which the net operating loss or net capital loss arose.

### ***3. Rate of interest***

Both the taxpayer and the United States must pay interest at the annual rate established under section 6621. Under present law if the current rate is at least one full percentage point above or below the average predominant prime rate for September of the current year the rate is adjusted, effective January 1, to be 100 percent of the new prime rate.

## H. Access to a Taxpayer's Books and Records

The Internal Revenue Service has broad, general powers to examine the books and records of taxpayers (sec. 7602). In general, it may do so for the purpose of determining whether a tax return is correct, making a return if none has been made, determining an individual's tax liability, or collecting such tax liability.

Moreover, the Service has the power to compel a taxpayer to produce his books and records by issuing a summons therefor. However, when the taxpayer has records that are within the custody of a third-party recordkeeper, there are special procedures that the Service must follow in order to gain access to those records (sec. 7609). In general, a third-party recordkeeper, for this purpose, is an attorney, an accountant, a bank, a trust company, a credit union, a savings and loan institution, a credit reporting agency, a person who extends credit through the use of credit cards, or a broker in stock or other securities.

If a summons served on a third-party recordkeeper requires the production of records made of the business affairs of any person (other than the third-party recordkeeper) who is identified in the description of the records in the summons, then the Internal Revenue Service must give notice to the person identified in the summons (hereinafter "taxpayer") within 3 days of the day the summons was served, but no later than 14 days before the day the records summoned are to be examined. The notice given to the taxpayer must contain directions for staying compliance with the summons.

The taxpayer may stay compliance with the summons if within 14 days of receiving notice of the summons the third-party recordkeeper is given written notice not to comply with the summons and a copy of that notice is sent by registered or certified mail to the Internal Revenue Service officer specified in the notice given to the taxpayer. (The notice requirements and the right of a taxpayer to stay compliance generally do not apply if a court, after being petitioned by the Service, determines that there is reasonable cause for believing that giving notice might lead to attempts to conceal, destroy, or alter records, to prevent the communication of information from other persons through intimidation, bribery, or collusion, or to flee to avoid prosecution, testifying, or production of records.)

The Internal Revenue Service may not examine any records required to be produced under a summons until after the 14-day period during which the taxpayer may act to stay compliance has expired. If the taxpayer successfully stays compliance by giving the requisite notices, then the Service may not examine the records without a court order or the consent of the taxpayer. In other words, the taxpayer may require the Service to go to court and obtain an order to enforce the summons against the third-party recordkeeper. Present law states that a proceeding brought to enforce

a summons takes precedence over all other cases except those the court considers of greater importance.

If compliance with the summons is stayed and the person who stayed compliance is the person whose tax liability is under investigation (or a person under the direction or control of the person whose tax liability is under investigation), then the running of the statutes of limitations for criminal prosecutions and the assessment and collection of tax is suspended while a proceeding to enforce the summons is pending.

## II. IRS ADMINISTRATIVE EFFORTS TO IMPROVE TAXPAYER COMPLIANCE

### A. Taxpayer Services Provided by the Internal Revenue Service

#### 1. Programs under the Associate Commissioner (Operations)

##### *In general*

The IRS conducts a year-round tax information program in each of its 7 regions, 59 internal revenue districts, 10 internal revenue service centers, and in various foreign countries (through the Office of International Operations). The basic assistance part of the program is operated by an Office of Tax Information under the supervision of the Associate Commissioner (Operations) and the Assistant Commissioner (Examinations). 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, centralized in 52 answering locations, 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 no longer provides direct return preparation assistance.

##### *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 pro-

grams 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 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 Ombudsman works under the direct supervision of the Deputy 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 decision-making 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 1981, 318,179 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 1981.<sup>1</sup>

### **1. Collection efforts**

#### ***Returns received***

During 1981, the IRS received and processed 166.5 million returns and supplemental documents. Over 94 million of these (about 56.5 percent) were individual income tax returns.

#### ***Mathematical correction***

During fiscal year 1981, the IRS checked the mathematics on about 91.4 million individual returns. As a result of this, refunds or credits were issued to 3.2 million taxpayers who overstated their tax liabilities by \$778 million. Tax liability was understated by \$1.2 billion, as a result of math errors, on 3.9 million returns.

With respect to estimated tax payments claimed on individual income tax returns, taxpayers understated those payments by \$446 million and overstated about \$950 million.

#### ***Tax receipts***

Gross tax receipts in fiscal year 1981 were \$606.8 billion. Income taxes accounted for more than two-thirds of this amount. Individual income tax receipts were \$332.9 billion and corporation income tax receipts were \$73.7 billion.

Social security, self-employment, Federal unemployment, and railroad retirement taxes accounted for \$152.9 billion. In addition, excise tax revenue was \$40.4 billion. Finally, receipts from estate and gift taxes were \$6.9 billion.

#### ***Refunds***

In 1981, the IRS paid \$63.3 billion in refunds to 73.6 million taxpayers. Of this amount, \$48.4 billion went to filers of Forms 1040 and 1040A.

#### ***Penalties***

During 1981, the IRS assessed \$22 million civil penalties, amounting to about \$3 billion (about \$1 billion in penalties was

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<sup>1</sup>The information discussed in this section was derived from the 1981 Annual Report of the Commissioner of Internal Revenue.

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 Administration. This reconciliation is designed to assure that the correct tax has been reported and that employees have received the correct social security coverage. From January 1980, through September 30, 1981, \$327.6 million in additional tax has been assessed under this program.

## *2. Enforcement efforts*

### *Examinations*

In 1981, the IRS implemented a new system for grouping individual income tax returns for examination selection. This new system involves grouping returns by total positive income (TPI) and total gross receipts (TGR).

TPI, which is used for nonbusiness returns, is the sum of all positive income values appearing on a return. Under the previous system of grouping returns by adjusted gross income, losses reduced income items and resulted in the grouping of high-income returns (with tax shelter losses) with low-income returns.

TGR is the sum of business gross receipts and is used to class business returns. Business returns are classed further according to Schedule C (Business or Profession) or Schedule F (Farm). Returns of taxpayers who are predominantly wage earners but have small amounts of business income are classed as nonbusiness returns.

### *Examination and correction results*

The IRS examined 1,930,292 returns in 1981. Examination coverage of income, estate, and gift tax returns was 1.84 percent.

The IRS examination program resulted in recommendations for additional tax and penalties of \$10.5 billion. Of that amount, individual income tax returns accounted for \$2.6 billion, corporate income tax returns for \$6.3 billion, fiduciary returns for \$38.8 million, estate and gift returns for \$1.4 billion, and employment and excise returns for \$125 million. This program also disclosed overassessments on 114,994 returns, resulting in refunds of \$395 million.

In addition to the IRS examination program, 814,023 returns were verified or corrected through correspondence from IRS service centers, including 668,610 that result from the matching of information documents. This type of examination resulted in recommended additional tax and penalties of \$205 million.

### *Information returns program*

The Internal Revenue Service received 645 million information documents in its tax year 1980 information returns program. More

than 336 million of these documents were submitted on magnetic media. The Internal Revenue Service matches most of the information returns submitted on magnetic media to verify that correct amounts are reported on taxpayers' returns. About 26 percent of the information returns submitted on paper are matched, and 84 percent of the combined magnetic media and paper receipts are matched. 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 1.2 million taxpayers of potential discrepancies between income reported on their tax returns and income reported on information returns. Furthermore, 1.6 million taxpayers were sent notices of apparent failure to file tax returns based on information returns. The information returns program resulted in collection of an additional \$500 million for returns processed in 1981.

### *Windfall profit tax*

In 1981, the IRS trained more than 700 personnel in oil and gas issues and in windfall profit tax administration. Moreover, 370 employees were trained to handle inquiries about the windfall profit tax. Windfall profit tax liabilities reported on returns processed through September 30, 1981, amounted to about \$16.9 billion.

### *Large corporations*

The coordinated examination program (CEP) covers financial institutions and utilities whose gross assets exceed \$1 billion and other corporations whose gross assets exceed \$250 million. CEP is a two-tiered program involving a national CEP and a regional CEP. The most complicated cases are assigned to the national program.

At the end of 1981, there were 942 large corporation cases in the national CEP and 536 cases in the regional CEP. Recommended tax deficiencies and penalties, during 1981, were \$4.33 billion.

### *Tax shelters*

As of September 30, 1981, there were 248,828 returns with tax shelter issues in the examination process. During 1981, 49,474 returns were closed with recommended tax and penalties of \$593.5 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 is in the process of developing a computer system to detect employers with large payrolls who have not submitted Forms W-4 to the IRS. In addition, a program is being established to follow up automatically on certain W-4 filers who failed to file 1980 income tax returns.

### *Unreported income program*

IRS unreported income programs resulted in the identification of more than 24,000 returns. Examination of these returns reflected a noncompliance rate of 83 percent.

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 235 international examiners located in 13 key districts. In 1981, these examiners participated in the examination of 2,900 returns and recommended adjustments and penalties of \$2.8 billion.

The Office of International Operations (OIO) has jurisdiction to audit foreign persons with U.S. income. 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, OIO and its overseas representatives are responsible for the exchange of information with U.S. treaty partners, and for other overseas tax information gathering. In 1981, OIO examined over 18,500 returns and recommended additional tax and penalty assessments of about \$950 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 1981, 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.

### *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.

### *Illegal tax protestors*

In early 1979, the IRS established a comprehensive program to identify illegal tax protestor schemes and to take appropriate action through examination, criminal investigation, and collection programs to assure compliance with the tax laws. As of June 30, 1981, 13,600 illegal tax protestor returns were under examination.

### *Collection of delinquent accounts*

During 1981, the IRS disposed of 2.2 million delinquent accounts and collected \$5.9 billion in overdue taxes. Of that amount, \$2.2 billion was collected in response to computer notices sent to taxpayers and \$3.4 billion was collected on delinquent accounts. In addition, overdue taxes of \$285 million were collected when 1.5 million delinquent returns, involving \$1.8 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. In addition, the service centers perform such procedures as associating taxpayer correspondence, screening cases to determine that a final notice has been sent, and verifying taxpayers' employment.

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.

### III. BACKGROUND ON TAX NONCOMPLIANCE

#### *Estimated amounts of unreported income*

During the 1970's, a number of analysts of the Federal individual income tax system concluded that substantial amounts of individual income were not reported on individual income tax returns. The estimates of the unreported amounts of income, usually attributed to the underground economy, have varied substantially, and the methods used in making the estimates also have differed.

Peter M. Gutmann, in estimating what he called "the subterranean economy," from which no income is reported for tax purposes, has developed estimates of currency in circulation held by banks and outside of banks, demand deposits and gross national product (GNP). By establishing a ratio of currency to demand deposits in an historic period (1937-1941), which preceded the onset of World War II higher taxes, rationing and price controls, he determined the amount of money needed for legal monetary transactions at any given level of GNP. This ratio then was applied to 1976 data for currency, demand deposits, and GNP, and the resulting estimates applied to 1976 and 1978 GNP and money supply data yielded an estimate of the subterranean economy of about 10 percent of GNP—\$176 billion in 1976 and \$200 billion in 1978.

Other assertions of the existence of the underground economy often are based on anecdotal information that include references to self-employed individuals in all kinds of activities (including merchants who travel from one flea market to another each weekend) who do not report income, unreported interest and dividend receipts, rents, royalties, capital gains, lottery winnings, and prizes and awards. Such informal information indicates the presence of an underground economy of unreported income, but it provides no guide to the magnitude of the problem.

The Internal Revenue Service reported in 1979 (Publication 1104 (9-79)) on its study of the underground economy in which it estimated separately the amount of income earned in each of the major income sources and further estimated the details for particular subcategories of income by independent contractors, self-employed business people, tip income, etc. The estimates were compared with the amounts reported on income tax returns, with the difference being the unreported amount. These estimates indicated that in 1976 individuals failed to report about \$12 to \$17 billion of income tax due on about \$75 to \$100 billion of unreported income from legal sources. These amounts were about 7 percent of \$1.073 trillion of income reported from legal sources and about 9 percent of tax due. In addition, the report also estimated that \$6 to \$9 billion in taxes were not paid on \$25 to \$35 billion of unreported individual income from criminal activities in narcotics, illegal gambling and prostitution.

These estimates amount to a range of \$100 to \$135 billion of total unreported income (from legal and illegal sources) for 1976. Given the difficulty of making accurate estimates of unreported income, the difference is quite small between Professor Gutmann's estimate of \$176 billion in 1976 and \$135 billion as the top of the range estimated by the Internal Revenue Service for the same year.

The Internal Revenue Service unreported income study did not focus on foreign income and the use of foreign secrecy jurisdictions to evade U.S. taxes. The significant problems raised by these types of transactions have been addressed in hearings before the House Ways and Means Oversight Subcommittee (April 24 and 25, 1979), and by a 1981 IRS study on tax havens. No reliable estimates of their impact on U.S. revenues have been made, however.

### *Unreported income from legal sources, 1976*

Table 1 lists several types of income that have been underreported by taxpayers. In general, the unreported total was less than 10 percent of the amount of legal income reportable in 1976.

TABLE 1.—ESTIMATED AMOUNT OF UNREPORTED INCOME FOR 1976 AS PERCENT OF REPORTABLE AMOUNT, BY TYPE OF INCOME

[Dollar Amounts in Billions]

Type of Income	Amount of income <sup>1</sup>			
	Reportable on tax returns		Reported on tax returns	
	From	To	Total <sup>2</sup>	As a percent of amount reportable <sup>1</sup>
Legal-source incomes:				
Self-employment <sup>3</sup> .....	\$93	\$99	\$60	60-64
Wages and salaries .....	902	908	881	97-98
Interest .....	54	58	49	84-90
Dividends <sup>4</sup> .....	27	30	25	84-92
Rents and royalties.....	9	12	6	50-65
Pensions, annuities, estates, and trusts.....	31	33	27	84-88
Capital gains .....	22	24	19	78-83
Other <sup>5</sup> .....	9	10	7	70-75
Total .....	1,148	1,172	1,073	92-94

<sup>1</sup> Sum of components may not add to totals due to rounding. Percents of amounts reportable were computed from unrounded figures.

<sup>2</sup> A small amount of illegal-source incomes are included in the figures below. These inclusions will not significantly affect the percentages shown in the right-hand column.

<sup>3</sup> Self-employment income covers net earnings of farm and nonfarm proprietorships and partnerships (at times referred to as unincorporated business income) as well as net earnings of self-employed individuals working outside the context of regularly established businesses in the legal sector.

<sup>4</sup> Dividends include an estimated portion of distributed net profits of qualified small business corporations.

<sup>5</sup> Includes alimony, lottery winnings, prizes and awards and other types of income.

The unreported income in each of the eight listed categories shows different percentages of compliance.

The highest degree of compliance, 97-98 percent, was in wages and salaries, which also is the predominant source of income—

about 78 percent of reportable income. Wage and salary income is subject to the withholding tax, and W-2 information returns are filed each January with the IRS with respect to the preceding year's income. Sufficient copies of the W-2 returns are distributed to the taxpayers for filing with Federal and State returns and for retention in the taxpayer's records.

Self-employment income is the next largest income category, about \$96 billion or 8 percent of total reportable income. The study estimated that only about 60 percent of this income was reported on income tax returns. Unlike wage and salary income, for which a person other than the taxpayer is the payor who withholds some tax each pay period and is responsible for filing W-2 information returns, the self-employed person often operates alone, maintains few or no records, and has nobody withholding or filing a W-2 for him.

Unreported wages and salaries and self-employment income have some common characteristics that make estimating the total amounts difficult and seriously restrict the ability of IRS to attribute the unreported amounts accurately to an individual taxpayer. A substantial portion—as much as two-thirds—of the unreported income is believed to be due to cash transactions. Another major explanation involves informal business activities which include substantial amounts of off-the-record transactions, whether or not payments have been made in cash. The participants in the informal activities may be full- or part-time workers or moonlighters.

Interest or dividend income is reported to the IRS and the taxpayer by the payor or his disbursing agent. The sum of these two sources of income is greater than the amount of self-employment income, but the reporting by the payor on Form 1099 has helped to achieve an 87 percent compliance rate. About the same level of compliance also characterized income from pensions, annuities, estates and trusts.

The estimates indicate the lowest compliance rate (50-65 percent) for reportable income was in the rent and royalty area.

### *Unreported income from illegal sources, 1976*

Separate estimates were made by the IRS of the unreported net income from gambling, illegal drugs and prostitution. Illegal gambling, consisting of the numbers racket, bookmaking and other assorted forms of gambling, produced between \$8.0 to \$10.0 billion in unreported income. Illegal drug traffic unreported income, estimated at \$19.9 billion which is the midpoint of the range from \$16.2 to \$23.6 billion, was derived from traffic in heroin, cocaine, marijuana, and a residual category that included hashish and psychotropic drugs and others. Prostitution unreported income was estimated at \$1.1 to \$1.6 billion; these estimates were based on police arrest records of streetwalkers and information collected by police of the volume of callgirl business. No estimates were made of the unreported income from other illegal sources, because there is too much uncertainty about the size of total incomes generated by such crimes as loansharking, welfare fraud, bribery, illegal kickbacks, and various other forms of larceny and white-collar crime.

### *GAO study of nonfilers*

The General Accounting Office released a study in 1979 in which it discussed the efforts by IRS to detect and pursue individuals who failed to file Federal individual income tax returns in 1972. This study differed from the IRS study, discussed above, in that it concentrated on the types of individuals who do not file returns. The IRS study focused on the amounts and kinds of unreported income, and did not distinguish between income that was underreported or omitted on a filed return or income that was unreported because no return was filed.

On the other hand, GAO tried to identify the nonfilers, constructed a profile of individuals who most probably would be nonfilers and recommended procedures for IRS to use in reducing the number of nonfilers.

GAO recommended that Congress consider alternative ways to amend section 6651(a) to impose a late filing charge on nonfilers, identified by the IRS, who subsequently file returns resulting in refunds. It also was recommended that Congress request the IRS to develop and provide the appropriate committees with information on the amount of additional funds needed to improve the effectiveness of IRS nonfiler compliance efforts. The information should include estimates of the costs for (1) estimating and analyzing the nonfiler population, (2) developing a better nonfiler case selection method, and (3) investigating all nonfilers selected.

For 1972 income tax returns, GAO estimated that between 4.1 and 5.3 million individual and joint returns were not filed by those who should have filed. The taxable income of the nonfilers was estimated between \$26 and \$35 billion, and they had a tax liability between \$1.3 and \$2.4 billion. The tax liability estimate was not adjusted for income tax withholding that could have reduced the estimate of lost tax receipts. Withholdings of nonfilers were estimated at \$500 million by GAO and about \$1 billion by IRS.

Using the Exact Match File (see the section that follows), GAO developed a socio-economic profile of nonfilers who had the following characteristics:

(1) About 26 percent of the nonfilers had 8 or fewer years of schooling; 15 percent of the 63 million filers had the same level of schooling. Nonfiling decreased as education levels increased. GAO believed that individuals with low levels of education may find tax laws too complicated and may not be aware of their filing responsibilities.

(2) About 52 percent of nonfilers had incomes of \$5,000 or less in contrast with 19 percent of filers in this income range. Individuals with higher incomes are more likely to be filers. GAO suggested that low income nonfilers may not have realized that their incomes exceeded the filing threshold.

(3) Laborers and workers made up about 33 percent of the nonfiler population, but 18 percent of the population of filers. Of the laborers and service workers required to file returns, 13 percent were nonfilers. About 33 percent of all farm laborers and 64 percent of all private household workers were nonfilers.

(4) Self-employed individuals made up 17 percent of the nonfiler population and 9 percent of the filer population. Of the

self-employed individuals, 15 percent did not file even though required to file.

### *Preliminary estimates resulting from recent studies*

Preliminary data for 1981 developed in a study which has not yet been published by the Internal Revenue Service indicates that the revenue loss resulting from noncompliance by individuals may be \$72 billion in 1981 and \$77 billion in 1982. This study projects a compliance gap of \$102 billion in 1985 absent any change in the tax laws or the current level of enforcement funding. The preliminary data shows underpayments of \$72 billion by individuals (including \$8 billion attributable to criminal activities) and \$4 billion by corporations.

Of the \$64 billion estimated underpayment by individuals engaged in legal activities, \$47 billion results from underreporting of income, \$12 billion from overstatement of deductions, credits and exemptions, and \$5 billion from failures to file tax returns.

Compliance rates by selected income source according to IRS preliminary estimates are shown in Table 2.

TABLE 2.—IRS ESTIMATES OF TAX COMPLIANCE RATES, SELECTED INCOME SOURCES, 1981 (PRELIMINARY)

[In percent]

Source		Source	
Wages.....	99	Pensions.....	80
Farm business .....	92	Nonfarm business .....	80
Interest .....	89	Capital gains.....	56
Dividends .....	85	Tip income .....	16
State tax refunds .....	81	Illegal income .....	5

### *Estimation methods*

The Internal Revenue Service used several sources to make estimates of underreported income, overstated expenses and the associated tax gap. The primary source of misreporting on returns filed was the Service's Taxpayer Compliance Measurement Program (TCMP). TCMP data are derived from a randomly selected national probability sample of individual returns filed. The weighted results of this sample provide estimates of underreported income by source and overstated deductions, exemptions, and credits discoverable by a reasonable examination. However, not all unreported income is ascertainable upon examination. As a result, IRS conducted a special TCMP-IRP study to determine how much unreported income covered by information reporting was not discovered by TCMP. The results of this special study were used to develop a factor to apply to the TCMP results to estimate total unreported income on individual returns filed.

Major outside sources of data on nonfiler incomes were two Exact Match Files relating to tax years 1972 and 1977. These files were constructed from studies representing joint efforts by the Census Bureau, the Social Security Administration (SSA) and the

Internal Revenue Service. They link information obtained from national household surveys with data from administrative records in SSA and IRS files. The Exact Match Files generated serve as data bases of public record to be used for general statistical research.

Income data from the national income and product accounts (NIPA) were also used, albeit with considerable modifications, mainly as checks of results obtained from the more direct IRS estimation methods. Subtracting estimates of income reported on individual tax returns from comparable NIPA estimates of income paid involves complex, roundabout estimation procedures. Moreover, the NIPA concepts of income differ in some instances from concepts relevant for tax purposes. Even so, the Internal Revenue Service was able to make some use of national income data, particularly in the areas of interest and dividends.

#### IV. POSSIBLE APPROACHES TO IMPROVING COMPLIANCE

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. If the penalties provided under present law are insubstantial in amount or uncertain in their application, 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. Thus, proponents of tax simplification 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.

### *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. In addition, if information reports are available on only some of the elements of a taxpayer's income, then the Internal Revenue Service may not be able to detect 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.

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, and by expanding the number of transactions subject to such reporting. Internal Revenue Service data also indicates that information transmitted in connection with withheld taxes has a significantly lower error rate than information on purely informational returns. 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 from third parties. For example, tax treaties could provide for information exchanges between taxing authorities or to permit U.S. access to records held by third parties overseas. In addition, the ability of the Internal Revenue Service to gain access to records held by third parties could be improved by placing

restrictions on the ability of taxpayers and third parties to delay response to summonses.

### *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 further attempting to improve the information reporting system.

### *Increased Internal Revenue Service enforcement efforts*

The ultimate deterrents to noncompliance are Internal Revenue Service enforcement efforts and the penalties imposed on taxpayers who fail to comply. Thus, an increase in compliance could be expected from increased spending on Internal Revenue Service enforcement activities, including increased audits of tax returns, and from increased penalties. On the other hand, reliance solely on this approach 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.

## V. SECTION-BY-SECTION DESCRIPTION OF S. 2198 <sup>1</sup>

### (TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1980)

#### Overview

The "Taxpayer Compliance Improvement Act of 1982" is intended to reduce taxpayer noncompliance through a series of provisions designed to encourage complete and accurate reporting of income and deductions. The bill includes provisions improving information reporting, increasing penalties for noncompliance, amending the methods under which interest is computed and substantially revising the withholding rules for pension distributions. Under the bill interest on bearer obligations and obligations of the United States, charged tips, transactions involving securities and commodities, and State and local income tax refunds would be subjected to new reporting requirements. The bill's penalty provisions include a minimum penalty for extended failure to file returns; a substantial increase in the penalty for failure to supply taxpayer identification numbers or to file information returns, and withholding in cases of continuing violations; a 10-percent penalty for any substantial underpayment of tax when the items giving rise to the underpayment were not disclosed on the return; and a penalty on corporate officers and agents, including attorneys and certified public accountants, who commit fraud with respect to a corporation's tax. The interest proposals include provisions for adjusting the interest rate payable by or to the Treasury, and compounding such interest, semiannually. Where applicable, these provisions would cover foreign as well as U.S. transactions.

#### Title I—Administrative Provisions

##### *Subtitle A—Reporting Requirements*

##### *Section 101(a)—Interest on bearer instruments and obligations of the United States*

Under present law, the definition of interest subject to information reporting permits the Secretary to provide that interest includes interest on bearer evidences of indebtedness issued by a corporation of a type offered to the public. The Secretary has not exercised this authority. Further, interest as presently defined in the statute, does not include interest on obligations of the United States or its agencies or instrumentalities. There is, therefore, no requirement under the Internal Revenue Code for reporting of interest on bearer obligations or obligations of the United States.

The bill would expand the information reporting requirements of present law to require reporting of interest (including discount on

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<sup>1</sup> Sponsored by Senators Dole, Grassley, Chafee, Domenici, Danforth, Stafford and Andrews.

original issue) on all corporate obligations, including bearer obligations, and interest (including discount on original issue) on obligations of the United States and its agencies and instrumentalities. The mechanics of such reporting would be prescribed under regulations. These new reporting requirements would apply to interest payments reportable on returns, the due date for filing of which is after December 31, 1982. Thus, interest paid in 1982 would be subject to the new reporting requirement.

#### *Section 101(b)—Information returns of brokers*

Present law requires that every person doing business as a broker make a return, when required under regulations issued by the Secretary, showing customer names, profits and losses, and such other information as the Secretary may require. There are, currently, no regulations issued under this section.

The bill would direct the Secretary to issue regulations with respect to commodities and securities brokers under the provisions of present law. It would be contemplated that the broker would be required to report only such information as would normally be acquired by the broker in the conduct of its business. Thus, if the broker had all information necessary to compute gain and loss, it would be required to include such information. Absent such information the broker would be required only to report the proceeds of sale. These new regulations would also require reporting on the sale or transfer before maturity of any bond or other evidence of indebtedness other than any sale or transfer by a corporation of any Treasury obligation or any corporate bond or evidence of indebtedness the issuance of which is not required to be registered with the Securities and Exchange Commission, having a maturity of not more than one year. Short-term obligations held by individuals would be subject to such reporting.

These regulations would be issued within six months of enactment of the bill. The first returns under these new regulations would relate to transactions occurring in 1983.

#### *Section 102—Information reporting on State and local income tax refunds*

Refunds of State or local income taxes that were deducted in a previous taxable year are includible in a taxpayer's gross income to the extent the deduction gave rise to a tax benefit. Under present law, there is no requirement that information returns for such refunds be filed with the United States or that persons receive information statements on those refunds during the tax filing season.

The bill would require that information returns for State and local tax refunds of \$10 or more be filed with the Internal Revenue Service, reporting the amount of any refund payment, credit or offset, the taxpayer's name and taxpayer identification number to the Internal Revenue Service. It would be anticipated that States may satisfy such obligations through voluntary information exchange agreements. A statement with respect to each such return would have to be furnished to the recipient of the refund during January of the year following the year in which the refund is made. This new requirement would apply to refunds, credits, and offsets after December 31, 1982.

### ***Section 103—Reporting of charged tips***

Under present law, an employee who receives tips in excess of \$20, in cash or its equivalent, in the course of his employment must report all such tips in a monthly statement furnished to his employer. The employer must generally take these tips (but no others) into account in determining the amount of tax to be withheld from the employee's wages. No other reporting requirements are imposed on employers with respect to tips.

Under the bill, any employer (other than a small employer) who pays over to an employee \$600 or more of charged tips in any taxable year would be required to report those tips to the Internal Revenue Service. Withholding on these charged tips (to the extent not paid over to other employees under pooling arrangements) would be required, as under present law, when the employee reports them together with other tip income to the employer. The amount reported by an employee on his tax return may be different, of course, from that reported by the employer because of pooling and other tip sharing arrangements. Small employers, who are defined as persons who normally have employed five or fewer employees during the previous calendar year, would be exempt from this reporting requirement. The new rules would apply to charge tips paid over to employees after December 31, 1982.

### ***Section 104—Form of information returns***

In general, returns required by the tax laws must be made according to the forms and regulations prescribed by the Secretary. As a general rule, these returns must be in written form except that in certain cases the return may be made by filing the required information on magnetic tape or other medium, provided that the prior consent to the Commissioner is obtained. There is no statutory or regulatory requirement that any particular sort of return be filed on magnetic tape or in other machine readable form.

The bill would clarify the authority of the Secretary to require that returns be in a form that would permit their prompt and efficient processing, including the filing of multiple returns in machine readable form. These provisions would apply to returns the due date for filing of which is after 1982.

### ***Subtitle B—Modification of Interest Provisions***

#### ***Section 111—Interest to be compounded semiannually***

Under present law, interest payable to or by the United States under the tax law is not compounded. Instead, interest is computed on a simple basis.

Under the bill, all interest payable under the Internal Revenue Code would be compounded semiannually. This compounding requirement would apply beginning in 1983 to amounts of interest attributable to periods before 1983 but remaining unpaid, as well as all other interest accruing under the internal revenue laws after 1982.

#### ***Section 112—Semiannual determination of rate of interest***

Under present law, the rate of interest to be paid on underpayments, on overpayments, and for other purposes, must be estab-

lished by the Treasury no later than October 15 of any year, based on the average predominant prime rate (the rate quoted by commercial banks to their preferred customers for short-term loans), during September of that year, effective January 1 of the following year.

Under the bill, interest rates would be determined semiannually and would be based on 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). The amendment would be effective for adjustments taking effect after December 31, 1982.

***Section 113—Restrictions on payment of interest on certain refunds, etc.***

In general, under present law, interest on refunds, credits and offsets runs from the date of overpayment, which is usually the last date prescribed for filing the particular return. Further, under present law, if an overpayment of income tax is refunded within 45 days after the last date prescribed for filing the return, or if later, within 45 days after the date the return is filed, no interest is payable on the overpayment.

Under the bill, no interest would be paid on overpayments shown on late returns for any day before the date on which the return is filed or on refunds made within 45 days after the return is filed. Likewise, an overpayment resulting from a net operating loss carryback, a net capital loss carryback or credit carryback would be deemed not to have occurred prior to the date a claim is filed for such overpayment or credit. Under the bill, for purposes of the payment of interest on overpayments, a return would not be treated as filed until it is filed in processable form. The amendments made by this provision would be applicable to interest paid after enactment except that interest accruing prior to March 11, 1982, would not be affected.

***Subtitle C—Penalty Provisions***

***Section 121—Fraud penalty on corporate directors, officers, employees and agents***

Under present law, a director, officer, employee or agent of a corporation who knowingly participates in fraud with respect to the corporation's tax liability may be subject to a criminal penalty but is not subject to any civil fraud penalty with respect to the corporation's underpayment of tax.

The bill would impose a new civil fraud penalty on corporate directors, officers, employees or agents (including attorneys, accountants, etc.), who knowingly participate in fraud that results in an underpayment of tax by the corporation. Such directors, officers, employees, or agents, would be jointly and severally liable for a penalty equal to 50 percent of the part of the corporate underpayment due to fraud, but the amount that could be collected from any one individual would not exceed \$100,000. Participation giving rise to this penalty would include ordering a subordinate to participate in a fraud or condoning the participation of a subordinate in

fraud. This civil fraud penalty could be asserted at any time before the later of six years after the due date of the corporate return (including extensions) or one year after expiration of any extension of the statute of limitations on assessment of the corporation tax. The new penalty would apply to returns due to be filed after December 31, 1982.

***Section 122—Minimum penalty for extended failure to file***

Under present law, if a taxpayer fails to file a tax return on the date prescribed (with extensions of time for filing), a penalty is imposed based on the amount of any underpayment of tax for the year. The penalty is 5 percent of the underpayment per month, or fraction thereof, while the failure continues, but not more than 25 percent in the aggregate. Thus, no penalty is imposed on the taxpayer if there is no underpayment for the year or if a refund is due. Likewise, no penalty is imposed if the failure is due to reasonable cause and not due to willful neglect.

The bill would add a new minimum penalty for the extended failure to file any income tax return. If an income tax return is not filed within 60 days of the date prescribed (with extensions), the penalties for failure to file would not be less than \$100. Also, this minimum penalty would not be imposed if the failure to file the return was due to reasonable cause. The penalty would apply to returns due after December 31, 1982.

***Section 123—Criminal penalty for failure to file estimated tax***

Present law imposes a criminal penalty for willful failure to pay any estimated tax at the time required by law. A person convicted of such willful failure is guilty of a misdemeanor and may be fined not more than \$10,000 or imprisoned not more than one year (or both), together with costs of prosecution. Such penalty may apply even if no civil penalty can be assessed.

The bill would provide that any person who fails to make any estimated tax payment would not be subject to the criminal penalty for such failure if the civil penalty for failure to pay estimated tax is not applicable.

***Section 124—Penalty for failure to file information returns or supply identifying numbers***

Present law imposes a penalty on any person who fails to file on the date prescribed (with extensions) information returns including returns relating to certain information at source, payments of dividends aggregating \$10 or more, payments of patronage dividends aggregating \$10 or more, payments of interest aggregating \$10 or more, reporting requirements of certain fishing boat operators, income tax withheld, or payments of wages in the form of group-term life insurance. The penalty is \$10 for each such failure, but the total for all such failures during a calendar year can not exceed \$25,000. The penalty is not imposed if the failure is due to reasonable cause and not to willful neglect.

Also, present law imposes a penalty of \$5 per failure on any person who is required by regulations to include his taxpayer identification number (TIN) in any return, statement or document, to furnish his TIN to another person, or to include in any return or

statement made with respect to another person the TIN of such other person, and who fails to comply with such requirement at the time prescribed. The penalty is not imposed if the failure is due to reasonable cause. In practice, this penalty is rarely, if ever, imposed.

The bill would increase the penalty for failure to file the information returns noted above to \$50 per failure, the total amount for all such penalties for any calendar year cannot exceed \$50,000. The bill would also require a minimum penalty for such failures if the failures are due to intentional disregard of the filing requirements. In such circumstances, the penalty would not be less than 10 percent (5 percent in the case of reports of brokers) of the aggregate amount of the items not properly reported.

In addition, the bill would increase from \$5 to \$50 per failure (but not to exceed \$50,000 in any year) the penalty for a person who fails (1) to include his TIN in a return, (2) to furnish his TIN to another person, or (3) to include, in any return or statement filed or made with respect to another person the TIN of such other person. In the case of the third type of failure, the bill would impose an increased penalty on any filer who intentionally disregarded the requirement to include a payee's TIN on a return. Such filer would be subject to a penalty of \$100 per failure, with no limit.

Also, the bill would provide for withholding at source at a tax rate of 15 percent if a taxpayer fails to supply a TIN or supplies an incorrect TIN to another person who must file a return with respect to payments to the taxpayer. If the TIN is not supplied, the payor-filer would start withholding when aggregate payments to the taxpayer for the calendar year exceeded any threshold requiring the reporting of such payments. If the TIN is incorrect, the payor would start withholding upon notice from the Secretary that the taxpayer has failed to supply the correct TIN within 60 days after notice from the Secretary. Such withholding generally would continue as long as the taxpayer failed to supply or correct his TIN.

The penalty provisions would apply after December 31, 1982. The withholding rules would apply only for payments made (or other amounts reported) after December 31, 1983.

### *Section 125—Penalty for substantial understatement*

Under present law, a penalty is imposed for failure to pay tax shown on a return or required to be shown on a return, or if any part of any underpayment is due to negligence, certain valuation overstatements, or civil fraud. These penalties either are not imposed if the failure is due to reasonable cause, or require the Service to carry a positive burden of proof. Reasonable reliance on the advice of a tax advisor generally will prevent application of the fraud and negligence penalties.

The bill would add to the Code a new penalty for substantial underpayment of tax arising out of items not disclosed on the taxpayer's return. In the case of an individual, an understatement of tax liability would be substantial only if it exceeds the greater of \$5,000 or 10 percent of the amount of tax required to be shown on the return. For corporations, the understatement would be substan-

tial only if it exceeds \$10,000 or 10 percent of the tax required to be shown on the return. The new penalty would be 10 percent of that part of any underpayment of tax arising from an undisclosed item. This new penalty may apply to an underpayment in addition to the negligence penalty but would not apply if a fraud penalty or the valuation penalty is imposed. An item would be considered disclosed only if information on the return or an attachment to the return is adequate to apprise the Secretary of the nature and amount of the item. This penalty would apply to returns required to be filed after December 31, 1982.

### *Subtitle D—Withholding on Certain Deferred Income*

#### *Section 131—Withholding on pension payments*

Under present law, income tax generally is not withheld from amounts paid to an employee or beneficiary under a tax-qualified pension, profit-sharing, or stock bonus plan, under a tax-sheltered annuity program, or under an IRA (an individual retirement account or annuity or a U.S. retirement bond). Also, payments under a commercial annuity contract are not generally subject to withholding tax. Tax is required to be withheld, however, if a voluntary withholding request by the recipient is in effect with respect to the annuity.

Under the bill, in the case of a qualified plan, tax may generally be withheld, unless the taxpayer elects otherwise, from taxable benefit payments (typically, annuity payments) as if those payments were wages paid by the plan. In the case of certain total distribution of benefits, however, tax would be withheld under special rules designed to reflect the 10-year forward income averaging and capital gains treatment provided for lump-sum distributions.

In the case of a tax-sheltered annuity program, an IRA, or a commercial annuity contract, the bill would provide that tax would be withheld on taxable payments, unless the taxpayer elects otherwise, as if those payments were wages.

Under the bill, no tax would be withheld from benefit payments (other than total distributions from qualified plans) if the recipient elects not to have the withholding tax apply. Such election may be made for any reason. In the case of a total distribution from a qualified plan, the withholding tax would not apply if the recipient provides notice that the distribution will be rolled over, tax-free, to another qualified plan or to an IRA.

### *Title II—Rules and Regulations; Etc.*

#### *Section 201—Time for prescribing rules and regulations*

Present law (sec. 7805) provides that the Secretary shall prescribe all needful rules and regulations for the enforcement of the Internal Revenue Code, including rules and regulations necessary due to changes in the tax law. There are no specific time requirements for issuance of such rules and regulations.

Under the bill, the Secretary would be instructed to issue rules and regulations pertaining to amendments to the Code made by the bill and any subsequent Code amendments "as soon as possible." Furthermore, the bill would require the Secretary to report annu-

ally to the Congress concerning any delays in issuing regulations required by changes in the Code, the reasons for the delay, and progress made in eliminating such delays.

### *Section 202—Paperwork reduction*

Under present law (Paperwork Reduction Act of 1980), information collection requests must be referred to the Office of Management and Budget for approval. The OMB has taken the position that this requirement applies to Treasury Regulations as well as to tax forms.

Under the bill, the Paperwork Reduction Act of 1980 would not apply to any rule or regulation promulgated under the Internal Revenue Code or to any information collection request that the Secretary determines to be authorized by the Code or by any rule or regulation.

### *Section 203—Report on forms*

The final provision of the bill would require the Secretary, no later than March 31, 1983, to study and report to the Congress methods of modifying the design of the forms used by the Internal Revenue Service to achieve greater accuracy in the reporting of income and the matching of information reports and returns with the actual income tax returns.

### **Revenue Estimates**

The revenue estimates for S. 2198 are not yet available.



