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[JOINT COMMITTEE PRINT]

STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS)

Volume II

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), contains a study of present-law penalty and interest provisions as required by section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act").[2] The IRS Reform Act directs the Joint Committee on Taxation and the Department of the Treasury to undertake separate studies of the penalty and interest provisions of the Internal Revenue Code (the "Code"), and make any legislative and administrative recommendations they deem appropriate to simplify penalty administration and reduce taxpayer burden. The studies are due by July 22, 1999. Included in the Joint Committee staff recommendations contained in this document are (1) recommendations of general applicability, (2) recommendations relating to specific penalty and interest provisions, and (3) recommendations to address corporate tax shelters.

Volume I of this document contains the following: (1) an executive summary (Part I); (2) a discussion of the methodology employed by the Joint Committee staff in conducting the study (Part II); (3) an overview of the principal civil penalty provisions (Part III); (4) an overview of the present-law interest provisions (Part IV); (5) a discussion of the economics of the penalty and interest provisions (Part V); (6) an analysis of the administration of the present-law interest and penalty provisions by the IRS (Part VI); (7) the Joint Committee staff recommendations relating to penalties and interest (Part VII); (8) the Joint Committee staff recommendations relating to corporate tax shelters (Part VIII); and (9) an overview of the interest and penalty regimes in selected foreign countries (Part IX). In addition, Volume I contains several Appendices: (A) a list of Internal Revenue Code ("Code") penalty provisions (Appendices A1-A5), and (B) a brief summary, organized by topic, of comments received by the Joint Committee staff in connection with the study (Appendix B).

Volume II of this document contains: (1) a summary of comments received by the Joint Committee staff organized alphabetically by commentator (Part I); (2) a reprint of the comments received (Part II); and (3) a reprint of General Accounting Office ("GAO") reports prepared at the request of the Joint Committee staff in connection with the study (Part III).

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[1] This document may be cited as follows: Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring And Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999.

[2] Public Law 105-206, signed by the President on July 22, 1998 (H.R. 2676). For legislative history, see H.Rept. 105-599 (Conference Report), S.Rept. 105-174 (Senate Committee on Finance), and H.Rept. 105-364, Part 1 (House Committee on Ways and Means).

I. SUMMARY OF COMMENTS RECEIVED BY JOINT COMMITTEE STAFF ON PENALTY AND INTEREST PROVISIONS
(Alphabetically by Submitter)

1. AT&T

The Taxpayer Relief Act of 1997 changed the definition of a tax shelter for purposes of the substantial understatement penalty (sec. 6662) from one with "the principal" purpose of tax evasion or avoidance to one with "a significant" purpose of tax evasion or avoidance. AT&T contended that lack of guidance as to the significance of this change has injected an expensive and disruptive element of uncertainty into the tax planning process for corporations. It also said that the possible open-endedness of this standard may impact dealings between taxpayers and IRS personnel analogous to the situation that developed in the wake of the Supreme Court's *Indopco* decision on expenditures required to be capitalized. AT&T said this standard "provides IRS personnel with significant discretion to apply the penalty in non-abusive situations" and will increase the use of penalty assertions as bargaining chips.

AT&T urged that the "significant purpose" standard be defined narrowly to ensure that responsible business taxpayers can continue to structure their affairs and engage in legitimate business transactions even where these actions produce tax savings. It also suggested the creation of a set of safe harbors from the imposition of the substantial understatement penalty.

2. Ambrecht & Associates (A&A)

A&A asserted that the IRS generally imposes penalties, especially the negligence penalty, without sufficient justification. A&A cited behavioral research that harsher penalty regimes tend to decrease voluntary compliance, in the long run, by reducing fairness and causing taxpayer resentment. It suggested Congress experiment with a positive reward structure to enhance compliance. For example, A & A suggested that a taxpayer whose returns are accepted as filed, with no changes for 10 consecutive years might be given a one-time tax reduction in the 11th year.

Because A&A expressed the belief that the IRS asserts negligence penalties "with impunity", and that they are "the penalty most often asserted by the IRS" it suggested that a Penalty Appeals Board (PAB) independent from the IRS be established. A & A envisioned that this system would be a simple and inexpensive way for taxpayers to contest penalty assertions and would tend to relieve taxpayers' feelings of helplessness and powerlessness concerning the IRS. Under this system, taxpayers would initiate a negligence penalty appeal (even while the audit is still in process) by completing a simple form that would be given to them each time an IRS agent asserts a negligence penalty. The form would list specific and standardized factors that could lead to imposition of the penalty and provide space for the taxpayers to explain why they believe the penalty does not apply. IRS agents would be given an opportunity to reply in writing, and the appeal would be handled by a PAB or "regional or national penalty appeals

processing center." The PAB could sustain the penalty, reverse it, or defer decision pending resolution of the underlying tax dispute. PAB decisions would be accompanied by written explanations and taxpayers would be afforded an opportunity to discuss the decision with a PAB member.

While recognizing that its proposal will not eliminate all the problems with the administration of the negligence penalty, A & A felt that it will have four principal benefits. First, it would create a more standard national application of the negligence penalty than results under the combination of the current IRS administration and court decisions. Second, it would allow an immediate and inexpensive independent hearing for taxpayers. Third, IRS examiners would assert negligence penalties less often and no longer use them as bargaining chip. Fourth, the courts, including the Tax Court, would have a reduced burden.

3. The American Bar Association Section of Taxation ("ABA")

The ABA submitted its comments in the form of answers to six of the seven questions presented in the December 21, 1998 press release of the Joint Committee on Taxation.[1]

Question 1: To what extent do the present-law Federal penalty and interest provisions and the administration of these provisions by the Internal Revenue Service (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) produce inequitable results in undue hardships for taxpayers, (d) result in unequal treatment of similarly situated taxpayers, (e) result in inequitable treatment of taxpayers and other third parties such as tax return preparers or providers of information returns, (f) result in tax overpayments or underpayments because of disparities with commercial borrowing rates, or (g) result in inefficient or ineffective tax administration?

Generally, the ABA identified four factors which it views as probably more important than penalties in encouraging voluntary compliance and deterring noncompliance: (1) the ability to understand the law; (2) a generalized belief in the legitimacy of the Federal government and its entitlement to tax its citizens and residents; (3) fear that noncompliance will be discovered through audit, computer matching, or other programs; and (4) the belief in the legitimacy of, and the unbiased administration of the tax laws by, the Internal Revenue Service. The ABA believes that these four factors are more important for encouraging compliance and deterring noncompliance for both: (i) individual taxpayers, and (ii) corporations and others with complex returns, though members of the second group are more likely to take a more aggressive interpretation of the law for various reasons. Finally, the ABA recognizes that some individuals and corporations do fall into the category of "willfully noncompliant" notwithstanding these four factors.

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[1] The ABA did not submit a response to the question (question 5) relating to a comparison of the U. S. and foreign tax systems penalty and interest provisions.

Responding more specifically to the question of penalties and interest encouraging compliance, the ABA pointed to the application of the accuracy-related penalty (section 6662) as failing to meet its goal of the disclosure of uncertain tax return positions which could facilitate IRS audits, administrative guidance, corrective legislative action, and ultimately improved compliance. It asserted that the lack of disclosure under section 6662 is because there is no penalty relief for disclosed items which are found to be: (i) tax shelters; or (ii) items without a "reasonable basis" for their tax treatment by the taxpayer. Further, it believed that the accuracy-related penalty (sec. 6662) and the return preparer penalty for understatement of tax liability (sec. 6694) and other return preparer penalties (sec. 6695) are poorly coordinated. It suggested an approach with only two standards: one for undisclosed positions and one for disclosed positions, with the application of such standards to the practitioners appropriately adjusted to reflect the limits of the practitioner's professional involvement.

Regarding the production of inequitable results and undue hardships for taxpayers by penalties, the ABA suggested that Congress should consider replacing the failure to deposit penalty (sec. 6656) with an interest charge. Regarding unequal treatment of similarly situated taxpayers as a result of penalties, the tax section had two main suggestions: first, that the term "penalty" be reserved for more egregious taxpayer failures to file or pay than the current statutory system allows; and second, that the IRS stop targeting principally the cases that are easy to find (i.e., individuals and entities that have filed returns with errors) and increase the number of investigations that may involve more serious conduct, such as omitted income, complete failure to participate in the tax system, and other types of civil or criminal fraud.

In response to the question of inequitable treatment of taxpayers and other third parties as a result of the penalty and interest provisions, the ABA said that much of the taxpayer frustration with respect to penalties comes from their administration by the IRS. It suggested that the present-law penalty system which relies heavily on automatic computer generated penalties followed by significant levels of penalty abatement be replaced with a system that utilizes some initial IRS inquiry before the assessment of penalties.

The ABA had four comments relating to the issue of interest charges on overpayments and underpayments of tax. The four comments are: (1) interest rates charged and paid on over and underpayments should be the same and linked to commercial rates; (2) serious thought should be given to integrating the time-value inherent in the estimated tax and failure to pay penalties with the interest rate on underpayments; (3) consideration should be given to the repeal of "hot interest"; and (4) the rate structure of the failure to deposit penalty is excessive and should be conformed to commercial rates.

Question 2: Do communications from the Internal Revenue Service to taxpayers provide an adequate explanation of why penalties and interest were imposed?

The ABA stated that the complexity of the tax law and IRS's own inadequate computer resources are primarily responsible for the IRS failure to adequately explain interest and penalties

to taxpayers. It suggested a moratorium of further legislation regarding this issue until the IRS has been given time to implement two recently enacted provisions (sections 6631 and 6751(a)).

Question 3: With respect to the Commissioner's authority to waiver penalties and abate interest: (a) what are the sources and scope of the Commissioner's authority to waiver or not enforce penalties; (b) should such authority be modified; (c) should the Commissioner's authority to abate interest be modified, and (d) is the administration of the penalty waiver and interest abatement authority applied uniformly and fairly and what is the effect of such administration (including the effect on compliance)?

The ABA found that the current statutory waiver structure "works reasonably well" and recommended extending administrative waiver authority to the IRS in all cases. Also, the tax section recommended that the Commissioner's authority to abate interest should not be modified again until recent changes to section 6404 are "given time to work".

Question 4: Should certain provisions of the Internal Revenue Code be clarified to identify whether they impose a penalty or a tax?

Recognizing a "strong interest element" to the estimated tax penalties (secs. 6654 and 6655) and failure to pay penalty (sec. 6651(a)(2) and (a)(3)), the tax section urged caution in a recategorization of such penalties as interest. The two advantages of the present-law penalty terminology given are that: (1) it helps establish the normative nature of the obligation to pay one's tax liability in a timely manner; and (2) a recategorization of these penalties as interest could result in the application of the more stringent rules applicable to waivers of interest which the tax section deems inadvisable. Alternatively, the tax section saw three advantages to the creation of a "late charge" for such circumstances. The advantages are that it would allow: (1) tailored waiver rules; (2) recognition of the fact that the Government is collecting "deficiency interest on these late payments"; and (3) reservation of the "penalty" terminology for "more serious transgressions".

Question 6: Should different entities be subject to different penalty regimes and should such different regimes be determined by reference to the four operating units in the Commissioner's restructuring plan for the Internal Revenue Service?

The ABA took the view that the fundamental tax obligations of a U.S. taxpayer should be enforced and administered in a uniform fashion and did not believe that the creation of four separate regimes would be productive.

Question 7: What specific recommendations can be made on ways to (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) align the structure of the penalty and interest provisions with the pending reorganization of the Internal Revenue Service, (d) simplify the present-law penalty and interest provisions, (e) make the administration

of penalty and interest provisions more efficient and effective, and (f) reduce inequities and burdens of taxpayers who are (or may be) subject to the penalty and interest provisions?

The ABA listed four issues relating to information return penalties that it believes should be addressed. First, the IRS enforcement programs rely too heavily on computer generated notices. Second, the IRS does not routinely communicate with filers regarding errors in information returns where it has determined not to impose a penalty. Third, there is a lack of uniformity in the administration of the waiver of information penalties among IRS offices. Fourth, the present-law imposition of penalties for voluntarily corrected errors discovered after the due date of information returns provides very little incentive for such corrective action by the return preparers.

In the interest of consistent administration of penalties and interest, the ABA believed that departures from a uniform structure across operating units of the IRS should only be allowed upon the strong showing of evidence that such a departure is needed to support voluntary compliance.

Finally, regarding the reduction of inequities and burdens on taxpayers under the penalty and interest provisions, the ABA had three suggestions. First, it suggested "legislative direction" for the IRS penalty relief policy regarding federal tax deposit penalties for missed deposits prior to the time when IRS computers are reprogrammed to eliminate "snowballing" of penalties when a single deposit is omitted. Second, it suggested a review of the present-law application of the Electronic Federal Tax Deposit System to all applicable taxes for certain taxpayers. Third, the ABA suggested that the issue of complexity in the deposit regime for fuel taxes be addressed.

4. American Council of Life Insurance (ACLI)

Application of penalties

In general, ACLI suggested that the ability to modify or waive penalties be expanded and made more uniform at the IRS examination level. It also had five more specific recommendations:

(1) ACLI called for additional IRS guidance regarding the waiver of penalties under section 6662 for certain disclosed items. Specifically, it was concerned about the operation of the rule that denies the waiver of penalties for tax shelters. It urged that the term "tax shelter" be defined narrowly enough to ensure that legitimate planning designed to reduce taxes is not treated as tax shelter activity. It also argued that disclosure should create a presumption that a return position is not taken to substantially understate taxes. ACLI felt that this would encourage disclosure of such planning and facilitate IRS's audit selection.

(2) ACLI suggested that the penalty for failure to pay estimated taxes provide an exception for underpayments due to unanticipated income as result of market fluctuations.

(3) ACLI suggested that a formal safe harbor be established for filers of information returns. It suggested a standard wherein no penalties are assessed on a company if it files at least 95% of its information returns correctly. On a related point, ACLI noted that in the past there was a pilot program under which information return filers were able to verify the accuracy of the taxpayer identification numbers ("TIN's") supplied to them before filing their information returns. It said participants in this program considered it successful and suggested that the program be expanded and made permanent.

(4) ACLI suggested that the IRS be barred from transferring funds between amounts paid to satisfy a taxpayer's corporate, employment, or income taxes without the taxpayer's permission. Alternatively, it suggested the waiver of any penalties or interest resulting from such transfer of funds made without prior notice to the taxpayer.

(5) ACLI suggested that Treasury and IRS consult with information return preparers and consider their administrative costs before implementing changes to information reporting and withholding obligations. ACLI believes that information return rules are changed and compliance obligations are increased too often with insufficient consideration of the costs to industry in revising their information systems to comply.

Communications with taxpayers

ACLI found that taxpayer notices relating to interest and penalties generally do not include an adequate description of the penalties and interest imposed nor the availability of abatement. It suggested that such taxpayer notices include that information as well as the name of an IRS contact person who is familiar with the issues raised in the notice.

Once a taxpayer does contact the IRS, ACLI reports that two other problems sometimes result.

(1) One such problem is the IRS's unilateral change of the taxpayer's name or address on its master file from the address of the taxpayer provided on the taxpayer's return to the address of a division of the taxpayer or the taxpayer's outside representative after some correspondence from such division or outside representative. It suggested that master file addresses be changed only in the following three circumstances: (1) the company files a form 1120 with a new address; (2) the company specifically requests a change of address be recorded on IRS records by filing form 8822 or its equivalent; or (3) the IRS has actual knowledge of a change in a corporate taxpayer's name or address and it advises the taxpayer of the change it is making in the taxpayer's master file.

(2) Another problem reported by ACLI is the IRS practice of contacting various departments of a corporate taxpayer. It advocated a mechanism whereby a corporate taxpayer can designate, on its tax return, a particular officer to whom all IRS communications should be directed.

Differential interest rates on under- and overpayments

ACLI urged that the interest rate differentials between over- and underpayments and "hot" interest rates be eliminated. ACLI noted that strengthened penalty provisions over the past few years should be sufficient to discourage improper behavior without the additional sanction of increased interest rates on deficiencies. Pending rationalization of rates, ACLI said its members need additional guidance from the IRS on global interest netting as mandated by the IRS Reform and Restructuring Act of 1998.

5. American Institute of Certified Public Accountants ("AICPA")

The comments of the AICPA were organized two ways: (1) as a series of comments to the four factors it found to be contributing to the current problems with the administration of the penalty and interest provisions; and (2) as a series of answers to the seven questions presented in the December 21, 1998 press release of the Joint Committee on Taxation.

The four factors found by the AICPA to be contributing to the current problems with the administration of the penalty and interest provisions and its comments relating to these factors follow.

Complexity of the tax law

The AICPA recommended that Congress enact tax legislation that is easier to understand and comply with.

Penalty and interest complexity

The AICPA recommended the creation of safe harbor provisions for "reasonable cause" exception under various penalty provisions. It also recommended simplification of the interest computations in the case of both underpayments and overpayments.

Poor communications with taxpayers regarding penalties and interest

The AICPA recommended:

- Accelerate the inclusion of the description of the penalty (including its name and Code section) and the computation of the penalty currently required for notices issued and penalties assessed after December 31, 2000.
- Accelerate and apply to all interest notices, the inclusion of the description of the interest (including the code section) and the computation of the interest currently required for notices issued to individual taxpayers after December 31, 2000.
- Use simple and concise language in the notice.

- Include an explanation of the procedures for requesting an abatement of the penalty and/or interest in the notice.
- Include a simple explanation of how the taxpayer can avoid the future imposition of the penalty and/or interest in the notice.
- Create an IRS phone "hotline" to provide taxpayers with penalty information and abatement requests and include such phone number in the notice.
- Allow tax practitioners to discuss a notice and its related account with the IRS without a power of attorney, if the practitioner provides the IRS with the "personal identification number" given on the notice to the taxpayer.

Lack of training and insufficient communication of policy within the IRS

The AICPA recommended:

- Have a single person oversee penalty administration in all four operating divisions under proposed new IRS structure.
- Review all internal policies on penalty administration and remove any inconsistencies.
- Train all affected IRS personnel on their policies, including: (1) the "reasonable cause" definition; and (2) the prohibition against using penalties as bargaining chips.
- Periodically review compliance with these policies.
- Communicate changes in these policies to all affected personnel

The AICPA also provided responses to the questions presented in the December 21, 1998 press release of the Joint Committee on Taxation. To avoid duplication, the AICPA's responses to the issues raised by those questions have been summarized without repeating the specific recommendations listed above.

Question 1: To what extent do the present-law Federal penalty and interest provisions and the administration of these provisions by the Internal Revenue Service (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) produce inequitable results in undue hardships for taxpayers, (d) result in unequal treatment of similarly situated taxpayers, (e) result in inequitable treatment of taxpayers and other third parties such as tax return preparers or providers of information returns, (f) result in tax overpayments or underpayments because of disparities with commercial borrowing rates, or (g) result in inefficient or ineffective tax administration?

The AICPA believed that the penalty and interest provisions of the Code encourage voluntary compliance because most taxpayers wish to avoid their imposition. Beyond the issuance of the taxpayer notices, however, the AICPA found that the IRS's actual administration of the penalty and interest provisions does not engender voluntary compliance. In particular, it found that the inherently subjective nature of the "reasonable cause" standard for abatement of

interest and penalties results in inconsistent treatment of different taxpayers which leads to taxpayer misunderstanding, resentment, and sometimes the lack of voluntary compliance. The two recommendations made to combat this problem were: (1) the creation of a system of safe-harbors that would allow taxpayers and the IRS to establish objectively that the reasonable cause exception should apply; and (2) better training of IRS personnel, including the policy against using penalties as bargaining chips.

The AICPA also suggested that the reasonable cause standard for abatement should generally follow the principles embodied in the section 6724 regulations (concerning penalties for late or non-filed information returns). For example, a taxpayer has reasonable cause if the taxpayer acted in a responsible manner and either there were "significant mitigating factors with respect to the failure," or the failure resulted from events beyond the taxpayer's control. Further, a taxpayer's not having previously had to file the return in question or the taxpayer's previous "clean record" of compliance should be explicitly recognized as mitigating factors.

The AICPA believed that current system of obtaining and filing powers of attorney before IRS personnel can discuss penalty notices with a taxpayer's representative coupled with the vague descriptions in these notices results in a unduly cumbersome process. The AICPA suggested these problems can be mitigated by having each penalty notice bear a unique identifying number. A practitioner who can supply this number to an IRS representative would be presumed to be authorized to speak on behalf of the client. Also clearer, more detailed penalty notices would make it easier to represent clients more cost effectively.

Finally, while the interest rates on underpayments and overpayments do not encourage taxpayers to treat the IRS as either a lender or borrower, the AICPA found that their calculations are too complex and suggested that these varying provisions be harmonized.

Question 2: Do communications from the Internal Revenue Service to taxpayers provide an adequate explanation of why penalties and interest were imposed?

The AICPA found that IRS communications with taxpayers contain neither an adequate explanation of the interest or penalties nor guidance regarding ways to avoid penalties or interest in the future. It suggested swift and expanded implementation of section 6751which currently requires more specific detailed information in certain taxpayer notices. It also believes that each taxpayer notice should contain a phone number that gives access to an IRS employee who has direct access to immediate resources needed to resolve questions expeditiously. Finally, it suggested that each taxpayer notice provide guidance to the taxpayer to assist in avoiding future imposition of interest and penalties.

Question 3: With respect to the Commissioner's authority to waiver penalties and abate interest: (a) what are the sources and scope of the Commissioner's authority to waiver or not enforce penalties; (b) should such authority be modified; (c) should the Commissioner's authority to abate interest be modified; and (d) is the administration of the penalty waiver and

interest abatement authority applied uniformly and fairly and what is the effect of such administration (including the effect on compliance)?

The AICPA suggested that first-time violators should be given a warning in lieu of a penalty, and/or the alternative of attending an educational seminar on the issue in question. It also suggested that abatement be allowed for interest resulting from all unreasonable delays caused by the IRS rather than just delays relating to administrative or managerial acts.

Question 4: Should certain provisions of the Internal Revenue Code be clarified to identify whether they impose a penalty or a tax?

In most cases, interest on penalties runs from the date of notice and demand but only applies where the penalty is not paid within 21 days from the notice and demand. The AICPA suggested that this treatment be made uniform to all penalties.

Question 5: How do the Federal penalty and interest provisions compare to penalty and interest provisions of voluntary tax systems of other countries?

Though flawed, the AICPA believes that the U.S. system is better than other countries' systems at reflecting the understanding that the role of penalties is to encourage compliance, not raise revenues.

Question 6: Should different entities be subject to different penalty regimes and should such different regimes be determined by reference to the four operating units in the Commissioner's restructuring plan for the Internal Revenue Service?

While it would not be unreasonable for each operating division of the IRS to administer penalties to their taxpayers, the AICPA believes that there should only be one set of penalties under the Internal Revenue Code. It further suggested that one penalty administrator be appointed to insure consistent application of penalties across operating divisions.

Question 7: What specific recommendations can be made on ways to (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) align the structure of the penalty and interest provisions with the pending reorganization of the Internal Revenue Service, (d) simplify the present-law penalty and interest provisions (e) make the administration of penalty and interest provisions more efficient and effective, and (f) reduce inequities and burdens of taxpayers who are (or may be) subject to the penalty and interest provisions?

Specific suggestions are described above.

6. American Land Title Association (ALTA)

ATLA members are required under section 6045(e) to report certain information including the seller's taxpayer identification number ("TIN") in connection with certain real estate transactions. If the seller's TIN is incorrect, the IRS may assert penalties against the filer. Because these penalties often are asserted after the filer's records are warehoused and therefore are difficult to access, ALTA members claimed that they often find it cost effective to pay the penalty rather than to prove to the satisfaction of the IRS that they satisfy the "reasonable cause" exception from the penalties. ATLA suggested that filers be permitted to prove satisfaction of the reasonable cause exception with respect to reported TINs at the time of the information returns are filed with the IRS.

7. American Society For Payroll Management (ASPM)

Communications with taxpayers

The ASPM commented that taxpayer notices relating to penalties currently lack important information. It suggested that such notices include the: (1) type of tax, tax form number, or amount and date of deposit date in question; (2) tax period; (3) type of penalty; (4) reason the penalty is imposed; and (5) specific calculation of the penalty. It suggested that the IRS send timely "warning notices" to taxpayers who appear not to be depositing under the correct rule or by the proper method before asserting a penalty. Also, it suggested that the IRS offer "employment tax classes" and even waive penalties to certain employers who fail to comply with the law. Another recommendation is the creation of a tiered penalty structure so that an infrequent violator would not be penalized as heavily as someone that has a history of frequent errors.

ASPM also commented that even when its members respond to taxpayer notices well before the response date specified, they often receive second notices that contain no indication of the receipt by the IRS of the taxpayer's response to the initial notice. It suggested that the IRS's system be changed to allow for more rapid input of information including taxpayer responses to original notices. The ASPM also had a more specific recommendation relating to the next-banking day deposit rule for certain monthly payroll tax depositors. It suggested a change to reduce the number of penalties assessed on employers who inadvertently fail to comply.

8. Association of Private Pension and Welfare Plans (APPWP)

The APPWP suggested four sets of penalties relating to retirement plans that it considers excessive: (1) the 50-percent nondeductible excise tax for failure to take timely minimum required distributions from retirement plans (sec. 409); (2) the penalties and taxes imposed on parties engaging in prohibited transactions (sec. 4975); (3) the penalties imposed on plan administrators by the IRS and the Department of Labor for failure to file annual reports relating

to pension activities (i.e., Form 5500 series report and attachments); and (4) the late payment penalty charge for failing to pay Pension Benefit Guaranty Corporation premiums.

9. Ceridian Corporation

The Ceridian Corporation ("Ceridian") submitted comments and recommendations about what it sees as three elements of the present-law penalty system: (1) the failure to distinguish and apply penalties differently based on the existence of willful noncompliance; (2) the lack of the uniform application of penalties and interest; and (3) the lack of proportionality between the penalty and the offense. It also made the general comment that the present-law system has failed to uphold the basic tenet that penalties should be used solely to enhance voluntary compliance.

The failure to distinguish and apply penalties differently based on the existence of willful noncompliance

Ceridian believes that a fair and effective penalty system should take into account the taxpayer's record of past compliance. It also believes that the system should take into account the number of compliance transactions the taxpayer processes annually in determining the level of penalties. It believes that inadvertent noncompliance should not be the focus of penalties. For example, Ceridian proposed penalty relief from the failure to deposit penalty under section 6656 for certain monthly depositors.

The lack of the uniform application of penalties and interest

Ceridian argued that the inherently subjective "reasonable cause" standard for abatements is not uniformly applied by employees in different IRS service centers. It suggested that all penalty notices and appeals should be handled by one centralized office to promote uniformity of administration in applying this standard.

The lack of proportionality between the penalty and the offense

Ceridian cited two examples where one inadvertent human mistake or technical error can lead to excessive penalties for an employer. The first example was the 10% penalty for deposits (sec. 6656) that are made by cash or check at a federal depositary instead of by an electronic funds transfer. Ceridian argued that the present-law penalty bears no relation to the government's loss of revenue and suggested that the size of the penalty be reduced.

Ceridian also noted that a simple mechanical error may sometimes cause a deposit to be directed to the wrong account triggering assessment of a failure to deposit penalty (section 6656). For example, if the wrong box is checked on a voucher, payroll taxes may inadvertently be deposited into an account for backup withholding on interest or dividends. If the error goes more than two weeks without being discovered, a 10% penalty rate will apply. Ceridian believes that

such a penalty is excessive because the funds in question have been paid to the government in a timely manner and have merely been misdirected.

10. Deloitte & Touche

Penalty abatement

Deloitte & Touche believes that the overriding purpose of penalties should be to encourage voluntary compliance. It also believes that the current system should do more to encourage voluntary compliance. It gave two examples where a taxpayer is currently subject to penalties even though the taxpayer takes action to correct noncompliance immediately after its discover by the taxpayer and before the IRS discerns any compliance problems. One example is a 25-percent foreign-owned U.S. corporation that incurs a $10,000 penalty under section 6038A for each failure to file an information return. Another example is an individual taxpayer who incurs substantial understatement penalties under section 6662 for failing to correctly report an item of income resulting in a substantial understatement of income tax.

Recognizing that the administration of the "reasonable cause" standard for the abatement of penalties and interest is inherently subjective, Deloitte and Touche suggested supplementing the present-law system of abatement with a series of "safe harbor" provisions. The three safe harbors suggested by Deloitte & Touche would allow abatement where a taxpayer: (1) expeditiously corrects an error upon discovery; (2) has not previously been required to file the particular type of return or statement at issue; and (3) has an established a history of compliance. It also suggested that education efforts, not penalty assessments, be the IRS's "first resort to encourage compliance."

Notices

Deloitte and Touche had two comments relating to taxpayer notices. First, that corporations and not just individual taxpayers should receive IRS interest computations in their taxpayer notices. Second, that the IRS should develop procedures to allow a taxpayer to attain a waiver of penalties under the reasonable cause standard without waiting for a computer generated proposed penalty notice.

11. Dewey Ballantine LLP (on behalf of American Payroll Association, American Society for Payroll Management, National Federation of Independent Businesses, National Retail Federation, Service Bureau Consortium, Small Business Legislative Council, US Chamber of Commerce, and UWC–Strategic Services on Unemployment and Worker's Compensation)

Dewey Ballantine had several comments all relating to the administration of the electronic federal tax payment system (EFTPS). The comments and their recommendations follow below.

1. When employers are first mandated to deposit under EFTPS procedures, they should be notified of this fact before being subjected to penalties for failing to comply.

2. The proposed $200,000 threshold for EFTPS coverage should be inflation indexed.

3. EFTPS mandated taxpayers, including those who have been moved to a semi-weekly deposit schedule, that fail to comply with EFTPS should be notified of their error in a timely manner to allow remedial action before additional penalties are incurred.

4. The 10% penalty for failing to use EFTPS should be reduced to the cost of interest plus an administrative fee of not more than 1%. Dewey Ballantine feels that the current penalty rate is excessive.

5. There should be a "window" for adjusting EFTPS deposits. Making correct payroll deposits is often impractical because necessary information on certain items of compensation (e.g., special bonus payments, third party sick pay, the value of personal use of company cars, meals and lodging, and prizes and awards) are not ascertainable by the tax deposit due dates. Historically, payroll service providers have dealt with this problem by overdepositing their clients' liabilities and then taking advantage of a 5-day window for making adjustments under current rules that apply to data submitted on magnetic tape. Dewey Ballantine believes that a similar system for adjustments is needed for EFTPS deposits.

12. Dr. Harb S. Hayre

Dr. Hayre believes that the estimated tax penalty (sec. 6654) is an unfair burden on "regular on-time" taxpayers, particularly retirees.

13. KPMG Peat Marwick ("KPMG")

KPMG submitted responses to six of the seven questions presented in the December 21, 1998 press release of the Joint Committee on Taxation.[2]

Question 1: To what extent do the present-law Federal penalty and interest provisions and the administration of these provisions by the Internal Revenue Service (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) produce inequitable

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[2] KPMG did not respond to the question (question 5) relating to a comparison of the U.S. and foreign tax systems penalty and interest provisions.

results in undue hardships for taxpayers, (d) result in unequal treatment of similarly situated taxpayers, (e) result in inequitable treatment of taxpayers and other third parties such as tax return preparers or providers of information returns, (f) result in tax overpayments or underpayments because of disparities with commercial borrowing rates, or (g) result in inefficient or ineffective tax administration?

KPMG believes that the fair system of penalties and interest involves a balance between administrative ease and fairness to the taxpayer which is not always achieved presently. To accomplish this balance, KPMG suggested a two-fold approach to penalties with "safe harbor" standards crafted to cover most situations, supplemented by "facts and circumstances" reasonable cause exceptions applicable to all penalties. It believed that this approach would provide the flexibility needed for fairness in unusual circumstances. Also, KPMG suggested that a taxpayer's reliance on a well reasoned treatise or a IRS failure to provide guidance about a tax law should be a two factors considered in determining eligibility for reasonable cause abatement.

Regarding IRS administration of interest and penalties, KPMG had some general and some specific suggestions. First, it suggested that an educational notice should precede a proposed or actual penalty assessment in certain cases where a taxpayer has previous history of compliance. Second, the IRS policy against using penalties as bargaining chips during examination should be more strictly enforced. Third, it suggested that the administration of all information return penalties be handled at one location (e.g., the Martinsburg Computing Center). Fourth, the IRS should issue comprehensive guidance the calculation of interest taking into account all legislative and judicial action on the subject.

The more specific suggestions regarding penalties made by KPMG include:

1. KPMG also highlighted the $10,000 penalty for each failure to file an information return imposed on certain 25-percent foreign-owned U.S. corporations under sections 6038A and 6038C as examples of penalties that discourage rather than encourage voluntary compliance. It suggested relief from these penalties for taxpayers who correct their filing errors before discovery by the IRS and argued that similar relief is granted under the special rules relating to the substantial understatement penalty (sec. 6664).

2. The repeal of the failure to pay penalty under section 6651(a). It claimed that the use of market rates of interest in section 6621 make this penalty unnecessary.

3. If the failure to pay penalty is not repealed, KPMG says there should be a 10% safe harbor for amounts paid before a return's original due date. It argued that this would equalize the treatment of taxpayers who file timely (without an extension), but have a minor payment shortfall, and taxpayers who file for an extension. Currently, a taxpayer can avoid the failure to pay penalty, if at least 90-percent of the tax liability is paid by the return's original due date and the

taxpayer files for an automatic extension. This creates an incentive for a taxpayers without adequate money to pay the balance of their tax liability by the original due date to file for an automatic extension.

4. KPMG said companies that go to the trouble of retaining a payroll service provider should be accorded a presumption of eligibility for reasonable cause abatement or "safe harbor" relief. IRS could overcome this presumption by showing the company's behavior was inconsistent with reasonable cause and good faith.

5. KPMG also urged that mechanisms be developed for handling "mass penalty assessments." For example a single programming or operational error by a payroll service provider may trigger penalty notices against a large number of separate subscribers. Given the common issue, KPMG suggested that handling such cases on a consolidated basis would be both more efficient and lead to more consistent results between similarly situated taxpayers.

6. KPMG urged that the IRS stay any collection of amounts under section 6672 pending the completion of administrative or judicial proceedings regardless of the posting of a bond by the taxpayer.

Question 2: Do communications from the Internal Revenue Service to taxpayers provide an adequate explanation of why penalties and interest were imposed?

Regarding taxpayer notices, KPMG suggested expanding the requirements of section 6751 which currently requires an explanation of the name, section number and computation of certain penalties and interest to include: (1) the rationale for imposing the penalty; (2) an analysis of how it applies to the particular taxpayer; and (3) the phone number of the local taxpayer advocate. It would also apply these requirements to all penalties and interest. Also, KPMG said that the requirement under section 6631 that taxpayer notices for individual taxpayers include interest calculations be expanded to include corporate taxpayers.

Question 3: With respect to the Commissioner's authority to waiver penalties and abate interest: (a) what are the sources and scope of the Commissioner's authority to waiver or not enforce penalties; (b) should such authority be modified; (c) should the Commissioner's authority to abate interest be modified; and (d) is the administration of the penalty waiver and interest abatement authority applied uniformly and fairly and what is the effect of such administration (including the effect on compliance)?

KPMG had several recommendations relating to penalties. First, that all penalties include a "reasonable cause and good faith exception". Second, that "first-time offenders" receive an educational notice rather than the imposition of a penalty. Third, that the failure to file or pay tax penalty (sec. 6651) and the failure to pay estimated tax penalty (sec. 6654) should have financial

hardship exceptions. Fourth, a specific Code section should be enacted to allow the Commissioner or the National Taxpayer Advocate to waive or abate any penalty or addition to tax if it is in the interest of tax administration.

KPMG recommended that the Secretary's authority to abate interest be amended to include situations where "equity and good conscience" warrant abatement. It also suggested that abatement authority in the case of unreasonable delays or errors by the IRS be extended to employment taxes. Finally, KPMG suggested that, to meet the legislative mandate for the most comprehensive possible interest netting, IRS should provide an effective rate of zero to the extent over and underpayments are or have both been outstanding during the same period with respect to the same calendar year.

Question 4: Should certain provisions of the Internal Revenue Code be clarified to identify whether they impose a penalty or a tax?

KPMG believes that clarification is necessary on the issue of whether penalties other than those imposed by Chapter 68 (i.e., secs. 5761, 6038A, 6038C, and 7261-7273) are subject to interest. It also requested clarification of how interest accrues on certain "taxes", (e.g., the tax on excess contributions to a retirement plan under sec. 4979). It recommended that these issues be resolved in a manner that does not unnecessarily "stack" sanctions.

Question 6: Should different entities be subject to different penalty regimes and should such different regimes be determined by reference to the four operating units in the Commissioner's restructuring plan for the Internal Revenue Service?

KPMG believes that a single IRS National Office level function should oversee the administration of interest and penalties. It believes that will promote uniformity and fairness.

Question 7: What specific recommendations can be made on ways to (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) align the structure of the penalty and interest provisions with the pending reorganization of the Internal Revenue Service, (d) simplify the present-law penalty and interest provisions, (e) make the administration of penalty and interest provisions more efficient and effective, and (f) reduce inequities and burdens of taxpayers who are (or may be) subject to the penalty and interest provisions?

Specific suggestions are described above.

14. Marjorie Kornhauser (Professor, Tulane Law School)

Professor Kornhauser urged that conscientious objection to war be recognized as "good cause" for abatement of interest and penalties incurred by taxpayers who refuse to pay taxes because of their use for military purposes. She says that this exemption from interest and

penalties is less radical than the FICA tax exemption provided under section 3127 to members of religious groups which are opposed to participation in Social Security Act programs.

15. Judy M. Morrell

Ms. Morrell suggested general penalty and interest relief for small business owners. She stated that these provisions (e.g., information returns) were "overly burdensome and complex."

16. Hugh O. Mussina (Dallas, TX sole practitioner attorney)

Mr. Mussina asserted that the interest and penalty provisions are overly complex, burdensome, and that problems are exacerbated by duplicative penalties, excessive interest compounding, and delays in resolving cases, particularly partnership assessments.

After recounting the experience of one of his clients who became subject to interest and penalty charges far exceeding her original tax deficiency, Mr. Mussina suggested capping interest and penalties. He also suggested that, in disputes such as the partnership matter his client was involved in, taxpayers be given notice early in the process of the amount of possible exposure and be allowed to make a deposit of the disputed amount to stop the running of interest and penalties pending final resolution of the case.

17. Tom Persky (of TimeValue Software)

Mr. Persky advocated repealing the failure to pay penalty under section 6651(a)(2) and increasing the interest rate on underpayments under section 6621 to a level comparable to credit card rates.

18. William Stevenson, E.A (former member of Commissioner's Advisory Group, on behalf of National Society of Accountants)

Mr. Stevenson believes "most of the penalties are levied on normally compliant taxpayers." He added that a complete review of the penalty structure is needed and suggested that: (1) penalties be minimized; and (2) the IRS begin to administer penalties more equitably. Mr. Stevenson suggested that certain penalties impose heavy burdens on taxpayers without acting to encourage voluntary compliance (e.g., the failure to deposit taxes under sec. 6656; the failure to pay estimated taxes under sec. 6651; and the premature withdrawal from IRAs under sec. 72(t))

Mr. Stevenson also included three case studies in his submission. Each of these cases described taxpayers who: (1) ran afoul of the system; (2) were assessed large interest and penalties burdens; and (3) were unable to reach a reasonable resolution with the IRS because of IRS organizational barriers and/or statutory impediments.

19. Tax Executives Institute (TEI)

TEI suggested four principles for a fair and effective penalty system. First, penalties should be used to punish intentional or negligent noncompliance, not inadvertent errors or omissions. Second, all penalties should allow abatement for reasonable cause. Third, penalties should encourage disclosure. Fourth, penalties should not be used to raise revenue. It also suggested that penalties should be: (1) based on clearly defined and communicated standards of conduct; and (2) administered more uniformly.

The remainder of TEI's comments were divided into three categories. These categories discuss: (1) specific penalties; (2) interest; and (3) estimated taxes.

1. Specific penalties

Accuracy-related penalty under section 6662

Generally, a taxpayer with "substantial authority" for its return position may have the accuracy-related penalty abated for reasonable cause. TEI argued that the operation of the "substantial authority" standard is too ambiguous and suggested that a taxpayer be allowed to simply rely on court opinions from its jurisdiction, without weighing them against other court decisions, when applying the substantial authority standard. Also, TEI believes that, in the absence of other guidance, certain "well known" treatises, such as Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* or McKee, Nelson & Whitmire's *Federal Taxation of Partnerships & Partners* should be allowed to satisfy the substantial authority standard.

Generally, the accuracy-related penalty will not apply to items that are adequately disclosed, but such relief is not available in the cases involving tax shelters. The definition of tax shelter was recently expanded to include cases in which tax avoidance or evasion was "a significant" purpose. TEI felt that this definition is inappropriate and suggested a return to the previous standard under which a tax shelter was defined as something in which tax avoidance or evasion was "the principal" purpose.

Information reporting penalties under sections 6721-4

TEI argued that automatic penalties for noncompliance should be replaced with a system of initial warning notice describing the problem and the steps needed to correct and prevent it. It believes that only failures subsequent to such notice warrant the imposition of the penalty. On a somewhat related point, TEI urged that the taxpayer identification number ("TIN") verification system that the Martinsburg Service Center experimented with a few years ago be reinstated to help taxpayers, particularly large-volume filers of information returns, verify TINS.

Failure to deposit taxes penalty under section 6656

TEI suggested that the compressed time frame of this tiered penalty structure operates inequitably. It suggested that the number of instances of errors be added to the time factor in applying this penalty. TEI also suggested moving forward the effective date of the provision in the IRS Restructuring Act designed to eliminate "cascading penalties" .

Notices

TEI argued that penalty notices should be clearer and more informative and that taxpayer responses to penalty notices should be processed more promptly. Further, TEI recommended the expansion of a IRS district office pilot program relating to third parties (e.g., a payroll service bureaus) who handle a taxpayer's compliance functions. Under that pilot program, a unique identifying number was included in each penalty notice. If a caller responded by phone to the notice and gave the correct number, the caller is presumed to be authorized to discuss the matter. Similarly, TEI suggested developing a mechanism for identifying on each tax return the person (e.g., a third party preparer) authorized to respond to IRS questions about that return.

2. Interest

TEI has five principal comments relating to interest. First, it believed that the interest rate differential between under- and overpayments is inequitable and should be eliminated. It believes that adequate safeguards to prevent taxpayer manipulation of payments already exist. Second, TEI believed that elimination of the differential will obviate the need for "interest netting" which itself is an imperfect response to the interest rate differential. If the interest rate differential cannot be eliminated, TEI believes that the scope of interest netting should be expanded (e.g., to allow interest netting in a taxable year of the taxpayer if the statute of limitation is open for either the underpayment or the underpayment for that year). Third, TEI suggested that interest calculations be simplified by using simple interest rather than compound interest. Fourth, TEI believed that the IRS's authority to abate interest, which focuses on "unreasonable errors or delay" and "ministerial or managerial acts" raises too many complex factual questions. Instead TEI suggested that the IRS be given the authority to abate interest on equitable grounds and that such authority cover all taxes, including employment taxes. Fifth, TEI argued that the Tax Court's authority to review interest abatement refusals should be available to all taxpayer regardless of its net worth or number of employees.

3. Estimated tax

The penalty for failure to pay estimated tax under section 6655 is assessed against corporations unless a safe harbor is satisfied. Generally, a corporation that is not a "large corporation" can satisfy the safe harbor if its quarterly deposits equal the lesser of: (a) 100-percent of its actual tax liability for the year, or (b) 100-percent of its prior year tax liability. A large corporation, which is defined as a corporation that had taxable income of $1,000,000 or

more in any of the three previous taxable years, may not rely on the second prong of the test to qualify for the safe harbor. TEI's first comment relating to estimated taxes is that "large corporations" be permitted the same safe harbor as other taxpayers. It argued that large corporations have difficulty estimating the correct amount of their tax liability for the year and effectively must overpay their taxes to avoid the penalty.

TEI's second comment on estimated taxes relates to consolidated groups of corporations that include a foreign sales corporation (FSC). It argued that a section 482 adjustment within such group sometimes results in unfair interest and penalty assessments. Specifically, TEI argued that because the penalty for failure to deposit estimated tax is applied separately to the FSC and the rest of the consolidated group, the section 482 adjustment results in the imposition of the penalty on the FSC when no penalty would be triggered if applied to the group on a consolidated basis. TEI proposed there be no interest, underestimation, or failure to pay penalty for changes relating to section 482 adjustments if such adjustments would not have produced interest or penalties when payments by both the FSC and its related supplier are taken into account.

20. Teahan & Constantino (Poughkeepsie, NY law firm)

Teahan & Constantino suggested that the failure to pay penalty under section 6651(a)(2) be eliminated and the interest rate on underpayments under section 6621 be increased. It believes that such a change would reduce complexity while continuing to induce the timely payment of taxes. It would also reduce the interest rate imposed on installment agreements as long as the taxpayer remains in compliance with the agreement. The intent of this reduction is to encourage compliance by this financial incentive rather than through threats of hostile collection actions. Its alternative suggestion was the total abatement of the failure to pay penalty when the taxpayer enters into and complies with an installment agreement. It noted that compliance with an installment agreement results in a partial abatement under present law.

21. Washington Counsel, PC ("Washington Counsel")

The comments of Washington Counsel concerned charitable remainder trusts ("CRT"s). Washington Counsel explained that a CRT is not subject to income tax unless it earns unrelated business taxable income ("UBIT") in which case all of its income becomes subject to tax. Washington Counsel argued that CRT investment managers must therefore take extreme precautions to avoid inadvertently incurring even minor amounts of UBIT. While Washington Counsel admitted that although, "section 664(c) is not *per se* a penalty provision in the Code, the severe consequences mean it operates more like a penalty provision than a tax." It therefore suggested two changes to the tax treatment of CRTs in the context of penalty reform.

Washington Counsel's first suggestion was that CRTs with UBTI which is less than 5% of total income be taxed only on their UBTI. If the CRT's UBTI was more than 5% of its total

income, it suggested that it pay the tax on its UBTI multiplied by a factor of 4. Finally, if its UBTI exceeds 25% of its total income, the CRT should pay tax on all of its income.

Washington Counsel's second suggestion related to the penalty for failure to file information returns (sec. 6652(c)). For most exempt organizations, the penalty for not filing certain information returns required under section 6033 is $20 a day subject to a ceiling equaling 5% of the organization's assets, not to exceed $10,000. If the organization's gross receipts are over $1 million, the ceiling is $20 a day not to exceed $50,000. For a CRT and other trusts, the penalty for failure to file returns required by §6034 is $10 a day, not to exceed $5,000. Washington Counsel said setting the penalty so much lower, regardless of the CRT's annual income, may be insufficient to encourage voluntary compliance. It suggested applying to CRTs the same rules that apply to other exempt organizations.

II. REPRINT OF COMMENTS RECEIVED RELATING TO PENALTY AND INTEREST PROVISIONS

The following documents are reprints of the comments received by the Joint Committee staff in connection with its study.

AT&T

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March 9, 1999

Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515

Dear Ms. Paull:

The IRS Restructuring and Reform Act of 1998 (H.R. 2676) requires the Joint Committee on Taxation and the Treasury Department to each conduct a separate study reviewing the interest and penalty provisions of the code. As you prepare your study, please consider the following information relating to the change in the substantial understatement penalty under IRC Section 6662 made by the Taxpayer Relief Act of 1997.

The Taxpayer Relief Act of 1997 revised the definition of a "tax shelter" for purposes of the substantial understatement penalty under IRC Section 6662. IRC Section 6662 now provides that any plan or arrangement a ***significant*** purpose of which is the avoidance or evasion of Federal income tax will be considered a tax shelter. The change is effective for transactions entered into after August 5, 1997, and reflects a considerable departure from prior law which applied a "principal" purpose standard. In addition, the change has not been accompanied by any guidance defining the significant purpose standard and how such a standard should be applied by IRS personnel.

The lack of any guidance with respect to the new significant purpose standard has had a stifling effect on the ability of responsible corporate taxpayers to enter into legitimate business transactions for fear that the transaction may be characterized as a tax shelter if the transaction also produces significant tax savings. While corporate taxpayers can avoid imposition of the substantial understatement penalty under the "reasonable cause and good faith exception under IRC Section 6664," the exception requires a facts and circumstances determination to be made in each situation. As such, reliance on the exception: (a) does not provide a corporate taxpayer with any certainty in performing its corporate tax planning and structuring its affairs; and (b) imposes a tremendous resource drain on both the IRS and taxpayers.

This new "significant" purpose standard also creates an environment for the inconsistent and abusive application of the substantial understatement penalty by IRS field personnel analogous to the situation that developed following the *INDOPCO* decision. It should be noted that many issues are negotiated and settled for reasons other than their merits at examination, appeals, or prior to litigation. The new open-ended definition of a "tax shelter" will inevitably result in revenue agents unfairly using this particular penalty as a bargaining chip in their dealings with taxpayers. Furthermore, this new standard provides IRS personnel with significant discretion to apply the penalty to non-abusive situations. This type of activity undermines the intent of the IRS Restructuring and Reform Act of 1998, which was to protect taxpayers from IRS abuse.

Recycled Paper

The lack of information regarding the legislative intent behind this new standard makes the reason for its enactment unclear. It may be inferred that the significant purpose standard was enacted in response to abusive, purely tax-motivated transactions (*e.g.,* the stepped down preferred stock and rent-stripping offerings) that were marketed by tax shelter promoters. It should be noted that taxpayer use of these transactions was not as widespread as generally perceived as most corporate taxpayers concluded not to enter into them after reviewing their terms. In addition, the IRS was able to effectively "shut down" these transactions by issuing a notice authorizing the issuance of new regulations and mandating that such regulations be retroactive in effect. Furthermore, these transactions would have fallen within the old "principal" purpose standard of IRC Section 6662, thereby eliminating the need for the new significant purpose standard. The creation of this new standard gives the IRS a great deal of latitude in imposing the substantial understatement penalty and could result in the abusive application of the penalty by IRS agents.

While we support the IRS's attempts to curtail truly abusive transactions, the change to the definition of a "tax shelter" made in the Taxpayer Relief Act of 1997 is overly broad and is disruptive to legitimate corporate tax planning. The "principal" purpose standard is well known and is long-standing in its application, whereas there is no history of using a "significant" purpose standard. We have previously sought clarification in the Joint Committee on Taxation Report (the "Blue Book") which described the Taxpayer Relief Act of 1997.

We now respectfully request that, as part of your study, clarification be given which narrowly defines the "significant" purpose standard to ensure that responsible corporate taxpayers can continue to engage in legitimate business transactions even if such transactions also produce tax savings. This guidance should also address transactions that would **not** be considered to be tax shelters (i.e. safe harbors). This would ensure consistent and fair application of the penalty to taxpayers. We appreciate your consideration of this issue.

Sincerely,

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JAN 14 1999

January 7, 1999

Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth
Washington, DC 20515

_X_ Per Mr. Ambrecht's request.

___ For your files.

___ Per your request.

___ Please respond to the undersigned.

Enclosed for your Penalty and Interest Study, please find a diskette and paper entitled, "Increasing Taxpayer Compliance: A Discussion of the Negligence Penalty".

If you have any questions, please do not hesitate to call our office.

Sincerely,

AMBRECHT & ASSOCIATES

By Stephanie Fry

Stephanie Fry
Staff Assistant

/sf
Enclosures

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STATE BAR OF CALIFORNIA
TAXATION SECTION[1]

INCREASING TAXPAYER COMPLIANCE: A DISCUSSION OF THE NEGLIGENCE PENALTY

This proposal was principally prepared by John W. Ambrecht and Dr. Ralph Daniel. The authors wish to thank Gregory Arnold, Ambrecht & Cummins, LLP, Santa Barbara, California for his contribution to this paper.[2]

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[1]The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

[2]Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

John W. Ambrecht
Ralph M. Daniel

EXECUTIVE SUMMARY

The United States Internal Revenue Service (IRS) has never been a popular government agency. However, it may be disliked even more now than any time in the past. Although many factors have lead to the current unpopularity of the IRS, one of the principal reasons is the zest with which the IRS asserts penalties against taxpayers. A staff report of the congressionally appointed National Commission on Restructuring the IRS concluded that penalties and interest "are often at a level where they actually are a significant disincentive for many taxpayers to reach agreement with the IRS." The IRS Commissioner himself has stated in Congressional hearings that it is time to reexamine the penalty system.[3]

Many, if not most, taxpayers make an honest attempt to comply with the virtually incomprehensible Internal Revenue Code (IRC). When told by the IRS that they not only misunderstood the IRC, but also are liable for a penalty, the typical result is a feeling of injustice, rage, and a hardened attitude toward the IRS.

There are many examples of citizen outrage against the government (not all of it, of course, directed at the IRS). At one extreme, one reads almost daily about groups and individuals who distrust the US government so greatly they are willing to live in armed isolation, refuse to pay all taxes, plot to blow up government buildings, and even murder government employees. While these individuals may act rather like rebellious adolescents, there are many reasons why they feel disenfranchised and helpless. On the other end of the spectrum, one finds highly-educated high-earning individuals who feel anger and resentment about the poor treatment they and others taxpayers receive at the hands of the IRS. They lose respect for the tax system when the IRS, justifiably or not, accuses them of inaccurate reporting, or when it applies an overly punitive sanction. This resentment reduces compliance with the tax system, and certainly has led to support for proposals to eliminate the IRS.

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[3]See the attached Santa Barbara News-Press article dated March 16, 1998 (News-Press Article). Also, see the attached letter from Ronald L. Wolfe dated March 16, 1998, to one of the authors.

This paper suggests one reform that, if implemented by Congress, could help rebuild and maintain trust and respect between taxpayers and the IRS. This reform concerns the manner in which the IRS asserts the negligence penalty.[4] We focus on the negligence penalty because it is the penalty most often asserted by the IRS, and thus is the penalty causing most of the problems.

This paper is essentially divided into in three parts. First, it generally discusses the manner in which the IRS and the courts apply the negligence penalty. Second, it briefly summarizes some of the psychological research that has been done on two fronts—taxpayer responses to the IRS, and individual responses to authority situations similar to those involving the IRS. Third, it suggests some general reforms to encourage taxpayer compliance and offers a specific proposal that may help relieve some of the tension that the negligence penalty causes between the IRS and taxpayers.

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[4]See section 6662(b)(1) and section 6662(c) of the Internal Revenue Code of 1986, as amended. The negligence penalty equals 20% of the portion of an underpayment due to negligence.

DISCUSSION

I. THE CURRENT APPLICATION OF THE NEGLIGENCE PENALTY

IRC Section 6662 provides in part that:

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

"(b) ...This section shall apply to the portion of any underpayment which is attributable to one or more of the following:

"(1) Negligence or disregard of rules or regulations ...

"(c) ...For purposes of this section, the term `Negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term `disregard' includes any careless, reckless, or intentional disregard."

Regulation section 1.6662-3(b)(1) provides in part that:

> *"(2) Negligence. The term NEGLIGENCE includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return... Negligence is strongly indicated where—*
>
> "(i) *A taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in section 6724(d)(1);*
>
> "(ii) *A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or*

exclusion on a return which would seem to a reasonable and prudent person to be `too good to be true' under the circumstance; ..."

Although omitted here, the regulations continue by discussing specific situations where the application of the negligence penalty "is strongly indicated" but *not* automatic.

Regulation section 1.6662-3 (b)(2) provides:

"(2) DISREGARD OF RULES OR REGULATIONS. The term DISREGARD includes any careless, reckless or intentional disregard of rules or regulations. The term `rules or regulations' includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. A disregard of rules or regulations is `careless' if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is `reckless' if the regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is `intentional' if the taxpayer knows of the rule or regulation that is disregarded. Nevertheless, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits."

Many tax professionals believe that the IRS routinely asserts the negligence penalty against taxpayers any time there is an underpayment of taxes, notwithstanding that section 6662 of the IRC and the regulations do not provide any basis for such a blanket assertion of the negligence penalty.[5] For

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[5]Compare Rev. Rul. 75-330, 1975-2 C.B. 496 wherein the IRS held that, "it is improper to automatically assert the negligence penalty in every case in which the accumulated earnings tax is applicable" since "a determination of negligence depends on the facts and circumstances in each case."

example, in many cases where the underlying tax law itself is not clear, the IRS still has asserted the negligence penalty only to be overruled in court.[6]

It appears that the negligence penalty is often used not only as a penalty for certain behavior, but also as "hidden tax."[7] Because the IRS uses the penalty as a way of raising tax revenue in addition to the normal means of raising revenue through the tax rates, a special conflict in the taxpayer's mind occurs that will be discussed in greater detail following.

The confusion in the taxpayer's mind is further amplified by the courts because they do not appear to offer helpful guidance or reliable interpretation of the standards for applying the negligence penalty. For example, the Tax Court's standard approach to determining whether the Commissioner's assertion of the negligence penalty should be affirmed is illustrated by the language in the *Estate of Ralph B. Campbell v. Commissioner*:[8]

"The Commissioner determined that an addition to tax should be assessed under section 6653(a), IRC 1954[9], for underpayment of tax in 1963 `due to negligence or intentional disregard of rules and regulations.' The burden of proof on this issue is upon petitioners. (citations omitted). We have found that the burden was not carried."

In other cases, the Tax Court may review the facts of the situation in more detail to confirm the appropriateness of the penalty. Although this approach may be more helpful in establishing some uniformity in the application of the negligence penalty, courts may still disagree on the import

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[6]See, for example, *Kochnasky v. Commissioner* KTC 1996-368 (9th Cir. 1996) and *Charley v. Commissioner*, KTC 1996-329 (9th Cir. 1996).

[7]See News-Press Article, footnote 3.

[8]56 T.C. 1 (1971).

[9]IRC section 6653(a) is the predecessor to section 6662(a) and (b)(1). For a discussion of the history of section 6662, see, *Korshin v. Commissioner*, KTC 1996-327 (4th Cir. 1996).

of the specific facts on negligence. For example, the Tax Court in the *Estate of Louise S. Monroe v. Commissioner*[10] said that:

"Negligence includes a failure to make a reasonable attempt to comply with the provisions of the internal revenue laws. (citations omitted).

"The determination of whether a taxpayer acted with reasonable cause and in good faith depends upon the pertinent facts and circumstances. (citations omitted) ...

"Reliance on a qualified advisor will constitute reasonable cause only if the taxpayer has acted in good faith and has made full disclosure of all relevant facts to the adviser. (citations omitted).

"Petitioner contends that it acted with reasonable cause, because it relied upon the advice of its accountants for an understanding of the requirements for a qualified disclaimer under section 2518. Petitioner argues that it reasonably concluded that Monroe was free to give the disclaimants cash gifts equaling the amounts of their renounced bequests within weeks of the execution of the disclaimers.

"Respondent maintains that petitioner may not rely on the advice of its accountant as a shield against the negligence penalty, because petitioner failed to disclose relevant information to the accountant. In respondent's view, petitioner did not rely on its accountant in good faith, because petitioner did not inform them of Monroe's cash gifts to the disclaimants equaling the renounced bequests."

The court continued:

"We are not persuaded by petitioners contention that, because the accountants told the nephew that Monroe could continue to make gifts or leave a bequest to the disclaimants, there was no reason to inform the accountants of these cash gifts by Monroe: The accountants should have been informed of

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[10] 104 T. C. 352 (1995).

these facts. We do not believe that petitioner acted in good faith reliance on the accountants."

The court continued:

"Furthermore, on brief, petitioner conceded that Monroe and the nephew were `entirely dependent upon the accountants for their understanding of the nature and utilization of disclaimers.' Because petitioner failed to disclose the material fact of Monroe's essentially contemporaneous `gift-giving' the accountants were unable to provide a fully informed opinion on whether or not the disclaimer satisfied the requirements of section 2518. We hold that petitioner is liable for the addition to tax under section 6662."

Despite the Tax Court's extensive factual discussion justifying its application of the negligence penalty, the Fifth Circuit Court of Appeals disagreed and reversed the Tax Court. This reversal is quite significant because of the rule that a Tax Court determination of negligence is a factual finding which an appellate court must review for clear error.[11]

In other words, the Fifth Circuit necessarily found clear error by the Tax Court. Such a "clear error" approach compels the conclusion that reasonable persons can differ in the application of the current standards utilized to determine the appropriateness of the negligence penalty.

For example, the appeals court in *Monroe* said in part:

"Although the Commissioner conceded at trial that the fraud penalty was inapplicable, she nonetheless argued for the imposition of a 20% negligence penalty under IRC section 6662(a). The Tax Court, rejecting the estate's arguments, concluded that the estate could not rely on the accountants' advice because Monroe had failed to disclose material facts. In particular, the Tax Court felt that without being told that Monroe intended to make gifts to the legatees shortly after the disclaimers were executed, the accountants could not properly advise him..."

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[11]See *Reser v. Commissioner*, KTC 1997-97 (5th Cir. 1997).

The *Monroe* court continued:

"The Tax Court erred...

"(N)o negligence penalty should have been or is warranted. Negligence is defined in section 6662(a) as `any failure to make a reasonable attempt to comply with the provisions of this title...' Monroe was advised by Touche Ross that gift giving to the disclaimants was allowed, as long as no promises were made to induce the legatees to renounce. Based on that advice, it was not unreasonable for Monroe, who was 93 years old at the time the disclaimers were made, to decide that the better course was to make any gifts that he wished to make sooner rather than later..."

The confusing application of the current standards concerning the negligence penalty in cases such as this as well as many others[12] is of particular concern since the IRS asserts the penalty with such frequency and in such an apparently arbitrary manner. In addition, given the fact that the negligence penalty is, in fact, a "penalty", the question must be asked, "What impact does the application of the negligence penalty have on taxpayer compliance?"

II. PSYCHOLOGY OF TAXPAYER BEHAVIOR

IRS overreaching has two effects. First, it eliminates one essential feature of any tax system—fairness. Second, it causes resentment toward the tax system which leads to a decrease in total tax collections. The first of these two effects is well known. The second is less known, but should be of great concern to Congress, since the purpose of penalties is to increase, not reduce, compliance.

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[12]See, for example, *Monroe v. Commissioner, supra, and Durrett v. Commissioner, KTC.* 1996-18 (5th Cir. 1996) where both Appellate Courts overruled the Tax Court and allowed the taxpayer to rely on the advice of a tax expert); See also *Otis v. Commissioner*, 73 T.C. 671 (1980); and *Charley v. Commissioner*, KTC 1009-329 (9th Cir. 1996).

Here, we will discuss the second of these two effects. Specifically, we will review the psychological aspects of the current tax law and its application to the IRS' apparent uniform application of the negligence penalty.

Many factors affect the way in which taxpayers respond to IRS penalties. These factors include the taxpayers' education, socio-economic status, past interactions with the IRS, and personal attributes (such as varying "degrees of locus of control"). Other factors include the degree of certainty that taxpayers attribute to sanctions, the severity of the sanctions, the social milieu regarding tax paying, and the experiences of others vis-à-vis the IRS. A review of a few of the aspects of taxpayer response in more detail is appropriate.

Locus of Control: Groenland and Van Veldhoven[13] (1983) found that "Locus of Control" can predict tax evasion (when education and occupation are controlled). Individuals with an internal locus of control generally feel they are the masters of their own destiny. Individuals with an external locus of control feel at the mercy of others. An individual's locus of control is often thought to be a life-long characteristic, but in fact it can readily change in response to the environment or circumstances surrounding an individual. War time military brain-washing, as well as the hopeless feelings of Nazi concentration camp victims demonstrate how this attitude can profoundly change.

When an agency of authority misuses its authority, for example the misuse of punitive sanctions by the IRS, there may develop a shift away from an "internal locus of control," to an "external locus of control." The individual may now perceive the authority as evil, unwarranted, or arbitrary and the individual will feel helpless and powerless.

Helplessness and Powerlessness: The psychological literature is well-documented with decades of research that indicates what happens when

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[13]Groenland, E. and Van Veldhoven, G. Tax Evasion Behavior: A Psychological Framework. Journal of Economic Psychology. 3, pp. 129-144.

individuals feel helpless and powerless (Seligman).[14] To some degree, individual responses to feeling thwarted or punished will vary according to the individual's temperament and most importantly, to his or her past experience.

When well integrated, instrumental, pro-active individuals feel thwarted or punished, they will initially get angry. These individuals will use past behavior patterns that have been effective, until those behaviors no longer work. At a certain point, these individuals will seek new behavior until they find something that works—in many cases that may involve non-compliance, the fabrication of information, and the withholding of information or tax payments. Further, when individuals feel brutalized or powerless, they may regress to child-like behavior.

Individuals who are chronically helpless will often just take whatever is "dished out" to them by authorities. This group will pay negligence penalties. If the penalty is unwarranted, the IRS's demand for a penalty will only confirm these individual's sense of the injustice of life. The result may be a greater and greater depression, ingrained helplessness, hopelessness, and passivity.

Certainly, IRS arbitrary behavior which may result in an individual's feelings of helplessness and powerlessness with either type of individuals are not desirable attributes for US citizens or taxpayers.

Professor Ronald G. Worsham, Jr.[15] discovered a profound paradox resulting from IRS procedural injustice (unfair or unreasonable penalties, overly lax enforcement for privileged individuals or corporations, etc.). "Procedural injustice which is experienced indirectly through becoming aware of another's unfair treatment increased the level of non-compliance." In other words, as citizens observe others being mistreated by the IRS, the observers become less compliant. Worsham concludes that "unfair tax enforcement procedures experienced vicariously" do lead to adverse taxpayer behavior and greater non-compliance. This is of great concern, since the unjust treatment

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[14]Seligman, Learned Helplessness. U of Pennsylvania (1970-1995).

[15]Seligman, Learned Helplessness. U of Pennsylvania (1970-1995)

of just one individual is likely to have a cascading non-compliance effect on a multitude of observing taxpayers.

Other influences also impact taxpayer compliance. For example, Furnham (1983)[16] found that individuals with a strong Protestant Work Ethic (PWE) "assigned a higher priority to freedom and independence and were significantly more opposed to taxation than low PWE subjects. This leads to the interesting observation that, although the PWE may promote some values that are well regarded in a democratic society, these values do *not* necessarily include income tax compliance."[17]

One of a few studies that measured actual tax evasion (in contrast to self-reporting regarding tax evasion), Hessing, Elffers and Weigel(1988)[18] found that the best predictor of actual tax evasion is "Alienation." These researchers stated it "has been argued that a sense of alienation from others together with generalized feelings of dissatisfaction with life and pessimism about the future increases the probability of deviance by minimizing personal concerns regarding the propriety of one's actions." The degree of alienation actually predicts the amount of tax evasion for individuals—greater alienation correlates with greater amounts of tax evasion!

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[16]Furnham, A (1983) "the Protestant Work Ethic, Human Values, and Attitudes Towards Taxation," *Journal of Economic Psychology*, 2, pp. 113-128.

[17]Jackson, B.R., and Milliron, V.C,: Tax Compliance Research, *Journal of Accounting Literature*, 1986, pp. 129-165

[18]Hessing, D, and Elffers, H., and Weigel, R. Exploring the Limits of Self-Reporting and Reasoned Action: An Investigation of the Psychology of Tax Evasion Behavior, *Journal of Personality and Social Psychology*, 54 (3), 405-413, 1988.

> *"This study of long-term tax evasion used 155 tax payers in the Netherlands. Tax returns were audited. `Among 57 individuals whose audited returns resulted in additional taxes levied of 1000 guilders (about $600), 70% denied any misrepresentation'. In this study Alienation was measured using a 9 statement scale drawn from Srole's 1956 Alienation Scale (e.g. `life is getting worse for people like me,' `you can't count on other people these days') [Srole, L. Social integration and certain corollaries. American Sociological Review, 21, 709-716]"*

These authors also found that independent measures of competitiveness were highly correlated with actual tax evasion, but not self-reports of tax evasion.

III. DOES THE NEGLIGENCE PENALTY INCREASE TAXPAYER COMPLIANCE

Learning theory tells us a great deal about the effect of penalties (called "punishments" by learning theorists.) There are two basic types of learning. The first is associative learning, often called conditioned response learning, or classical conditioning. The learning occurs when two events occur fairly simultaneously. The learning that occurs is an association—when a person experiences one of the stimuli, he or she is "reminded" of the associated event. An example of conditioned response learning occurs when someone is reminded of the good feelings associated with the odor of cooking turkey or chocolate chip cookies baking in the oven.

The second type of learning is called operant conditioning. Operant conditioning, often called instrumental learning, is based on giving a reward or punishment following some type of behavior on the part of the individual. B.F. Skinner[19] conducted thousands of studies to better understand the parameters of operant conditioning. Punishment, in the case of the IRS the use of penalties and audits, is intended to teach citizens to avoid non-compliant tax behavior, or to teach citizens to become compliant taxpayers. Most behavior modification systems are built on operant conditioning models.

Behavioral psychologists have studied the rules that govern behavior modification for many decades in this century. A basic set of learning principles have been discovered. This area of research encompasses thousands of articles, research, journals, etc. Some of the most basic principles are as follows:

- Rewards lead to more lasting behavioral change
- Rewards lead to more internalized change

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[19]Skinner, B.F. Science and Human Behavior, Macmillan, NY 1953.

- Rewards lead to greater cooperativeness and collaboration
- Rewards lead to "approach" behavior
- Punishment works by creating fear (fear = anticipation of a noxious outcome, which an individual wishes to avoid)
- The effects of punishment tend to wear off more quickly than rewards
- Punishment leads to anger, resentment, hostility, sabotage and minimal compliance
- Punishment leads to "avoidance" behavior

Tax penalties are a form of punishment.[20] The Government hopes that individuals will want to avoid these punishments, and hopefully modify their tax behavior accordingly. However, as can be seen above, this form of behavior modification is far inferior as a means of shaping the taxpayer's behavior.

The old adage, "honey will get you a lot more than vinegar" certainly applies to the positive reinforcements (rewards) and negative reinforcements (punishment, penalties) utilized by the IRS.[21] In fact, these authors are unaware of any positive reinforcements that are utilized by the IRS to encourage taxpayer compliance.

IV. GENERALIZED SOLUTIONS

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[20] *May v. Commissioner*, 65 T.C. 1114 (1976).

[21] Jackson and Milliron suggest conducting research to test whether financial rewards such as special refunds and lottery tickets for honest reporters will impact tax compliant behavior. Jackson, B.R., and Milliron, V.C., Tax Compliance Research, *Journal of Accounting Literature*, 1986, pp. 129-165.

The above research suggests various ways of improving taxpayer compliance with the tax system. Congress may wish to consider the following suggestions as a means of improving taxpayer compliance:

Conditioned Response-Social Milieu: Based on Furnham's study (1983)[22] of the Protestant Work Ethic, it is in the interest of Congress, through the IRS, to create a stronger "conditioned response" between the notion of freedom/independence and positive tax compliant behavior. This will encourage citizens to voluntarily report accurate information to the IRS, and will increase taxpaying compliance.

Use of Rewards: Congress and the IRS may want to reward "good" taxpayers by offering some form of tax reduction where the taxpayer has complied 100% with the internal revenue laws. For example, if a taxpayer has not had any changes on his or her income tax returns (1040) for say 10 years, then on the 11th year, the taxpayer would be entitled to reduce his or her tax due by 20% (or some maximum dollar amount) as a reward.

Moderate Use of Penalties: Ironically, Spicer and Lundstedt (1976)[23] in a survey of US taxpayers "... found that experience with tax audits was positively and significantly related (long-term) both to increased tax resistance and to admitted tax evasion."[24] Although tax audits do increase tax payments, this effect wears off by the third year following an audit![25]

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[22]Furnham, A (1983) "the Protestant Work Ethic, Human Values, and Attitudes Towards Taxation," *Journal of Economic Psychology*, 2, pp. 113-128.

[23]Spicer, M, and Lundstedt, S., Audit Probabilities and the Tax Evasion Decision: An Experimental Approach, *Journal of Economic Psychology*, 2, p. 303.

[24]Jackson and Milliron, *Supra*.

[25]Westat, Inc. Self-reported tax compliance: A pilot survey report. Prepared for the IRS, March 21, 1980.

Mild Sanctions: Mild sanctions may be as or more effective than severe sanctions. Schwartz and Orleans (1967)[26] argue that "taxpayers may become alienated if sanctions are perceived as too severe, resulting in general antagonism and disrespect for the law." They cite examples from moonshining during Prohibition, the burning of draft cards during the Vietnam War, and 18th century English law which required the death sentence for certain thefts over a certain magnitude, with the result that juries routinely found the theft to be for one shilling less than the threshold amount.

V. A SPECIFIC PROPOSAL—AN INDEPENDENT PENALTY APPEALS BOARD

A Proposal:

We have seen that the IRS' ability to assert the negligence penalty with impunity may lead to taxpayer hostility which can reduce rather than increase compliance with the tax system. Therefore, we believe that one step that can be taken by Congress should be to reform the current application of the negligence penalty by empowering taxpayers. Such a reform can be accomplished through the creation of a simple and inexpensive appeal process, which would counterbalance (in the taxpayer's mind) the ease with which the IRS can assert the negligence penalty and would relieve a taxpayer's feelings of helplessness and powerlessness.

Specifically, Congress could create a national negligence penalty appeal process that is independent from the IRS. The appeals process could be administered by a "Penalty Appeals Board" ("PAB"). Any time that the IRS asserted the negligence penalty, the taxpayer could immediately appeal the imposition of the penalty to the PAB. This appeal would be independent of the audit process itself, so taxpayers could obtain a hearing on the penalty issue even while the audit was still in progress.[27]

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[26] Schwartz, R. and Orleans, S. On Legal Sanctions The University of Chicago Law Review, Winter, 1967 pp. 274-300.

[27] An immediate review of the proposed negligence penalty would allow the penalty issue to be resolved

(continued...)

Ironically, the IRS has a penalty review procedure already in place albeit not "independent" from the IRS itself. However, this review process is not readily known by taxpayers, or as stated in the Internal Revenue Manual ("I.R.M."),

> *"Taxpayers are often unaware that certain penalties may be waived or abated for reasonable cause."*[28]

The I.R.M. sets forth a detailed review of the negligence penalty, abatement procedures, definitions of reasonable cause,[29] reasonable cause guidelines,[30] and reasonable cause guidance for specific situations, among others.[31]

The I.R.M. even provides that,

> *"Taxpayers have the right to challenge the assertion or assessment of a penalty, and may do so at <u>any</u> stage in the penalty process" (emphasis added)."*

Generally, tax practitioners who know of the appeals process for penalty abatement believe that the process is simply a "rubber stamp" and of no real benefit to the taxpayer.

The fact that procedures for the approval of a penalty exist in the I.R.M., albeit not generally known by taxpayers, should enable the service to easily implement the PAB process in the following manner:

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[27](...continued)
quickly so that the taxpayer would not have to agonize over the penalty during the tax audit itself and over the increased interest associated with the penalty.

[28]See I.R.M. (20) 321. *et seq.*

[29]See I.R.M. (20) 320. *et.seq.*

[30]See I.R.M. (20) 330. *et seq.*

[31]See I.R.M. (20) 360. *et seq.*

1. Each time an IRS agent asserted the negligence penalty, the taxpayer would be given a "negligence appeal form" that would be divided into two parts. The first part would list specific and standardized factors that could lead to the imposition of the penalty.[32]

2. The second part of the negligence appeal form would allow the taxpayer to explain on the form why he, she or they believe the penalty does not apply to the case.

3. After completing the form, the taxpayer would send it to a regional or national penalty appeals processing center.

4. The PAB would, in turn, send the taxpayer's appeal form back to the IRS agent who would then be given the opportunity to respond to the taxpayer's concerns. It should be a simple matter for the examining agent to comply with this requirement since the I.R.M. already requires that the agent provide for such an analysis in his or her work papers.[33]

5. The PAB would then review both the taxpayer's appeal and the IRS agent's response and make any one of three decisions:

   - the taxpayer's appeal could be denied with the written decision sent back to the taxpayer with an explanation;

   - the appeal could be granted;

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[32]See for example, Publication 1586 (8-97) where the IRS has already established such a procedure for the appeal of a penalty based on reasonable case for missing and incorrect names on tax forms.

[33]According to I.R.M. (20) 939, "the examining agent is responsible for the assertion of the accuracy penalties.... Consideration for assertion is made on all examinations and appropriate comments as to why the penalty is recommended or not recommended are mandatory on the examiner's workpapers... EMPHASIS IS PLACED ON THE FACT THAT THE EXAMINER MUST GIVE A THOROUGH EXPLANATION FOR ASSERTION OR NON-ASSERTION OF THE PENALTY."

- the decision could be delayed until the substantive tax issues are resolved.

6. If the taxpayer desired, he, she or they would be given the opportunity to discuss the matter with a member of the PAB.

7. If the taxpayer disagreed with the decision of the PAB, an appeal to the Tax Court would be made available.

A. Benefits of the Penalty Appeals Board

The establishment of a Penalty Appeals Board would have many benefits. First, there would be a standard national approach to the imposition of the negligence penalty. This would be an improvement over the current situation, where the IRS typically asserts the negligence penalty on an ad hoc basis, and where even the Tax Court and appeals courts sometimes appear to lack a clear idea of when the negligence penalty should be imposed.

Second, taxpayers would have the right to have an immediate, independent hearing (outside the IRS) without having to incur the expense of taking their case through the IRS standard appeals process and Tax Court. This would be fair to the taxpayer, since he, she, or they would not need to wait for a resolution of the negligence penalty over a many year period.

Third, and perhaps most important, IRS agents would lose the incentive to assert the negligence penalty arbitrarily. Because the actual imposition of the penalty would be out of their hands, they no longer could use the penalty as a bargaining chip. As a consequence, the IRS most probably would use the penalty more sparingly in the future, applying it only to those situations where its use was clearly justified.

Fourth, the Tax Court (and other courts) would not have to spend as much time analyzing the appropriateness of negligence penalties since the issue would more often have been resolved by a prior independent body, PAB.

B. Disadvantages of the Penalty Appeals Board

Of course, any new tax proposal has potential problems. One problem with this proposal is that it would create yet another layer of bureaucracy in the tax system, the PAB. Another problem is that at times the appropriateness of the negligence penalty is clear only after the underlying tax dispute is resolved—one can determine whether a taxpayer is negligent only after determining whether the taxpayer is liable for tax. Thus, at times the PAB appeals process would be able to commence only after the IRS and the taxpayer agreed upon the underlying tax liability, as above mentioned. This usually should not be a problem, however, as the negligence penalty typically is imposed in a situation where the tax liability is clear. In the rare situation that involves a more complicated tax situation, the PAB appeals process perhaps could not begin or, as mentioned above, would be delayed until the substantive case was at IRS Appeals or at Tax Court. However, few cases go to Appeals or Tax Court. Thus, in most cases the suggested reform would be beneficial.

VI. CONCLUSION

The current use of the negligence penalty by the IRS is presently engendering taxpayer hostility and may be contributing to less compliance by taxpayers. The IRS is perceived as applying the negligence penalty arbitrarily and in an automatic fashion. According to various psychological research data, such arbitrary IRS practice causes taxpayers to feel helpless and powerless, which in turn can lead to taxpayer anger and, in the long run, less compliance with the internal revenue laws. Of even greater concern is the vicarious anger and resentment taxpayers feel when they observe procedural injustice applied to others leading to generalized non-compliant tax behavior.

Congress needs to develop a simple and inexpensive way to allow taxpayers to appeal the negligence penalty. It is suggested that Congress consider establishing a Penalty Appeal Board (PAB) for two main purposes. First, the PAB will enable taxpayers to quickly appeal any attempt by the IRS to assert the negligence penalty. In this way, taxpayers would feel empowered to deal with the negligence penalty thereby reducing taxpayers' feelings of helplessness, powerlessness, anger, and resentment. Second, the board will help standardize the application of the negligence penalty to taxpayers in a more consistent manner.

Defending Liberty
Pursuing Justice

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March 12, 1999

MAR 1 2 1999

Ms. Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515

Dear Ms. Paull:

Attached please find the views of the American Bar Association's Section of Taxation on the issues raised in your press release of December 21, 1998 regarding penalties. We very much appreciate the opportunity to provide these comments and we look forward to sharing with you our final report on this important subject when it is completed.

Sincerely,

Stefan F. Tucker
Chair
Section of Taxation

Enclosure

cc: Mark Prater, Chief Tax Counsel Majority, Senate Finance Committee
Nicholas Giordano, Chief Tax Counsel Minority, Senate Finance Committee
James D. Clark, Chief Tax Counsel, House Ways & Means Committee
John L. Buckley, Chief Democratic Tax Counsel, House Ways & Means Committee
Charles O. Rossotti, Commissioner, Internal Revenue Service
Stuart L. Brown, Chief Counsel, Internal Revenue Service
Donald C. Lubick, Assistant Secretary Tax Policy, Department of Treasury

Serving as the national representative of the legal profession with regard to the tax system

The views expressed herein are being presented on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

These comments respond to the December 21, 1998, press release of the Joint Committee on Taxation, which requested comments from interested parties on matters relevant to the Joint Committee Staff's study of the interest and penalty provisions of the Internal Revenue Code (the Code). The comments follow a question and answer format, responding directly to the questions specifically posed in this press release. The ABA Section of Taxation's Civil Penalty Task Force[1] is presently preparing a more comprehensive study of the interest and penalty provisions of the Code, and the following comments are offered at an early point in this endeavor. Accordingly, the thoughts expressed here will not necessarily constitute the final views of the Section of Taxation.

These comments do not discuss the corporate tax shelter provisions of § 6662 of the Code because these provisions and proposed changes to them will be the subject of testimony by the Section of Taxation at a March 10 hearing before the House Ways and Means Committee.

[1] These comments were prepared by Section of Taxation's Civil Penalties Task Force, the members of which are James A. Bruton, III, Ian Michael Comisky, Miriam L. Fisher, Kenneth W. Gideon, Patrick G. Heck, Farley P. Katz, Donald L. Korb, Rajiv Madan, Charles McReynolds, Charles J. Muller, III, Pamela F. Olson, Paula D. Porpilia,

However, members of the Civil Penalties Task Force would be pleased to meet with you after this hearing to discuss this testimony and any supplementary thoughts that we may have on this important subject.

Question 1: To what extent do the present-law Federal penalty and interest provisions and the administration of these provisions by the Internal Revenue Service (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) produce inequitable results or undue hardships for taxpayers, (d) result in unequal treatment of similarly situated taxpayers, (e) result in inequitable treatment of taxpayers and other third parties such as tax return preparers or providers of information returns, (f) result in tax overpayments or underpayments because of disparities with commercial borrowing rates, or (g) result in inefficient or ineffective tax administration.

(a) and (b) Encouraging Voluntary Compliance and Deterring Noncompliance. Voluntary compliance is the self-assessment and payment of income taxes by taxpayers and compliance with other tax obligations without audit, collection action, or other direct intervention by the IRS. Social science research in this area is rudimentary, and thus one cannot be certain why taxpayers comply with the tax laws voluntarily. It seems likely that four factors are more important than penalties in encouraging voluntary compliance and deterring noncompliance. These are the ability to understand the law's requirements; a generalized belief in the legitimacy of our Federal government and its entitlement to tax its citizens and residents; fear that noncompliance will be discovered through audit, computer-matching, or other programs; and belief in the legitimacy of, and the unbiased administration of the tax laws by, the Internal Revenue Service.

In the case of individual taxpayers, we think the foregoing four factors are more

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Christopher S. Rizek, Michael I. Saltzman, Peter Scott, and Richard C. Stark (chair). Substantive contribution was

important than penalties and interest in encouraging compliance and deterring noncompliance. However, we also think that penalties and interest are important contributors to a generalized belief in the legitimacy of our tax system and the moral importance of discharging one's tax obligations, both because they signify society's disapproval of noncompliance and because taxpayers believe that they and others who fail to discharge their responsibilities will be punished if their noncompliance is detected. The precise terms of penalty and interest provisions are probably not well known among most individual taxpayers, and the deterrent effect of these provisions probably does not turn on such knowledge. Thus, simple, generally applicable provisions probably work best for this set of taxpayers and excessive complexity and fine-tuning of such provisions probably does not ordinarily have a positive compliance effect.

Corporations and others with more complex returns respond to the same concerns and beliefs as individual taxpayers. However, complexity, ambiguity, and constant change in our tax laws; greater use of professional tax advisors; and the larger sums involved all combine to provide substantially more opportunities for aggressive interpretation of the law and to increase the cost-effectiveness of doing so. Since these taxpayers generally examine issues more carefully and their self-interest is more aggressively asserted by more knowledgeable participants, the precise terms of the Code's penalty and interest provisions are more important to them, as is the existence of a realistic probability of detection.

A third category of taxpayer – both individual and corporate – is the willfully noncompliant. For this class of taxpayer, effective programs for detection and the imposition of

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also provided by James P. Holden, Phillip L. Mann, William M. Paul, and Ronald A. Pearlman.

civil and perhaps criminal sanctions is important, both to deter such conduct and to assure compliant taxpayers that the noncompliant are getting their just desserts.

Some aspects of the § 6662 accuracy-related penalty do not do a good job of deterring noncompliance. In general, § 6662 permits taxpayers to avoid the risk of penalty by disclosing uncertain positions, on the theory that IRS can then easily determine whether the taxpayer should be audited, administrative guidance issued or changed, or a legislative change requested. In recent years, Congress has removed the utility of disclosure when the position lacks a "reasonable basis" and when the position involves a corporate tax shelter. In such cases, the taxpayer usually cannot avoid the § 6662 penalty even if disclosure is made, and accordingly no incentive exists to disclose the most aggressive positions. We think the practical consequence is that many questionable positions in both individual and corporate returns are no longer disclosed, and that, given IRS's limited audit resources, these anti-disclosure provisions often have a negative impact on compliance. This situation deserves study. Eliminating the penalty when aggressive positions are disclosed would provide an incentive to advise the IRS of such issues. However, some commenters have expressed the countervailing concern that, if disclosure established an assured penalty-free situation, some nonnegligent but excessively aggressive conduct might result.

The § 6662 accuracy-related penalty and the § 6694 return preparer penalty are also poorly coordinated with each other. If a taxpayer, acting on the advice of a return preparer, takes a position that lacks a "reasonable basis," the taxpayer may be subjected to a penalty of 20%,

even if the position is disclosed. However, so long as the position is disclosed and not "patently improper," the preparer is not subject to penalty. According to Congress, "reasonable basis" is "a relatively high standard of tax reporting, that is, significantly higher than 'not patently improper.'" H. R. Conf. Rep. No. 103-213, at 669 (1993).

We think that consideration should be given to better coordinating these two provisions so that taxpayers and return preparers are governed by the same standard with respect to initial return filings, giving due regard to the preparer's dependence on the taxpayer for the relevant facts. We think particular attention should be given to the definition of the standard selected, and we are concerned about the present lack of meaningful definition of the "not patently improper" standard, since a precondition for compliance with any reporting standard is the ability to understand whether a position complies with or violates it.[2]

Additionally, a taxpayer may take a position on a return without penalty under § 6662 if the position is supported by "substantial authority, " while a preparer may advise taking such a position without penalty under § 6694 if the position has a "realistic possibility of being sustained on its merits." These standards differ slightly; and, to complicate the landscape further, each group of practitioners authorized to practice before the IRS – lawyers, accountants, enrolled agents, and actuaries – is subject both to its own professional standards and to those of Treasury Department Circular 230, while commercial tax return preparers are governed only by the

[2] A somewhat separate issue from coordination of the taxpayer and practitioner standards for the initial filing of a return is the proper standard for the preparation and filing of claims for refund. Since a claim for refund is the first step in testing a position in court, the existing differential in standards may be appropriate in this particular situation.

penalty provisions of §§ 6694 and 6695. This rather complex situation does not support voluntary compliance as well as a simpler, more uniform landscape would. For example, under the existing provisions, some tax advisers can, without fear of § 6694 penalty, counsel a taxpayer not to disclose an aggressive position, even though such nondisclosure could result in the taxpayer's being penalized. A simpler approach to these penalties would involve only two standards: one for undisclosed positions and one for disclosed positions, with the application of such standards to the practitioners appropriately adjusted to reflect the limits of the practitioner's professional involvement.[3] Ideally, such an adjustment in the statutes would occur only after consultation with practitioner groups, so that it could be coordinated to the maximum extent possible with the various groups' ethical rules.

(c) Inequitable Results and Undue Hardships for Taxpayers. The failure to deposit penalty is one obviously inequitable situation in the Code. It applies to the failure to timely deposit, in the appropriate way, employment, excise, and certain other taxes, and thus can be imposed on a deposit that is late or that is made in the wrong way (e.g., a check mailed to the IRS, rather than a deposit in a designated depositary institution). Clearly, the prompt payment of taxes withheld from wages and other amounts is very important. However, for larger deposits, the potential penalties – 2, 5, or 10% on an amount delinquent for 1, 6, or 16 days, respectively – can be completely out of proportion to the harm to the fisc resulting from modest delay. A 10% penalty for a two-week payment delay is equivalent to an interest rate of approximately 260% ; and, unlike interest, the penalty is not deductible.. A restructuring of the failure to deposit

[3] See, however, n.2, supra.

penalty may be warranted, with consideration given to adjusting the size of the penalty to reflect more closely the processing costs associated with unfavored forms of payment and the time-value costs of delayed payment, while continuing to provide an adequate financial incentive for prompt correction of the delinquency. Congress may wish to consider whether an interest charge would be more appropriate than a penalty, at least in the case of relatively modest delays in payment.

While we have only anecdotal information, in our view the greatest hardship associated with penalties arises in older delinquency cases involving individual taxpayers who have – generally through their own neglect of their tax affairs – accumulated crushing totals of unpaid tax, interest, and penalty that it is unlikely they will ever be able to pay. These hardships may often not be "undue," because the taxpayer is usually responsible both for the situation and for avoiding resolution of it. However, IRS enforcement personnel generally do not give these cases much priority until they are quite old. At this point, it becomes inordinately difficult to resolve the cases, even through the offer-in-compromise program provided by IRS and despite the attention that IRS has given in recent years to making this program more accessible and useful. We encourage IRS to continue to seek ways to help delinquent taxpayers deal definitively with their cases in a way that both supports voluntary compliance by nondelinquent taxpayers and allows delinquent taxpayers to bring their cases to a close at an earlier point in time. See also our discussion of differential interest rates, infra.

(d) Unequal Treatment of Similarly Situated Taxpayers. Administration of the tax laws

by IRS proceeds in two basic ways: Noncompliance that can be identified systemically through computer analysis generally is subjected to computer-based penalty routines. This can lead to large numbers of penalties asserted. Alternatively, noncompliance that is identified through audit is subjected to penalty as a result of the individual, case-based decisions of auditors. This results in a much smaller number of penalty assertions. Thus, for example, of the 21.3 million penalties asserted against individual income tax filers in 1996, less than 13,000 of them (on 116 million individual returns) were accuracy-related penalties , while over 21 million were systemically-asserted failure to file or pay penalties.[4] It seems doubtful either that the returns filed by individuals are essentially negligence-free or that compliance with payment obligations is so poor that one in five individual returns must be subjected to penalty. It seems more likely that most of the payment penalties function more characteristically as interest charges and that their numbers are high because they are systemically asserted, while the low number of accuracy-related penalties is attributable to relatively low audit coverage and auditors' exercise of discretion. Similar phenomena exist with other classes of returns.

While little data on which to base recommendations exist, we think that the large number of collection-related penalties indicates a flawed statutory system, since it is likely classifying as noncompliant conduct fairly marginal failures by individual taxpayers. It would seem wiser to provide economic incentives for prompt payment while reserving penalty terminology for the more egregious failures to file or pay. We think IRS should continue to encourage audit

[4] See IRS FY 1996 Data Book, Table 1 (Number of Returns Filed or To Be Filed with the Internal Revenue Service, Calendar Years 1996-2004) and Table 15 (Civil Penalties Assessed and Abated), at http://www.IRS.ustreas.gov/prod/tax_stats/soi..

personnel to exercise discretion in the assertion of accuracy-related penalties, but that audit coverage has become so light that, for most classes of taxpayer, being the subject of audit has become akin to being struck by lightning, and that the audited, noncompliant taxpayer may therefore take as a lesson from the experience that he was unlucky rather than unwise. This situation should not endure.

A more serious problem is that, even in the audit context, IRS seems to target principally the cases that are easy to find – i.e., individuals and entities that have filed returns with errors – rather than the cases that may involve more serious conduct, such as omitted income, complete failure to participate in the tax system, or other types of civil and criminal fraud. The most recent statistics available indicate that, if one is not under investigation for narcotics violations, the chances of criminal investigation are about 2 in 100,000, and the chances of actually serving time in prison is about 7 in 1,000,000.[5] The likelihood that a return would be subjected to criminal investigation has been dropping for years. One must wonder whether the incidence of criminal investigations has dropped below the level required to establish among compliant taxpayers the view that the deliberately noncompliant have a substantial risk of being caught and convicted, although we can do little more than wonder because the long-term implications of such changes in the level of criminal investigations have not been much studied and are not clear.

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[5] See IRS FY 1996 Data Book, Tables 1 (Number of Returns Filed or To Be Filed with the Internal Revenue Service, Calendar Years 1996-2004) and 21 (Criminal Investigation Program), at http://www.IRS.ustreas.gov/prod/tax_stats/soi. Dividing criminal investigations and incarcerations in 1996 by returns filed in 1996 slightly distorts the results, since the crimes involved would have been committed in earlier years.

(e) Inequitable Treatment Of Taxpayers And Other Third Parties. Issues of administrative discretion must be examined from two perspectives: that of the particular taxpayer toward whom enforcement action is directed, and that of other taxpayers who comply with our tax laws in part due to the belief that the tools available to IRS to deter noncompliance will be used. Given a set of civil sanctions with which to administer the law, the principal concern for taxpayers is whether such sanctions are administered in an evenhanded and fair way. We think that much of the frustration taxpayers experience with respect to penalties has to do with the way in which they are administered and a perception that the taxpayer does not have the opportunity to tell his side of the case to an impartial listener who will then make a decision and adequately explain the reasons for it. Automatic assertion, followed by abatement, is far less satisfactory than assertion after inquiry, because taxpayers resent being penalized first and then having to prove compliance, and because many penalties that are asserted and paid probably should never have been assessed. We acknowledge the high case loads, low salary structure, and limited training budgets available to IRS, and all of these points make it difficult for it to do this aspect of its job well. However, we think that increased effectiveness in this area is highly desirable.

(f) Disparities With Commercial Borrowing Rates. We cannot comment explicitly on the disparity between interest rates charged and paid by IRS with respect to under and overpayments and those charged and paid by commercial financial institutions because taxpayers have differing levels of creditworthiness and differing abilities to invest funds. We do think that,

in general, interest rates charged and paid on over and underpayments should be the same and should be linked to commercial rates, having due regard for the involuntariness of the Federal government's status as lender or borrower. We further think that serious thought should be given to integrating the time-value charge inherent in the estimated tax and failure to pay penalties with the interest rate charged on underpayments., We would encourage the Joint Committee to consider elimination of the so-called "hot interest" charge imposed on certain large corporate deficiencies and the differential overpayment rate for corporations, since we think the basic interest rates charged are adequate and that particular types of deficiencies should not be singled out for punitive interest charges without regard to the quality of the taxpayer's position. Finally, as discussed elsewhere, the rate structure of the failure to deposit penalty is excessive and is not related to commercial rates at all and therefore should be adjusted downwards.

As currently structured, "hot interest" in effect functions as a complicated "no-fault" penalty for large corporate taxpayers. If a "no-fault" audit addition is desirable as a policy matter – a question on which we are internally divided – it could be accomplished in a dramatically simpler fashion, by simply adding the audit charge to the deficiency and making it bear interest from the due date of the return.

(g) Result In Inefficient Or Ineffective Tax Administration. We have no further comments on this topic at this time.

Question 2: Do communications from the Internal Revenue Service to taxpayers provide an adequate explanation of why penalties and interest were imposed.

Due in large part to its antique and limited computer system, IRS's correspondence does not do a good job of explaining penalties and interest to taxpayers. Because they are issued systemically in large batches, the letters are impersonal, written to suit many different situations, and the use of only capital letters makes them hard to read. Further, some of the letters must explain complex information, such as the computation of compound interest, which many taxpayers cannot easily understand. We encourage the IRS to continue to work on the way that it communicates with taxpayers. We think the difficulties in this area are largely due to complexity in the law and superannuated technology, rather than shortcomings of the IRS in its approach to administering the law. We note that two provisions recently enacted, §§ 6631 and 6751(a), direct IRS to provide in its notices information regarding interest computations and penalty impositions. To give IRS time to implement these provisions, we think that further legislation regarding this subject is not needed at this time.

Question 3: With respect to the Commissioner's authority to waive penalties and abate interest: (a) what are the sources and scope of the Commissioner's authority to waive or not enforce penalties; (b) should such authority be modified; (c) should the Commissioner's authority to abate interest be modified, and (d) is the administration of the penalty waiver and interest abatement authority applied uniformly and fairly and what is the effect of such administration (including the effect on compliance).

(a) Source and Scope of Penalty Waiver Authority. As an administrative agency created by Congress, the only sources of IRS authority to waive penalties are the federal statutes. If a statute does not provide waiver authority to IRS or limits it, presumably such authority does not exist. In general, the tax statutes provide IRS the authority to waive penalties based on a finding of the existence of "reasonable cause" and that the taxpayer acted in "good faith." See, e.g.,

§ 6664. A finding by IRS that reasonable cause does not exist is generally reviewable in federal court either de novo or for the abuse of administrative discretion. In general, this statutory approach works reasonably well, since IRS and the courts can take into account the particular circumstances of each case to determine whether a waiver is warranted. Such flexibility is important, since a penalty statute cannot incorporate all of the mitigating factors that might arise.

(b) Modification of Penalty Waiver Authority. We think that a modification of waiver authority would be desirable in circumstances in which IRS is not permitted to exercise its administrative discretion to make a waiver decision. In circumstances in which IRS is required to impose a penalty based on objective criteria and is not allowed to take into account extenuating circumstances, there is a potential for inequitable treatment. We suggest that Congress consider whether all such situations be eliminated, so that IRS invariably has the administrative discretion to waive a penalty for reasonable cause. An example of a situation in which IRS does not have adequate discretion is § 6662(e), which imposes penalties on transfer pricing adjustments unless the taxpayer has adequate contemporaneous documentation and makes it available to IRS within 30 days of a request. Congress has specifically withheld from IRS discretion to abate this penalty for reasonable cause. Thus, for example, if the taxpayer is a week late in its documentation or produces it to IRS on the 31st day after request, the statute prohibits IRS from granting a waiver. We suggest that the rigidity of this regime be revisited.

(c) Modification of Interest Abatement Authority. For many taxpayers, interest imposed on deficiencies simply reflects an appropriate time-value charge for what constitutes, in effect, a

loan from the U.S. Treasury. For other taxpayers, particularly those who have no savings, an interest charge may be perceived as akin to a penalty. We think abatement of interest is a subject that should be approached and dealt with gingerly. We also note that substantial changes were recently made to § 6404, which deals with the abatement of interest. We think that these changes should be given time to work and that any further changes in interest abatement authority should be delayed for the time being, since the great bulk of taxpayers who pay their tax bills on time are entitled to expect that those who do not will pay an appropriate charge for their delay.

(d) Administration and Effect of Waivers and Abatements. We have no further comments on this subject at this time.

Question 4: Should certain provisions of the Internal Revenue Code be clarified to identify whether they impose a penalty or a tax.

Certain failures to pay tax and estimated tax in a timely way result in additional charges that grow over time. These charges – the estimated tax penalty of §§ 6654 and 6655 and the failure to pay penalty of § 6651(a)(2) and (a)(3) – are classified as penalties, rather than as tax or interest. They constitute a disproportionate share of penalties assessed. For example, in 1996 (the last year for which information is available on IRS's website), these two penalties made up about 86% of the 21.3 million penalty assessments against individual income tax returns and about 81% of the 767 thousand penalty assessments against corporate income tax returns.[6] Categorizing these charges as penalties, as current law does, helps establish the normative nature of the obligation to pay one's tax liability timely. However, these charges clearly have a strong

[6] See IRS FY 1996 Data Book, Table 15 (Civil Penalties Assessed and Abated), at http://www.IRS.ustreas.gov/prod/tax_stats/soi..

interest element to them (in the case of the estimated tax "penalty," the rate is the same as the interest rate), and many taxpayers view them as interest charges.

By recategorizing these charges as "interest", over 80% of all penalty assessments would be eliminated. However, such a recategorization should be approached with some caution because at present different and more stringent rules apply to discretionary waivers of interest. Further, failing to pay one's actual or estimated liability on time is in fact noncompliant conduct, and penalty terminology tends to support the thought that late payment is "wrong," while interest terminology does not. A third alternative might be to adopt the "late charge" label used by credit card issuers. Such an approach would allow tailored waiver rules, recognition of the fact that the Government is also collecting deficiency interest on these late payments, and reservation of the "penalty" terminology for more serious transgressions.

Certain conduct by exempt organizations and employee benefit plans may be subject to "excise taxes" that, in effect, operate as penalties. In our view, the terminology used to describe such charges is of little importance.

Question 5: How do the Federal penalty and interest provisions compare to penalty and interest provisions of voluntary tax systems of other countries.

We have no comment at this time on this question.

Question 6: Should different entities be subject to different penalty regimes and should such different regimes be determined by reference to the four operating units in the Commissioner's restructuring plan for the Internal Revenue Service.

The fundamental tax obligations of a U.S. taxpayer – to keep books and records, file returns and statements, and pay tax liabilities – should, in our view, be enforced and administered in a uniform fashion. Such responsibilities gain moral weight only if they are defined and enforced consistently. Taxpayers would not naturally compartmentalize their affairs depending upon the particular IRS operating unit having jurisdiction over the particular return, and a multiplicity of penalty regimes and behavioral standards for fundamental responsibilities would, in our view, be confusing and counter-productive for practitioners (who would often represent taxpayers under more than one operating unit) as well as taxpayers.

This is not to say that different types of taxpayers do not have different types of responsibilities or present different types of challenges to IRS or that IRS should not respond to such challenges in context-specific ways.

Question 7: What specific recommendations can be made on ways to (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) align the structure of the penalty and interest provisions with the pending reorganization of the Internal Revenue Service, (d) simplify the present-law penalty and interest provisions, (e) make the administration of penalty and interest provisions more efficient and effective, and (f) reduce inequities and burdens of taxpayers who are (or may be) subject to the penalty and interest provisions.

(a) Encourage Voluntary Compliance and Deter Noncompliance. In addition to considering the comments provided above with respect to other penalties, some attention should be given to information return penalties of §§ 6721-24. These penalties, which encourage financial institutions and others to provide Forms 1099 and other similar forms to taxpayers, generally seem to perform their function reasonably well. However, we perceive a few issues

that might be addressed. First, IRS in its enforcement programs probably relies excessively on computer generated notices (thus focusing on modest failures in the accuracy of what is reported to them) and perhaps too little on audits and other activities that might identify those who are not trying to comply with the law.

Secondly, IRS does not routinely communicate with filers regarding errors in information returns if it has determined not to impose a penalty, thus allowing inadvertent errors from one year to be perpetuated in the next, when the aggregate may merit a penalty. A more proactive annual approach to management of the accuracy of the information and less reliance on somewhat sporadic penalty assertions might establish a better working relationship with payors and establish a better working dynamic rather than the necessarily negative one generated in the context of penalty assertions and abatements.

Thirdly, requests for waiver of information penalties from payors tend to be handled differently, with different levels of factual detail required, depending on the office to which the request for waiver is made. Consideration might be given to ways to make the procedures for requesting an abatement more uniform.

Fourthly, as presently administered, payors have relatively little incentive to voluntarily correct errors discovered after the due date of the information returns, because penalties are imposed even if the taxpayer voluntarily provides corrections relatively promptly. IRS should consider whether those who voluntarily correct information returns within a few months after the due date for the original returns should receive some sort of penalty relief.

Finally, a few information returns (Forms 5498, 5498-MSA, and 1099-MSA, and certain Forms 1000-R (those for education IRAs)) are subject to penalty regimes different from those to which other information returns are subject. Consideration should be given to whether the statutory penalties applicable should be conformed to those applicable to other information returns.

(b) Alignment with Pending Reorganization. Our initial view is that the administration of penalties should be consistent across the new divisions within IRS, with departures from this consistency overseen centrally and permitted only based on strong evidence that, given differences in the classes of taxpayers served, such a departure is needed to support voluntary compliance. Unless strong central control is preserved, we are concerned that there will be a potential for the administration of sanctions to drift separate ways for unimportant or irrelevant reasons, and we think that care should be taken to prevent such unnecessary complications and possible inequities.

(c) Simplification of Penalties and Interest. We have discussed possible simplifying actions above; we have no further comments on this subject at this time.

(e) More Effective Administration of Penalties and Interest. See our comments elsewhere in this submission.

(f) Reduce Inequities and Burdens. In the area of federal deposit penalties, one problem that might be addressed is "snowballing." IRS's computer routines apply federal tax deposits to the earliest deposit due. If a single deposit is omitted, this algorithm causes a deposit penalty to be imposed with respect to every subsequent deposit until the omitted deposit is paid. We

understand that it is now IRS policy to grant relief with respect to the subsequent deposit dates by matching each date with the intended deposit. However, we also understand that it will not be possible to reprogram IRS's computers to fix the snowball effect systemically until the year 2001. While IRS is working on this issue, it might nevertheless be helpful to provide legislative direction regarding how these systemic problems should be handled in the interim.

A second issue that might be dealt with is the application of federal tax deposit penalties to situations in which the taxpayer is required to use the Electronic Federal Tax Deposit System (EFTS). As the IRS requires certain taxpayers to use EFTS for all applicable taxes, a variety of issues are likely to arise, due to the complexity of such taxpayers' tax situations, the early time at which EFTS deposits must be initiated, and the size of potential deposit penalties. For example, when payrolls are paid late in the day, situations can arise in which, in order to avoid penalty, a large employer must actually initiate a deposit of payroll taxes before it pays its employees. This seems an excessively stringent regime.

A third issue with respect to deposit penalties is the complexity of the deposit regime for fuel taxes, some of which must be deposited on a 9-day cycle and some of which must be deposited on a 14-day cycle. Although these taxes are reported on a single excise tax return, deposits attributable to one class of fuel excise tax cannot be applied to the other class of fuel excise tax or to other taxes reported on the same form. This walling off of one class of deposits from another, even though all are reported on the same return, seems arbitrary, particularly when

a 10% penalty can result. Deposits of tax under the excise tax payment procedures are far too complex.

Question 8: Any other matters that may be relevant to this study.

We have no further comments at this time.

American Council of Life Insurance

February 26, 1999

FEB 2 0 1999

Lindy L. Paull, Esquire
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: Joint Committee on Taxation Press Release 98-02
Interest and Penalty Study

Dear Ms. Paull:

We are writing on behalf of the American Council of Life Insurance in response to JCT Press Release 98-02 which indicates that comments are being sought from the public on a number of issues relating to the administration and implementation by the Internal Revenue Service (the "Service") of the interest and penalty provisions of the Internal Revenue Code. The 493 member companies of the American Council of Life Insurance have 77.3 percent of the life insurance in force in the United States in legal reserve life insurance companies. Their assets represent 82.3 percent of all United States life and health insurance companies and 83.7 percent of the pension business with such companies.

In reviewing the issues noted in the press release, our members would like to submit the following comments.

Penalties Related to Information Returns: Our member companies file a substantial number of information returns, including Forms 1099-INT, 1099-R, 1099-LTC, and 1099-MISC. In filing these returns, the companies make extensive efforts to obtain the correct name and matching taxpayer identification number (TIN) and to otherwise comply with reporting and withholding obligations. At times, however, the name and TIN do not match, resulting in an assessed penalty to the company filing the information return. While assessed penalties can be and generally are waived upon a showing of reasonable cause by the Taxpayer filing the information returns, the waiver process is costly and time consuming for both the Taxpayers and for the Service.

Currently, we understand that the Service has a policy of not assessing a proposed penalty if a company is in significant compliance with the information reporting requirements. Based on our member companies' experiences, this significant compliance standard is considered to be met as long as 99.5% of the returns are correct. Thus, there is an informal "safe harbor" of .5%.

While we appreciate the Service's need for correct information returns, we believe that this standard is excessively stringent.

There have been legislative proposals in recent years to formalize and increase such a "safe harbor." We suggest that the Service issue guidance providing for a formal safe harbor of 5% so that as long as 95% of a company's information returns are correct, no penalty would be assessed. Increasing the threshold will not discourage any company from undertaking reasonable efforts to obtain the correct name and TIN or otherwise meet its reporting and withholding obligations. It will ease the burden to Taxpayers and the Service in applying for and processing waivers of proposed penalties.

Based on substantial experience in complying with reporting and withholding requirements, our member companies believe that there should be a presumption that financial intermediary payors (information return filers) have "reasonable cause" for errors made in information reporting. Based on the large number of information returns filed by financial intermediaries, inadvertent errors are inevitable and it should be presumed that they are not intentional. Companies filing information returns spend substantial amounts to establish and maintain systems and procedures to correctly report and withhold. The reporting and withholding by financial intermediaries assist the government in the orderly collection of tax revenue. Information reporting and withholding by financial intermediary payors should be viewed as a partnership enterprise between the government and the payors. Penalties for failure to fulfill reporting and withholding obligations should only be assessed in the event that a payor has clearly failed to exercise reasonable cause.

TIN Validation Program: Our member companies responsible for filing information returns obtain the name and TIN from their policyholders and payees. Currently, they have no method of validating that the name and TIN provided are correct prior to the filing of an information return. If there is an error, the Service advises them after the returns have been filed. The notice of an incorrect name/TIN is often accompanied by a proposed penalty notice for filing an incorrect information return. In many cases, the Service does not advise the Company of an error for a number of years after the return has been filed. In the case of returns filed annually, the company may have filed multiple information returns with an incorrect name or TIN by the time it is notified of the error.

Were companies able to check whether the name/TINs were correct prior to filing their information returns, they would better be able to contact the affected policyholders or payees to obtain the correct information. In a two-year pilot application, the Service permitted some name and TIN verification. It is our understanding that information filers were in favor of this program and have requested that the Service institute a broad-based name/TIN matching system. We suggest that a name/TIN verification program for information return filers be instituted to reduce the number of incorrect information returns. This would result in a saving of resources for both the Service and information reporters.

Changes in Information Reporting and Withholding Obligations: As a general matter, our member companies are concerned that the substantial additional computer systems and administrative costs imposed on them as payors are not adequately considered when there are changes in withholding and information reporting obligations. In a real sense, these additional costs are a "tax" on payors; ultimately, this tax is taken into account by companies in determining the amounts that they can pay to policyholders. In this regard, we urge that Congress, the Department of the Treasury and the Internal Revenue Service coordinate with the payor community and seriously consider the administrative costs imposed on payors prior to revising or adding to our reporting and withholding responsibilities.

IRS Communication with Taxpayers: Our members report that certain communications, including penalty notices, from the Service lack adequate explanation as to the nature of the issue raised by the Service and the actions that may be taken by the Taxpayer. Taxpayers have indicated that when they contact the Service for additional information, the contact person noted on the communication often has no further information than that provided in the original communication and is unable to assist the Taxpayer in resolving the issues raised by the communication. For example, certain penalty notices for incorrect information returns have been issued without identifying the reportedly erroneous return; when the Taxpayer contacts the Service for more information, the Service has been unable to identify the information return to which the penalty relates. In the end, the Taxpayer cannot respond to the proposed penalty notice. There have also been instances in which a Taxpayer believes that an issue has been resolved based on a telephone conversation with a Service representative, only to find later that not only does the issue remain unresolved, but that the Service records do not reflect the conversation with the Taxpayer.

We suggest that the Service provide background documentation in all communications to a Taxpayer in order to explain and support the issue raised. In addition, we suggest that the Service provide the contact name of the person who initiated the communication and who is familiar with the issues raised therein. In addition, Taxpayers who contact the Service with respect to a communication should be able to affirmatively rely on the representations made by the Service representative during this contact. As to situations in which the Taxpayer has contacted the Service concerning an undocumented communication, the Service should not assess penalties or interest during the time that the Taxpayer is working to obtain information necessary to resolve the issue.

Changes of Address: Several of our member companies have experienced situations in which the Service has changed the Taxpayer's name or address when the Taxpayer has not requested that such a change be made. For example, a corporation provides its address on Form 1120; subsequently, a communication is sent to the Service concerning the Taxpayer, either from a division of the Taxpayer at a different address, or from an outside representative. Taxpayers have found that the Service has changed the address of the Taxpayer in its records to that of the correspondent, with no instruction to do so. Once the address is changed, there have been cases

in which the Service has sent future correspondence on unrelated matters to the new, incorrect, addresses. This incorrect mailing often delays Taxpayers' responses to Service correspondence. In other situations, Taxpayers have filed consolidated returns in the name of the corporate parent with the proper taxpayer identification number; subsequently, a communication is made to the Service concerning the return which notes the name of a subsidiary of the parent, with the parent's taxpayer identification number for reference. Taxpayers in this situation have found that the Service has changed the name of the corporate parent in its records to that of the subsidiary, again, without any instruction to do so.

In order to alleviate these inadvertent changes of name and address, we suggest that the Service be permitted to change its records of a Corporate Taxpayer's name or address only in one of three situations: (1) filing of a Form 1120 with a new name or address, (2) specific request on a Form 8822 or similar letter from the Corporate Taxpayer, or (3) the Service otherwise has actual knowledge of a change in name or address of the Corporate Taxpayer and advises the Taxpayer that the Services records are being changed.

Uniform Taxpayer Contacts: Our members report that, in some cases, the Service sends communications to various departments within the same corporation. Taxpayers have difficulty in timely responding to these communications when they are mailed to different locations or departments. In addition, the Service may not be aware in each situation as to the specific department within a corporation where any given correspondence should be sent and may select an incorrect department, thus delaying the Taxpayer's response.

As a means to centralize communications between the Service and Taxpayers, we suggest that Taxpayers be offered the ability to designate a corresponding officer within the company to receive either all of the Service's communications to the Taxpayer or all of a certain type of communications (such as all employment tax matters). Once the Taxpayer had made this election to designate a corresponding officer, the Service would be required to send all communications to this corresponding officer. There may be situations in which certain communications were sent to counsel for the Taxpayer pursuant to a power of attorney; once a designation is made, a copy of the original communication should also be sent to this corresponding officer. This designation could be made annually on the Form 1120 or Form 851, Affiliations Schedule. If a designation was made, the Service could be assured that its communications would be forwarded to the proper party.

Service Transfers of Tax Payments: Our member companies have indicated that the Service has, without their consent and often without notice, transferred funds between amounts paid to satisfy corporate income tax (Form 1120) obligations and those deposited with a Form 941, Form 945, or Form 1042 to satisfy income and employment tax obligations. That is, a Taxpayer who has made a Form 941 deposit may find that the Service has transferred the funds to the Taxpayer's 1120 account, with the result that there are insufficient funds in the Form 941

account. Insufficient funds in a Form 941 account can result in a penalty for failure to make adequate deposits.

We suggest that the Service be prohibited from transferring funds between different Taxpayer accounts absent specific consent by the Taxpayer. This prohibition will avoid the assessment of improper penalties for failure to make adequate deposits when in fact the deposits were timely made, but the funds were transferred by the Service to a different account. In the event that a prohibition is not feasible, we would suggest that, at a minimum, the Service be required to provide advance notice when funds are to be transferred among accounts. If amounts are transferred without consent or advance notice, the Service should be prohibited from assessing any penalties or interest which may arise due to a deficiency in any account from which funds were transferred.

Global Interest Netting: We note that since 1986, penalty provisions have been strengthened substantially to discourage inappropriate behavior. Because of the broad reach of the current penalty provisions, the time is ripe to equalize the overpayment-underpayment rates of interest to eliminate "hot" interest. The statutory interest rates should favor neither the Taxpayers nor the Government. While we understand that this problem was addressed as part of the IRS Restructuring and Reform Act of 1998 and the enactment of global interest netting provisions, these provisions are complex and do not completely resolve the problems caused by the interest rate differentials. We suggest that consideration be given to equalization of the interest rates. Absent such as equalization, our member companies have indicated that guidance is needed on the application of the global interest netting provisions, especially with respect to their applicability to pre-1999 tax years.

Disclosure and Penalties: Currently, Taxpayers are encouraged to disclose on their tax return items or positions that are not otherwise adequately disclosed on a tax return. Under section 6662(d)(2)(B) of the Code, if this disclosure is made, the Taxpayer may avoid the imposition of certain accuracy-related penalties. Disclosure does not reduce penalties, however, for items which are defined as "tax shelters." A tax shelter is broadly defined as "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax."

It should be clarified that this broad definition of tax shelter does not include tax planning which has as its result the reduction of Federal income tax. While Taxpayers may not evade tax, they are certainly able to arrange their affairs with the result that their tax burden is lower. Guidance is needed as to the distinction between whether a position is a result of tax planning or whether it is a result of a tax shelter transaction. In addition, for taxpayers who separately disclose positions under section 6662(d)(2)(B), there should be a presumption that the position taken is *not* taken to substantially understate taxes and should not be subject to penalties. This

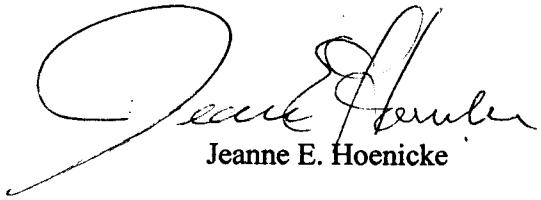
presumption will encourage Taxpayers to disclose their tax planning and will facilitate the Service's auditing of these returns.

Penalty Modification: Our members have reported varying experiences with respect to the ability of Service examining agents to adjust certain penalties during the examination process. In some districts, examining agents have indicated that they can modify penalties; in others, examining agents report that they are unable to do so. The ability to modify a penalty should be available at all levels of the administrative process. There are situations where an assessment could be accepted by a Taxpayer were penalties modified at the examination level. Often, when the penalties are not modified, the Taxpayer requests that the case be transferred to the Appeals Division of the Service. At this higher level, the penalties may be and often are modified, with the result of acceptance by the Taxpayer of an adjustment to the return. Were the ability to modify penalties available at the examination level, certain cases would not need to be referred to Appeals process. Thus, disputes could be resolved with use of fewer resources both by the Service and by the Taxpayers.

Estimated Tax Penalties: Taxpayers are subject to penalties for failure to pay the proper amount of estimated taxes. Under the current penalty structure, there is no exception to this penalty for underpayments which are due to erroneous estimates of investment return when that error is caused by market volatility. For example, a Taxpayer's capital gains will fluctuate each year depending on interest rates, asset performance and other market conditions. While Taxpayers make their best estimates of what their ultimate investment income will be and appropriately pay estimated taxes on this good faith estimate, in some years, this estimate will be different from the actual amount of income. As result of this discrepancy between the amount which the Taxpayer believed should be paid as estimated tax and the ultimate tax liability, Taxpayers may become subject to the penalty for underpayment of estimate taxes. We suggest that the penalty rules provide for an exception to the application of the underpayment penalty when the underpayment of estimated tax is due to unanticipated income as a result of market fluctuations.

In summary, the member companies of the American Council of Life Insurance support the review of the administration and implementation of the penalty and interest provisions of the Internal Revenue Code. Our member companies, both as corporate Taxpayers as well as information reporters, would like to work with you toward efforts to simplify penalty and interest administration and to reduce Taxpayer burdens. Thank you for your attention to these issues.

Sincerely,



Jeanne E. Hoenicke

Laurie D. Lewis

Delivered by Messenger

March 2, 1999

MAR 02 1999

Ms. Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515-6453

Mr. Charles A. Hall
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:DOM:CORP:T:R:IT&A (Branch 4)
Room 5228
Washington, DC 20044

Dear Ms. Paull and Mr. Hall:

Thank you for requesting suggestions and comments for consideration in connection with your studies reviewing the administration and implementation of the penalty and interest provisions of the Internal Revenue Code. We welcome the opportunity to explain our concerns and to provide you with our recommendations for improving the penalty and interest system.

Our comments are based on our continued belief in the philosophy embraced by the *Improved Penalty Administration and Compliance Tax Act of 1989*, that the purpose of penalties is to encourage compliance, not to raise revenue. We urge Treasury and Congress not to alter that philosophy.

Set forth below is an "Overview," containing our overall comments and recommendations regarding the penalty and interest provisions of the Code and their administration. Following the "Overview" is a "Response to Request for Comments," containing our specific responses to the issues on which you requested comments. Please note that as we developed these comments we considered only the penalty and interest provisions currently in the Internal Revenue Code. Therefore, these comments do not take into account the Administration's recently proposed changes to the penalty structure.

Overview

We believe that, in general, the penalty and interest provisions of the Code are designed to promote voluntary compliance. The current administration of those provisions, however, often does not meet that objective. Currently, the provisions are applied inconsistently to similarly situated taxpayers. The resulting inequity undermines voluntary compliance. In addition, the current administration of the provisions is unduly burdensome to affected taxpayers, tax practitioners, and the IRS.

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Factors Contributing to Problems with the System

Factors contributing to the current problems with the administration of the penalty and interest provisions include:

1. Complexity of the tax law;

2. Complexity of the penalty and interest provisions, including the subjective nature of the reasonable cause exception to penalties;

3. Poor communication with taxpayers regarding the nature and method of computing penalties and interest, actions necessary to avoid penalties and interest in the future, and the ability to seek an abatement or adjustment; and,

4. Lack of training and insufficient communication of policy within the IRS regarding such issues as:
   - the appropriate assessment of penalties and interest;
   - the prohibition on using the threat of penalties as a bargaining chip in negotiations;
   - the proper application of the reasonable cause exception; and,
   - the proper method of calculating interest.

Recommendations

In the *Internal Revenue Service Restructuring and Reform Act of 1998*, Congress directed the Internal Revenue Service to revise its mission to "place a greater emphasis on serving the public and meeting taxpayer needs." The Internal Revenue Service has complied by adopting the following mission statement:

> Provide America's taxpayers top quality service by helping them understand and meet their responsibilities and by applying the tax law with integrity and fairness to all.

If the IRS applies this mission statement to the administration of the penalty and interest provisions, most of the above-listed factors contributing to the problems with the current penalty and interest system should be addressed. The IRS has the authority, if not the means, to address most of the factors. Congress needs to address the other factors, such as complexity in the law. Congress also needs to provide adequate support to the Service to enable it to make the administrative changes needed.

We recommend the following steps be taken to address the factors contributing to problems with the current system:

1. Complexity of the Tax Law. With respect to the complexity of the tax law, Congress needs to give more than rhetoric to simplification of the Internal Revenue Code, both with respect to the current provisions of the Code and with respect to any new proposals. Congress has directed the IRS to place greater emphasis on serving the public and meeting taxpayer needs. Congress should hold itself to the same goals, acknowledge that, given the current state of the tax law, it has failed in achieving those goals, and then do something about it.

If Congress wants to serve the public, meet taxpayer needs, and encourage voluntary compliance, it should provide the citizens with a tax law that is more understandable and easier to comply with.

Recommendation Regarding Complexity of the Tax Law. The *Internal Revenue Service Restructuring and Reform Act of 1998* directed Treasury, the Joint Committee, and the Internal Revenue Service to address the problem of complexity of the tax law, through the use of a tax complexity analysis for new legislative proposals and through an annual analysis and report to Congress by the IRS indicating the sources of complexity and recommendations for simplifying the tax law. We urge each to earnestly work toward simplification by implementing both the letter and the spirit of the 1998 Act provisions.

2. Complexity of the Penalty and Interest Provisions. Virtually all the penalty provisions in the Code can be abated upon a showing of reasonable cause for the failure that gave rise to the proposed penalty. The subjective nature of the reasonable cause exception, however, makes the application of the penalty provisions confusing, and, in many cases, unduly burdensome and inconsistent.

Recommendation Regarding Penalties: Safe Harbors for Reasonable Cause Exceptions. We recommend that safe harbors be established that would be deemed to constitute reasonable cause for a variety of penalties. This would facilitate equal treatment of similarly situated taxpayers. Further, use of safe harbors would reduce burden on both taxpayers and the Service by eliminating the need for an assessment, a request for abatement, a review of the facts and circumstances to ascertain the existence of reasonable cause, and, finally, the actual abatement. The safe harbors could be structured to encourage voluntary compliance by making them available only to taxpayers that have a history of compliance. (Throughout this document, we propose the use of safe harbors for the reasonable cause exception to penalties. See Exhibit A for a more detailed discussion of this proposal.)

Recommendation Regarding Interest: Simplification. With respect to the interest provisions, some interest computations are so complex even the IRS computers cannot perform them correctly. The rate structure is such that it is possible for a taxpayer to have five different interest rates apply with respect to overpayments/underpayments for the same taxable year. Further, there can be several interest-free periods in a taxable year, to the benefit or detriment of the taxpayer. Simplification obviously is in order.

3. Poor Communication with Taxpayers. Currently, a taxpayer can receive a penalty notice that does not tell the taxpayer what penalty is being asserted, how the penalty has been computed, or what can be done by the taxpayer to avoid incurring the same penalty in the future. Similarly, a taxpayer can receive a notice of interest that does not tell how the interest has been computed. In addition, a taxpayer may not be notified of the possibility that penalty and interest can be abated.

Recommendations Regarding Penalty and Interest Notices.

- Indicate the specific penalty being asserted (name and Code section) and how the penalty has been computed. (Note: Code section 6751 requires this for notices issued and penalties assessed after 12/31/2000. We urge implementation as quickly as possible, rather than waiting until 2001.)
- Indicate the Code section under which the interest is being imposed and how the interest has been computed. (Note: Code section 6631 requires this for notices issued to individual taxpayers after 12/31/2000. We urge (1) implementation as quickly as possible, rather than waiting until 2001; and, (2) making this requirement applicable to all interest notices, not just those issued to individual taxpayers.
- Draft notices in simple and concise language that taxpayers can easily understand.
- Include an explanation of the procedures for requesting an abatement of the penalty and/or interest.
- Include a simple explanation of how the taxpayer can avoid imposition of the penalty and/or interest in the future.
- Create a "penalty hotline" to provide taxpayers with information about the specific penalties asserted and the procedures for requesting an abatement; include the phone number for that hotline in each penalty notice.
- To lessen the administrative burden on taxpayers, tax practitioners, and the IRS, allow tax practitioners to discuss a notice and its related account with the IRS without a power of attorney, if the practitioner provides the IRS with a "Personal Identification Number" given on the notice sent to the taxpayer.

4. Lack of Training and Insufficient Communication of Policy Within The IRS. Training of IRS personnel and improved communication of the Service's policies within the Service are vital to improving the administration of the penalty and interest system. Currently, there are inconsistencies between and within Service Centers and Districts regarding some of those policies.

Recommendations Regarding Training and Communication

- Appoint one individual to be the "Penalty Administrator" for all operating divisions of the modernized IRS.
- Make a thorough review of all internal policies regarding the penalty and interest provisions and remove any inconsistencies.

- Train all affected IRS personnel in the policies, including the definition of "reasonable cause" and the policy that penalties are not to be used as bargaining tools.
- Perform periodic reviews to ensure the policies are being complied with.
- Communicate any changes in policy to all affected personnel.

Voluntary Compliance System as a Cooperative Effort

To operate effectively, this country's voluntary compliance tax system requires a cooperative effort on the part of Congress, the IRS, and taxpayers. Congress needs to provide a tax law that is readily understandable, easy for the taxpayer to comply with, and easy for the IRS to administer. The Service needs to assist Congress in this effort, by providing Congress with input on proposed legislation's probable impact on the ease of compliance and administration and by making recommendations for simplifying current provisions. The Service also needs to assist taxpayers' understanding of the tax provisions applicable to them and how to comply with those provisions. Taxpayers must honestly and responsibly comply with the applicable laws.

The purpose of the penalty provisions is to encourage voluntary compliance by taxpayers. Since voluntary compliance is a cooperative effort, however, penalties should not apply to taxpayers if the cause for their noncompliance is due primarily to action or inaction by Congress or the Service. Given the current complexity of the tax law, it is unfair to impose a penalty on normally compliant taxpayers who make an occasional innocent mistake. Use of safe harbors for the reasonable cause exception to penalties would minimize that injustice.

Response to Request for Comments

The following are our specific responses to the issues on which you requested comments. You will note that there is significant overlap of this material with our comments and recommendations in the preceding section. We have provided the following in the format of the request to assist you in compiling responses to your request for comments.

Encouragement of Voluntary Compliance

We believe that the current penalty and interest provisions of the Code generally encourage voluntary compliance for the vast majority of taxpayers despite the fact that noncompliance exists for a relatively few. Most taxpayers seek to avoid penalties and interest, although they may not understand exactly what specific penalties may be imposed against them or precisely how the penalties and interest are calculated.

In contrast to our views on the penalty and interest provisions themselves, we believe the Service's administration of those provisions probably does not encourage voluntary compliance. Automatically-generated notices that are based upon mathematical computations (e.g., notices

issued for the underpayment of estimated tax, failure to file, and failure to pay penalties and for interest) generally encourage voluntary compliance; individuals fear their receipt and, therefore, endeavor to comply with the tax laws to avoid receiving them. Beyond the issuance of those notices, however, the Service's actual administration of the penalty and interest provisions frequently does not engender voluntary compliance.

Virtually all of the penalty provisions in the Code can be abated based upon a showing of reasonable cause for the failure that gave rise to the proposed penalty. The reasonable cause exception is an essential foundation of the penalty regime and IRS personnel clearly must have the authority to determine whether a taxpayer has established reasonable cause for abatement of a penalty. However, the reasonable cause standard, which by its nature is a very subjective standard, oftentimes is applied inconsistently by the Service, both between and within Service Centers and Districts. Similarly, inconsistencies exist in the manner of computing interest. As a result, similarly situated taxpayers are treated differently.

Such disparate treatment does not encourage voluntary compliance. The experience of our members shows that typically, the effect of inconsistent treatment is misunderstanding and resentment on the part of taxpayers. These sentiments often have a negative effect on compliance. We believe that, through the establishment of safe harbors for reasonable cause and through better training of IRS personnel, such inconsistent treatment, and the effects thereof, can be mitigated.

Efficient and Effective Tax Administration

As designed, the penalty and interest provisions are difficult for the Service to administer. While purely mechanical penalties appear to be relatively easy to administer, most penalties can be, and should be, abated upon a showing of reasonable cause. In order for the Service to determine whether reasonable cause exists to abate a penalty, Service personnel must review the facts and circumstances of the case. This procedure is neither efficient nor effective. The system can be made more efficient, however, with the creation of safe harbors that would allow a taxpayer to objectively establish that the reasonable cause exception should apply. Safe harbors would also result in more consistent application of the reasonable cause exception, which, in turn, would make the penalty regime more effective.

While the concept of the time value of money is relatively simple, the interest provisions in the Code are extremely complex. This complexity makes their administration very difficult and challenging. In many instances, Service personnel must calculate interest manually because the IRS computer systems are not capable of correctly applying the complex interest provisions. Such manual calculations regularly result in errors. While we support the IRS' efforts to improve its technology so that, among other things, its computers are able to make such computations, we do not believe improving computer capabilities is the best answer to this problem. Instead, we

believe the interest provisions can and should be simplified to minimize errors and administrative burden and promote consistent application.

Inequitable Results and Undue Hardship

The Service's administration of the penalty and interest provisions regularly results in both inequitable results and undue hardship on many taxpayers and on third parties. The Service's subjective and inconsistent application of reasonable cause exceptions to penalty provisions and its inconsistent computation of interest results in inequities between similarly situated taxpayers. In addition many taxpayers pay penalty and interest amounts that should not have been assessed or could have been abated or adjusted. They do so because they do not understand the nature or computation of the penalty or interest, do not realize the penalty can be abated or interest adjusted, or are either afraid of the Service or don't want to be bothered with the bureaucratic challenge of requesting an abatement or adjustment.

Those taxpayers who seek professional advice with respect to proposed penalties and interest must either pay for that advice or impose an economic burden on their tax advisers who often cannot charge clients for the time it takes to resolve penalty and interest issues. This burden on practitioners is amplified by each practitioner's need to obtain a power of attorney from the client authorizing the practitioner to represent the client with respect to the penalty notice. The AICPA regularly urges the Service to allow a practitioner to discuss a notice and its related account with the Service based on the practitioner providing the Service with a "Personal Identification Number" that could be given on the notice sent to the taxpayer. Furthermore, the burden and cost of responding to notices that assert penalties and interest but do not clearly explain their genesis or computation create an unnecessary hardship on both taxpayers and tax practitioners.

Treatment of Similarly Situated Taxpayers

The penalty and interest provisions are generally designed to operate fairly, such that similarly situated taxpayers should be treated alike. However, the reasonable cause exceptions, designed to promote fairness, frequently cause penalties not to be administered fairly or equitably, because of the subjective nature of "reasonable cause." For example, a definite position should be established regarding abatement of penalties attributable to a mistake made by the taxpayer's tax adviser. Currently, sometimes these penalties are abated and sometimes they are not.

In addition, the use of the threat of penalties by some revenue agents in negotiations causes penalties to be applied to some taxpayers but not to others, despite the fact that the taxpayers may be similarly situated. The accuracy related penalty is particularly susceptible to these threats. Comments in the 1998 IRS National Taxpayer Advocate's Annual Report confirm that the use of threats of penalties in negotiations has occurred. The Report notes that an IRS survey disclosed that thirteen percent of penalties appears to have been inappropriately negotiated. The

Report also indicates that steps have been taken to stop such a practice. Whether those steps will be effective remains to be seen.

Finally, the complexity of the interest provisions, especially as they relate to complicated situations, causes very diverse results, because of alternative interpretations of the applicable provisions and because of errors in making the complex computations. As noted earlier, there are even inconsistent interpretations regarding the computation of interest by the IRS between and within different Service Centers and Districts.

Interest Rate Disparity

As a general proposition, we do not believe that taxpayers take advantage of disparities between commercial borrowing rates and those imposed by section 6621. While a taxpayer may be able to earn more interest from the government than from the taxpayer's local bank, the limitations on when such interest is earned, the limited accessibility of the funds when held by the government, and the current condition of the world's economic markets all discourage taxpayers from treating the Treasury as a depository institution. Furthermore, while the interest charged by the government may be less than a taxpayer would have to pay to a commercial lender, the extensive authority of the IRS to collect taxes due through levies and liens does not make the Treasury a taxpayer's lender of choice.

Taxpayer Communications

Communications from the Service do not provide either an adequate explanation of why the penalty and/or interest was assessed or how the taxpayer can avoid penalties and interest in the future.

Penalty and interest notices are too long and convoluted. Many contain a "laundry list" of possible penalties, when only some have been applied, and explanations of the penalties are vague. Furthermore, penalty calculations are not described, nor are explanations given of the dates from and to which interest is calculated. The following is the standard language of notices for the accuracy-related penalties:

> Since all or part of the underpayment of tax for the taxable year ... is attributable to one or more of (1) negligence or disregard of rules and regulations, (2) any substantial understatement of income tax, or (3) any substantial valuation overstatement, an addition to tax is charged as provided by section 6662(a) of the Internal Revenue Code. The penalty is twenty (20) percent of the portion of the underpayment of tax attributable to each component of this penalty.

No rationale or analysis is given for the imposition of the penalties. Instead, penalties are merely summarily asserted.

Too many taxpayers must contact their tax advisers to understand and respond to the notices, resulting in an additional economic burden on either the taxpayers or the advisers. Other taxpayers pay penalty and interest amounts that are incorrect and should be abated.
We note that the *Internal Revenue Service Restructuring and Reform Act of 1998* created section 6751 of the Code which requires the Service to include with each notice of penalty information with respect to the name of the penalty, the section of the Code under which the penalty is imposed, and a computation of the penalty. Section 6751 is effective for notices issued and penalties assessed after December 31, 2000. We urge the IRS to implement section 6751 as quickly as possible, and as it does so, to draft simple and concise notice language that taxpayers can easily understand. We also believe that penalty notices should be required to contain a telephone number (just like most information returns must contain a phone number of the issuer) that will provide direct access to individuals with immediate resources to resolve a taxpayer's questions with regard to the notice in an expeditious manner. Finally, we believe that penalty notices should include simple explanations that describe how a taxpayer can avoid a future imposition of similar penalties.

We also note that the *Internal Revenue Service Restructuring and Reform Act of 1998* created section 6631 which requires the IRS to include with each notice of interest required to be paid by an individual taxpayer, information with respect to the section of the Code under which the interest is imposed and a computation of the interest. Section 6631 is effective for notices issued after December 31, 2000. We believe that section 6631 should be applicable to all taxpayers. We also urge the IRS to use language as simple and concise as possible for these notices and to implement the section as quickly as possible. Finally, we believe that interest notices should include a simple explanation that describes how a taxpayer can avoid a future imposition of interest.

Authority to Waive/Enforce Penalties

The Commissioner has extensive authority to waive or not enforce most penalties. To the extent that there are a limited number of penalties that cannot be waived as a result of reasonable cause but may warrant waiver, such as the estimated tax penalty, the Commissioner should be given such authority.

We believe that the Internal Revenue Manual's Penalty Handbook, which provides IRS procedures for penalty application, waiver and abatement, should be reviewed, and, to the extent that various reasonable cause standards are not consistent with each other, they should be modified for greater consistency.

For example, the section 6721 penalty for failure to file correct information returns can be waived under section 6724 upon a showing of "reasonable cause." The regulations under section 6724 indicate this waiver for reasonable cause is available if the filer acted in a responsible manner and either there were "significant mitigating factors with respect to the failure" or the

failure resulted from events beyond the filer's control. Mitigating factors include the fact that this was the first time the filer was required to file the particular return or the filer has an established history of compliance. Such concepts should be integrated into other penalty provisions, such as the failure to file and the failure to pay penalties.
We also believe that the reasonable cause requirements should be amended to provide that a taxpayer may have acted with reasonable cause even in situations where the taxpayer made an unintentional or innocent mistake. Finally, we believe that penalties should not be assessed the first time that a taxpayer makes an inadvertent error; instead, the taxpayer should be notified of the error and of the fact that a reoccurrence of such an error will result in the imposition of a penalty.

Interest Abatement

The Commissioner's limited authority to abate interest should be modified to allow abatement of interest resulting from all unreasonable delays caused by the Service, without limitation to ministerial or managerial acts.

Clarification to the Code Regarding Interest on Penalties

Simply stated, we believe that interest generally should not start to accrue on any penalties until the Service has issued a notice and demand for payment, and then, only if not paid within 21 days. We note that this is generally the current rule, however, under the current law there are exceptions that should not exist.

Penalty Provisions Abroad

It is our general understanding that the U.S. penalty system, though flawed, has a better understanding than that of certain emerging countries (such as those of the former Soviet Union) that the role of penalties is to encourage compliance, not raise revenues. Our system, unlike many others, also clearly distinguishes between civil and criminal penalties, provides for abatement provided reasonable cause exists, and attempts to tailor the amount of the penalty to the degree of noncompliance.

Differing Penalty Regimes

We believe that there should only be one set of penalties under the Internal Revenue Code. Separate penalty provisions by type of entity or operating division in the Service would create unnecessary confusion and complication. It certainly would seem reasonable, however, to expect each of the operating divisions in the reorganized IRS to administer those penalties applicable to their taxpayers. We believe that the Service should have an overall Penalty Administrator to insure consistent application of penalties across the various operating divisions.

Specific Recommendations

We have included our specific recommendations in the text of our comments. Attached as Exhibit A is a discussion of possible safe harbors for the reasonable cause exception to penalties.

Members of the AICPA Tax Practice and Procedures Committee would welcome the opportunity to meet with you to discuss these comments further. Please feel free to call either Mark Ely, Chair of the Committee, at (202) 467-3854, or Jean Trompeter, AICPA Technical Manager, at (202) 434-9279, to arrange such a meeting. Thank you.

Sincerely,

David A. Lifson
Chair, Tax Executive Committee

Exhibit A

Safe Harbors for Reasonable Cause Exception to Penalties

To reduce the burden on both taxpayers and the Service resulting from the imposition of many inappropriate penalties, we recommend that safe harbor provisions be established for a variety of penalties (particularly those that are mechanical in nature, such as the failure to deposit, failure to pay and failure to file penalties) that would be deemed to represent reasonable cause. The object of these safe harbors would be to minimize the assessment and subsequent abatement of many penalties. Safe harbor provisions could take the form of:

No penalty assessment for an initial occurrence; however, the taxpayer should receive a notice that a subsequent error would result in penalty;

Automatic non-assertion of a penalty based upon a record of a certain number of periods of compliance; and/or

Voluntary attendance at an educational seminar on the issue in question, as the basis for non-assertion or abatement.

Such safe harbors would encourage and create vested interests in compliance, since a history of compliance would result in relief. Additionally, the likelihood of future abatements would diminish if the taxpayer has a history of non-compliance. Furthermore, a system of automatic abatement would reduce the time spent by both the Service and taxpayers on proposing assessment, initiating and responding to correspondence, and subsequent abatement. The ability to abate a penalty for a reasonable cause other than those used for automatic abatements would exist; however, reasonable cause abatements requiring independent evaluation may be reduced.

AMERICAN
LAND TITLE
ASSOCIATION

February 26, 1999

FEB 26 1999

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:DOM:CORP:T:R:IT&A (Branch 4)
Room 5228
Washington, D.C. 20044

Dear Sir or Madam:

The American Land Title Association[1] appreciates the opportunity to comment on the penalty and interest provisions of the Internal Revenue Code. These comments were requested pursuant to Notice 99-4, 1999-3 I.R.B. 1, and section 3801 of the IRS Restructuring and Reform Act of 1998. Our members perform information reporting on real estate transactions and support initiatives to improve the fairness and efficiency of the information reporting penalty process.

Current Information Reporting Requirements and Penalty Process

Our industry has fulfilled information reporting requirements for real estate transactions since this requirement, established under IRC §6045(e), became part of the federal tax law in 1986. For reportable transactions, the person handling a real estate closing, such as a title or escrow closing/settlement agent, is required to collect, store, and report:

(a) selected financial information on the transaction including the gross proceeds and the buyer's portion of real estate taxes paid; and

(b) the transferor/taxpayer's Taxpayer Identification Number (TIN).

Our industry complies with current requirements to file information in a prescribed format and manner with the IRS and furnish a copy of that information to the taxpayer. Large companies have implemented separate individual systems to institute 1099-S reporting. Small companies, including practitioners who do only a few closings a year, must of necessity use a tax reporting service to send information to the IRS. Some services charge $35.00 a transaction.

We also presently incur substantial penalty costs that are imposed for incorrect filings. Real estate reporting persons are subject to penalties under IRC §§6721 and 6722 for inaccurate reporting of information to the IRS and the taxpayer. As a result of the uniform statutory reforms to the civil penalty system in 1989, the IRS submits 1099-S filers to the same automated regimes for penalties applicable to other information return filers. This penalty regime is applicable even though the 1099-S filer usually has limited contact with the taxpayer in question at the time of the real estate closing. This differs from other filers, such as banks, whose Forms 1099 report payments of interest, dividends, and gross sales proceeds to ongoing customers. A taxpayer may well give a 1099-S filer a social security number that does not match to IRS files, but the filer will not realize this until they receive the penalty notice, which is typically two years after the real estate settlement has occurred. At that point, the settlement agent has already sent the backup files to storage. Because the seller's address is that of the property being sold, the filer is usually not able to contact the seller two years later to verify a TIN.

The 1099-S filer thus faces two levels of cost, at two separate times. First, the filer must complete and transmit the original 1099-S form. Second, in a subsequent year, the filer must respond to IRS inquires and penalties for a mismatched TIN.

These penalties are set at $50.00 per incorrect filing. The penalties imposed by the IRS can be substantial for companies who perform a significant number of closings in the United States, annually approaching several hundred thousand dollars. These companies also have to face the possibility that (1) some individuals may have provided them with incorrect TINs, and (2) there is some margin of clerical error inherent in the volume of transactions filed. Consequently, our companies often face the dilemma that it may be cheaper to pay a fine to the IRS, as opposed to committing staff time to retrieve warehoused files and attempt to track down the transferor of a property to check a TIN.

Question 8 -- The Commissioner's Authority to Waive or Not Enforce Penalties, and Whether Such Authority Should be Modified

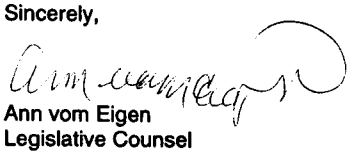
The title insurance industry is in a unique position with respect to TIN reporting requirements. Under Treasury Regulation §1.6045-4(l)(1), the real estate reporting person is required to request a TIN from the transferor at or before the time of closing. The regulations further provide that if the reporting person does not receive a TIN from the transferor, the reporting person will not be subject to any penalty by reason of such failure to report the TIN so long as the reporting person made a good faith effort to obtain the TIN. Treasury Regulation §1.6045-4(l)(2).

A strong possibility exists that a company could comply with the regulations for information reporting, but would be subject to substantial penalties. Consequently, our industry is caught in a never-never land where, in consonance with regulations, we have made a good faith effort to solicit a transferor's TIN but later face penalties when such TIN appears on a list of mismatched name-TIN combinations discovered through computer matching. Our companies have consequently relied on the "reasonable cause" regulations to demonstrate that they have a solicitation process in place, and attempt to abate penalties under the "reasonable cause" standards. As mentioned previously, it is often more cost effective from a business perspective, though patently unfair, to simply pay the penalty.

We believe that Form 1099-S filers should be permitted to meet the reasonable cause criteria with respect to reported TINs at the time the information returns are filed with the IRS. When these information returns are filed, the filer knows whether it meets the reasonable cause criteria for TINs. Allowing filers to make an "up-front" certification will eliminate the unnecessary generation of Form 1099-S penalty notices for missing and incorrect TINs. We believe this alternative method is in keeping with the Service's current customer-oriented approach rather than imposing unfair burdens on information return filers.

We would be pleased to work with the Service to arrive at a more fair and efficient penalty system.

Sincerely,



Ann vom Eigen
Legislative Counsel

Electronic copy - Original Faxed 2/26/99
American Society for Payroll Management
Daniel T. Glum, President
P.O. Box 117
Stormville, NY 12582
Ph (800) 684-4024 FAX (914) 227-9246

February 26, 1999

Ms. Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
Room 1015 Longworth House Office Building
Washington, D.C. 20515
via Fax: (202) 225-0832

Dear Ms. Paull:

Thank you for the opportunity to provide comments regarding the administration of the penalty and interest provisions of the Internal Revenue Code, as specified in JCT Press Release 98-02.

ASPM is a professional association of senior managers who control the preparation of payroll and employment taxes for large employers in the United States. As you know, *over two thirds of all federal tax receipts are paid by employers*: Over $1 Trillion for fiscal year 1997. At the same time, employers received nearly 10 million penalty notices, and paid nearly $2 Billion in penalties in FY1997. Clearly, employers are heavily impacted by the administration of the penalty and interest provisions of the Internal Revenue Code. ASPM has several issues and suggestions that we would like to see addressed in this review of penalty administration.

Implement "Warning Notices" in Certain Circumstances

The IRS appears to agree that the vast majority of employers intend to be compliant, and that intentional noncompliance occurs only rarely. The Service seems to recognize that taxpayer education is the key to helping the vast majority of well-intentioned employers to avoid falling into noncompliance; yet the Service misses the opportunity to educate or "warn" employers at the point that they start to stray.

For example, the IRS could notify employers when it appears that they are not depositing under the correct rule, or by the proper method. It should be feasible for the IRS to detect that an employer is using the wrong payment method or deposit schedule within a few weeks of the start of a year. Unfortunately, it often takes months for an employer to learn of a problem with their tax deposits. Consequently, innocent mistakes which would otherwise have been quickly corrected may continue for months, increasing the resulting penalty assessment. By warning employers of potential problems earlier, problems can be corrected sooner, and penalty assessments can be minimized.

Promote Taxpayer Education with Proposed Penalties

Employers who receive employment tax penalties should be given the opportunity to enroll in an "Employment Tax class", along the lines of the traffic schools many municipalities offer for ticketed

drivers. (Under certain circumstances, traffic tickets are "forgiven" if the driver attends traffic school by a certain date.) For "ticketed" employers , an employment tax class would substitute for the driving school. This type of education could yield dramatic improvements and encourage employers to become compliant with a kinder, gentler approach.

Tiered Penalty Structure

Several types of penalties use some form of tiered penalty structure (e.g. failure to deposit or failure to file correct information returns), which generally increase the penalty in accordance with the length of time the initial problem (such as failure to report) goes uncorrected. This encourages prompt correction of problems.

Similarly, the Service may want to consider a tiered system based on the number of instances of errors within a given tax period. Proposed penalties or "warning notices" should be issued for the initial tax period (i.e. quarter) in which a problem is detected, before penalties are actually assessed. For example, if an employer has a deposit error, but had no other failures to deposit within the past year, a warning notice should be issued but no actual penalty imposed. Subsequent failures would incur a penalty, and the penalty would increase for repeated failures within a relevant time period. This would encourage voluntary compliance and punish those taxpayers who make little or no effort to meet their requirements.

In addition, considering the degree to which large employers now rely on computers for routine tax compliance, we recommend defining "failure" to include multiple failures which are caused by a single instance of error. For example, a single programming error may cause hundreds of information returns to be reported late or incorrectly, or may affect multiple tax payments.

"Prepayment" Penalty for Next Day Depositors

Some ASPM members identified a problem in which employers have been penalized for depositing too early. Some employers administer multiple entities (FEINs), some of which are classified as monthly depositors. For administrative reasons, the employer makes all tax deposits (for all FEINs) on the more common semiweekly schedule. If a FEIN classified as monthly accrues more than $100,000 in total liability for a month, a deposit is due by the banking day following the payroll which caused the total for the month to exceed $100,000, even if the tax amount undeposited is very small. Employers are well aware of the $100,000 "next day" deposit rule, but this is assumed to apply to outstanding, unremitted amounts. This "quirk" is counterintuitive and not well understood. **The "next-day" exception rule should be changed to be based on undeposited funds.** An example follows:

ACME Company - a monthly depositor

Payroll Date	Liability Amount	IRS Due Date	Date of Penalty Deposit	Amount
01-8-99	$25,00002-16-99	01-13-99		
01-15-99	$25,00002-16-99	01-20-99		
01-22-99	$30,00002-16-99	01-27-99		
01-29-99	$30,00002-01-99*	02-03-99	$600	

* Penalty is 2% of the amount deposited "late": $30,000 in this case is technically due on February 1.

Notice Content

Some members commented that notices are sometimes difficult to decipher. All penalty notices should, at a minimum, identify the tax type or form number, or a particular deposit in question by date and amount, tax period, type of penalty, the reason for imposition, and the specific calculation of the penalty. Without this information it is difficult to identify the problem.

Prompt Processing Of Taxpayer Responses

Several of our members commented that although they submit written responses to notices a week or more prior to the response date specified on a notice, an additional notice is issued anyway. This requires an additional response which adds nothing of value to the situation, but increases the workload of both the employer and the IRS. This could be avoided by programming IRS systems to more rapidly recognize when correspondence has been received which may relate to a prior notice, in order to suppress subsequent notices.

Again, thank you for this opportunity to provide comments. Please feel free to call upon us should additional information or clarification be necessary.

Sincerely,

David Rakowski
Government Liaison

cc: ASPM Board Members
Government Relations Committee Members

The Benefits Association

APPWP

Association of Private Pension and Welfare Plans

June 3, 1999

JUN 0 9 1999

Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515-6453

Dear Ms. Paull:

This letter is respectfully submitted by the Association of Private Pension and Welfare Plans (APPWP – The Benefits Association) and contains comments on the penalties and interest study to be conducted by the Joint Committee in accordance with the Internal Revenue Service Restructuring and Reform Act of 1998.

APPWP is a public policy organization representing principally Fortune 500 companies and other organizations that assist plan sponsors in providing benefits to employees. Collectively, APPWP's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

In the IRS Restructuring Act, Section 3801, the Joint Committee on Taxation and the Secretary of the Treasury were directed to conduct a study reviewing the administration and implementation by the Internal Revenue Service of the interest and penalty provisions of the Internal Revenue Code of 1986 (including the penalty reform provisions of the Omnibus Budget Reconciliation Act of 1989). The Committee and the Secretary were also directed to make any legislative and administrative recommendations they deemed appropriate to simplify penalty or interest administration and reduce taxpayer burden.

APPWP urges the Joint Committee, as a part of this study, to evaluate a number of penalties and taxes imposed in the retirement plan arena that we believe are unwarranted or unreasonable.[1] The retirement plan penalties that we suggest for your review include:

[1] While not relevant for the Joint Committee's current study, we wish to make clear that we would not support elimination or reduction of these penalties if doing so would jeopardize the enactment of the many enhancements to the employer-sponsored retirement system contained in pending bills such as S. 646, S. 741 and H.R. 1102.

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e-mail APPWP@aol.com www.appwp.org

- **Failure to Take Minimum Distribution**: Under present law (e.g., Section 401(a)(9)), distributions from qualified plans and other retirement arrangements are required to begin no later than the participant's "required beginning date." The required beginning date is April 1st of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2, or (2) the calendar year in which the employee retires. In the case of an employee who is a 5-percent owner (as defined in Section 416), the required beginning date is April 1st of the calendar year following the calendar year in which the employee attains age 70-1/2. The sanction imposed on an employee for failure to take a minimum required distribution is a 50% nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules over the amount that was actually distributed. In many instances, this excise tax is greater than the income tax on the underlying distribution. We believe this level of penalty is excessive and should be reduced.

- **Prohibited Transactions**: Parties who engage in prohibited transactions under Section 4975(a) are subject to penalty taxes. A penalty tax equal to 15% of the amount involved in the transaction is imposed on the disqualified person (other than a fiduciary acting in that capacity) for each year or part thereof that the transaction remains uncorrected. An additional tax equal to 100% of the amount involved is imposed if the prohibited transaction is not corrected in a timely fashion. Also, parties who engage in prohibited transactions can be liable, in addition to the penalty tax, for another penalty for failure to file the form on which these penalties must be reported (Form 5330).

  The 15% penalty can have a pyramid effect for each year a correction does not take place. A loan or lease that remains unpaid is a continuing transaction. Therefore, the IRS treats each year that the loan or lease continues as giving rise to a new transaction. The excise tax is calculated separately for each new transaction, meaning that penalties can mount substantially. These excise taxes are complicated to calculate and burdensome to the taxpayer. We suggest that a simpler method for calculation of excise taxes be considered.

  It is also worth noting that prohibited transactions can occur inadvertently and may not be recognized until two to three years after the fact. One such example is the lending of money or other extension of credit between a plan and a disqualified person. This can occur when an owner in a C-corporation takes a plan loan and then the company is converted to an S-corporation. The outstanding loan becomes a prohibited transaction and must be repaid immediately with penalties. In situations such as these, we believe it would be appropriate to consider waiving the prohibited transaction penalties.

- **Late Filing of Form 5500:** There are several penalties that may be imposed for late filing of the Form 5500 series report and attachments. The Department of Labor (DOL) may assess a civil penalty against a plan administrator of up to $1,100 a day for the late filing of a Form 5500 series report. In addition, the Internal Revenue Service (IRS) can also impose four related penalties:

  1. A penalty of $25 a day (up to a maximum of $15,000) for each day a Form 5500 series report is overdue.
  2. A penalty of $1 a day (up to a maximum of $5,000) for each separated vested participant when a plan administrator fails to include all such participants in Schedule SSA, which is an attachment to Form 5500.
  3. A penalty of $1 a day (up to a maximum of $1,000) if a notification of change of status of a plan is not filed on time.
  4. A penalty of $1,000 if an actuarial report (Schedule B) is not filed along with the Form 5500 for a defined benefit plan.

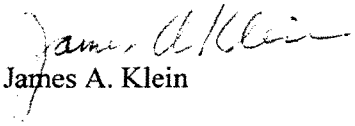
  Plan administrators who fail to file an annual Form 5500 with the DOL may be assessed a penalty of $300 per day -- up to a maximum of $30,000 per year -- until a complete annual report is filed. The DOL does have a Delinquent Filer Voluntary Compliance (DFVC) program in which late fees are reduced to $50 per day with a maximum of $5,000 for late filing of Form 5500 ($2,500 if filed within 12 months of the due date) and $2,000 for late filing of Form 5500-C ($1,000 if filed within 12 months of the due date). This has provided some relief. However, we would suggest that perhaps there could be greater consolidation of the various late filing fees -- particularly the $1,100 per day DOL fee and the $25 per day IRS fee -- rather than the possibility of five different penalties being assessed. We also recommend that DOL's program for self-correction of ERISA failures such as these, currently under development, be closely coordinated with the IRS's existing self-correction program.

- **Late Payment of PBGC Premiums:** Current law allows the Pension Benefit Guaranty Corporation (PBGC) to assess a late payment penalty charge for premiums that are not paid when due. The law limits the late payment penalty charge to not more than 100% of the unpaid premium (ERISA section 4007(b)). PBGC regulations impose a late payment penalty equal to the greater of $25 or 5% of the unpaid premium for each month (or portion of a month) that the premium remains unpaid. If the underpayment is "self-corrected," the late payment penalty charge is equal to 1% of the unpaid premium per month. This penalty charge is in addition to interest charged on underpayments. PBGC regulations provide for a waiver of the penalty charge on a finding of financial hardship or good cause.

Because the 5% penalty charge is imposed on a monthly basis, the total amount can be quite high. For example, if the underpayment is not discovered within one year, the amount of the penalty charge will be 60% (5% x 12 months). Even underpayments that are "self-corrected" will be subjected to penalty charges of 12% per year. This seems quite punitive, especially as the underpayment will also be subject to an interest charge.

We very much appreciate your willingness to evaluate retirement plan penalties as a part of your study and we thank you for your consideration of our specific suggestions. If you have any questions or need additional information, please do not hesitate to contact me or James Delaplane, APPWP's Vice President, Retirement Policy, at 202-289-6700.

Sincerely,



James A. Klein

James R. Burkle
Vice President,
Corporate Tax

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CERIDIAN

MAR 0 1 1999

February 26, 1999

Ms. Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515

Dear Ms. Paull:

Thank you for the opportunity to provide comments on the administration and implementation by the Internal Revenue Service (IRS) of the interest and penalty provisions of the Internal Revenue Code.

Ceridian Corporation, headquartered in Minneapolis, Minnesota, is a leading information services company that provides outsourced payroll processing, tax filing services, and integrated human resource management systems to predominantly large and mid-sized businesses. Ceridian's Tax Service is a high volume automated bulk filer serving approximately 60,000 employers. Ceridian collects and deposits $98 billion in employment taxes annually, files in excess of 800,000 quarterly tax returns with the IRS and 6,000 other tax agencies, and processes more than 2.6 billion electronic payroll tax transactions on behalf of clients. Ceridian has over 20 years of tax filing experience.

Ceridian's payroll and tax filing service, including the depositing of employment taxes, is comprised of many processes and procedures, all of which are designed to insure the accurate and timely filing and depositing of all federal and state tax liabilities, and are continually updated in order to fulfill the ever-changing needs of our client base and meet reporting requirements. The timely depositing of tax liabilities to the IRS on behalf of clients ranks as Ceridian's highest priority.

Current administration of the tax penalty system is inadequate and unfairly treats taxpayers who are compliant with the system. The IRS penalty handbook in Part XX of the Internal Revenue Manual states that "penalties are used to enhance voluntary compliance." (IRM (20)121). But the system has failed to uphold this basic tenet by

administering penalties arbitrarily, and by putting the burden on the taxpayer to prove good faith compliance. The penalty system for employers needs improvement in the following three areas:

1. Current administration of the penalty and interest provisions fail to distinguish between employers who intend to comply and those who are deliberately non-compliant.

2. The penalty and interest provisions are not uniformly applied. While the IRS national office may advocate one policy and set of goals, the IRS field offices generally do not follow that stated policy. The national office often defers to the regional service centers, resulting in delays and inconsistent policies based on local rulings.

3. The size of the penalty is often not proportionate to the offense.

1. A fair and effective penalty system should take into account a taxpayer's deposit history

Although the penalty and interest provisions, as currently defined in the Internal Revenue Code, are intended to deter noncompliance, avoidance and fraud in the tax system, they fail to encourage voluntary compliant behavior. Taxpayers generally can be broken down into three groups:

- Those who want to comply.
- Those who want to comply but have economic difficulty in doing so.
- Those who do not and will not comply despite the consequences.

It is the third group that the current code sections are intended to regulate. Taxpayers who fail to make deposits out of willful neglect, taxpayers with a truly egregious compliance history and those who demonstrate a pattern of non-compliance should be penalized severely. But it is the first two taxpayer groups that are being, and have been, negatively impacted.

Of particular concern to employers and bulk filers is that the tax penalty system penalizes taxpayers who want to comply and generally have outstanding compliance records as rigorously as the intentionally non-compliant. For instance, penalties are unnecessarily punitive on taxpayers who process a large number of transactions annually and incur one or two errors as opposed to taxpayers with very few transactions and who incur the same number of errors. The result is that taxpayers with high compliance rates are penalized as severely as those with high error rates. An important indication of a taxpayer's willingness or unwillingness to comply -- the taxpayer's record of compliance -- is not taken into consideration by the IRS when assessing penalties.

Taxpayers that make every effort to comply also are severely penalized for inadvertent, human errors and tax system problems. For example, as a result of human error, Ceridian transmitted a client's payroll using an incorrect client ID number, resulting in tax deposits

being misapplied. Ceridian corrected the error and immediately implemented procedures to ensure that a similar error does not recur. But Ceridian did not have visibility of the error until after the deposit already was made, causing penalty and interest to be assessed. Despite a history of compliance and having reasonable cause for the late deposit, the taxpayer and Ceridian had to go through extraordinary efforts to prove good faith compliance. Penalties are automatically assessed regardless of the type of error, putting the burden on the taxpayer to prove good faith compliance.

Another example is "catch-22" penalties, or penalties for early deposits. Some taxpayers choose to deposit on an accelerated schedule (semi-weekly as opposed to monthly). Those taxpayers include small businesses that are unsure of their tax deposit schedules, or employers with multiple EINs who decide to deposit on the most frequent schedule in order to reduce administrative complexity. The "catch" comes if a taxpayer is a monthly depositor and has tax deposits exceeding $100,000 in a month. The IRS' "next day" deposit rules then kick-in, requiring liabilities over $100,000 to be deposited the next day regardless of whether taxes have been previously deposited. The IRS should not send a punitive message for depositing early where taxpayers are merely attempting to be fully compliant and pay their tax to the government on time. No penalties should be assessed on taxpayers who make deposits early.

The seemingly unfair treatment of those who have a history of demonstrated compliant behavior directly undermines what is the stated goal of any voluntary tax system -- the encouragement of compliance by the taxpayer.

Recommendation: In a voluntary tax system, the taxpayer's prior actions and conduct should weigh heavily in determining the assessment of any penalty and interest. Otherwise, human or technical error is penalized to the same degree as willful noncompliance. The type of reporting should also be taken into account. A service bureau with a client base in the thousands has voluntary compliance as its implied, if not stated goal. An assessment of a Failure to Deposit Penalty for such an entity, for example, does nothing to encourage voluntary compliance and everything to prove the system's arbitrariness. The analysis of past behavior is the best, and at times, the only way to gauge the "intent" of the taxpayer and identify the members of the non-compliant group. Identifying taxpayers who are willfully non-compliant would improve administrative efficiencies and establish "the fairness of the tax system by justly penalizing the non-compliant taxpayer," as stated in the IRM XX-Penalty Handbook.

2. Penalty and interest provisions should be applied uniformly

One of the major problems with current penalty and interest administration is that the IRS national office's policy and goal of voluntary compliance by the taxpayer is often not the policy or goal of the IRS field offices. Uniform application of penalty and interest provisions across all levels of the IRS (including IRS service centers and district offices) as is intended in the Code and under the IRM XX-Penalty Handbook, would produce efficient and effective administration of the tax system. The reality is that the penalty and interest provisions are not being uniformly implemented or administered. Penalties are

intended to encourage compliant behavior. They should not be punitive to taxpayers who have an exemplary compliance record.

For example, each IRS service center will interpret the facts in similar penalty abatement requests differently, resulting in abatement in one case and upholding the assessment in another. The unintended result is service center "shopping" by large employers and bulk filers. Also, as a bulk filer, it is not unusual for penalty and interest abatements issued by the service center with jurisdiction over the client taxpayer to be rescinded by another service center. The tax system is undermined when the national office's stated policies and goals are not followed by IRS offices in the field which have direct contact with taxpayers. If the penalty and interest provisions were applied uniformly, the administration of the tax system would be more effective and fair as intended by the IRS.

Recommendation: The IRS could achieve more effective administration of the penalty and interest provisions if the stated policies and goals of the IRS national office were followed by service centers and district offices. Also, from a bulk filer standpoint, establishing a national group at a designated service center or district office would help to effectively resolve penalty issues for the vast majority of large employers represented by bulk filers. A designated point of contact for bulk filers would allow penalty and interest issues to be resolved uniformly and efficiently. It also would simplify the tax payment and filing process and reduce the compliance burden on both the taxpayer and the IRS.

3. The size of the penalty should be proportionate to the offense

The fairness of the tax system is negatively affected by the amount of penalty and interest that can be assessed. One inadvertent, human mistake or technical error not only puts the burden squarely on the taxpayer to prove good faith compliance, but it could cost an employer excessive penalties.

A good example of this is the "avoidance" penalty, which is exacerbated under the new Electronic Federal Tax Payment System (EFTPS). Employers are automatically penalized 10 percent per tax deposit if payments are not made through EFTPS -- even if tax liabilities are paid on time and the taxpayer has an otherwise unblemished deposit record. The amount of the penalty often is many times greater than the actual loss of revenue to the IRS and is disproportionate to the offense. The IRS and Congress have taken action to waive the 10 percent penalty for some employers, but the waiver does not address the unnecessary severity of the penalty. It also does not address the issue that a taxpayer should never be penalized in instances where their payments are on deposit with the IRS or its depository on or before the tax due date.

Another example is a Failure to Deposit assessment where a taxpayer has made an erroneous deposit to their 941 account instead of their 945 account. It is difficult to justify the penalty and interest where the IRS has received payment for liabilities, but due to a human or technical error they are deposited in the wrong account. The fact that payment has been deposited should be taken into account before assessing penalties. The imposition of a penalty in such an instance is wholly inappropriate and not proportionate to the error.

Conclusion

This study is an important undertaking that hopefully will shed light on inadequacies and inequities within the tax penalty system and prompt needed change. The vast majority of taxpayers want to comply and should be assisted and encouraged to do so. As Commissioner Rossotti has indicated in statements concerning EFTPS, the IRS now is working to encourage compliance by providing clearer communications, marketing the benefits of electronic payment and offering additional taxpayer assistance.

This is a tremendous step in the right direction. But the current administration of tax penalties does little to instill confidence in the tax system, while at the same time fails to reduce severe noncompliance. The penalty system has become arbitrary where taxpayers in different parts of the country may receive different treatment in similar situations. The arbitrariness extends to the actual amount of the penalty where excessive penalties can be automatically assessed without regard to the reason for the error or the taxpayer's deposit history. Resources could be focused more effectively. Uniform goals across all levels of the IRS and targeting efforts on deterring noncompliance among willfully non-compliant taxpayers will produce a more efficient and equitable system.

Thank you, again, for the opportunity to comment on the administration of the tax and penalty provisions of the Internal Revenue Code. Please contact me at 612.853.4653 or Stephanie Ward in Ceridian's Washington, DC, office at 202.789.6524 if you would like additional information.

Sincerely,

James R. Burkle
Vice President, Corporate Tax

cc: Congressman Jim Ramstad

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APR 2

April 19, 1999

Ms. Lindy Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on Penalty and Interest Provisions

Dear Ms. Paull:

The Internal Revenue Service Restructuring and Reform Act of 1998 requires the Joint Committee on Taxation to review the interest and penalty provisions contained in the Internal Revenue Code. Included below are recommendations regarding the administration and implementation of the interest and penalty provisions. We would be pleased to discuss with you in greater detail any of these recommendations.

Voluntary Compliance

The Internal Revenue Manual ("IRM") states that "encouraging voluntary compliance" is the overriding purpose for the assessment of a civil penalty. The collection of penalties is not intended to function as a revenue-raising mechanism. The encouragement of voluntary compliance is essential for the IRS to collect the proper amount of tax revenue at the least cost. To encourage compliant behavior, penalties are used to assert a cost on non-compliant behavior. In theory, asserting a cost on taxpayers not complying will assure that those who do comply will feel the system is fair and equitable.

Utilizing penalties to encourage voluntary compliance is not effective in all situations. One example of this ineffectiveness occurs whenever penalties are assessed without regard to fault. Strict liability for a failure to comply with the requirements of the Internal Revenue Code can punish taxpayers who act in good faith. Such penalties inherently undermine the integrity of the tax system by creating a sense that the system is not fair and by discouraging voluntary efforts to correct past errors.

For example, the assessment of a penalty on a taxpayer who immediately corrects a problem upon discovery accomplishes an opposite result. The taxpayer attempting to follow the provisions of the Internal Revenue Code is being punished. In the future, the taxpayer may take a chance and not come forward to correct the noncompliance for fear of being assessed another penalty. The taxpayer may surmise that the system is unfair and may wait for the IRS to uncover the mistake.

Another typical example involves a company that has filed its tax returns for several years, believing it has filed correctly and has complied with all the tax laws. The company then learns it was required to file several Forms 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.* The filing requirements for this form can be difficult to discern due to complex ownership structures or other issues. In such a situation, if the corporation comes forward and files the forms that were inadvertently not filed, it faces a $10,000 penalty for each form that was not filed timely. With multiple years and multiple Forms 5472 required, this can be a substantial amount of penalties. Even for taxpayers who come forward voluntarily, before any contact by the IRS, there is no guarantee that the penalties will be waived. Such taxpayers can be faced with very sizable penalties that can make them fearful to comply.

In another situation, an individual taxpayer who has filed each year, believing he has correctly reported all his income, then learns that an item has been incorrectly reported, resulting in a substantial understatement of income. In this case, six years could be open for assessments. If the taxpayer comes forward voluntarily, without any contact by the IRS, he still would face the substantial penalties and interest, in addition to the tax deficiencies. The taxpayer might be able to pay the tax, but might be unable to pay the penalties and interest. In such a case, the penalty and interest amounts are a disincentive for the taxpayer to amend his returns and correct the past filings.

Unequal Treatment of Similarly Situated Taxpayers:

We believe the tax system works best when results under the system can be predicted by taxpayers and their advisors with a fair degree of accuracy. The various rules permitting abatement of penalties are necessary to prevent the disincentives to compliance described above, but the introduction of essentially equitable standards into the tax collection process presents its own set of problems. Whenever a decision about how to apply the law is left to the discretion of a single IRS employee, similarly situated taxpayers will end up with disparate treatment. This is true whether the employee is applying a substantive provision or a procedural rule.

The process for abating penalties is subjective and inconsistent. In order for a taxpayer to have most penalties relieved, "reasonable cause" must be established. Determining if a taxpayer had "reasonable cause" is left solely to the judgement of the IRS employee reviewing the situation. A taxpayer requesting reasonable cause may or may not receive abatement depending on the subjective reasoning of the IRS employee's decision. In addition, penalties and interest sometimes are used as a bargaining tool, resulting in inconsistent application between comparable taxpayers.

Inconsistency and lack of uniformity also result between taxpayers who seek professional tax advice and those who do not seek guidance from a tax consultant. Due to the complexity of the interest and penalty provisions, taxpayers who do not seek tax advice often do not understand the computations or the ability to abate assessments. Apprehension of dealing with the IRS or lack of knowledge may lead the taxpayer to pay the interest or penalty charged even if the taxpayer had reasonable cause to abate the penalty, or the interest could be abated due to an error or delay on the part of an IRS employee.

Notices

The interest and penalty computations are intricate and complex, often leading to errors in the IRS calculations. The Internal Revenue Service Restructuring and Reform Act of 1998 requires the IRS to provide interest computations with the notices sent to individuals. ***Corporations also should receive*** IRS interest computations along with notices.

Procedures to efficiently suppress penalty notices should be established. For instance, if a taxpayer identifies that incorrect information returns have been filed, the taxpayer cannot provide "reasonable cause" and attain waiver of the penalty at the time the corrected forms are submitted. Instead, upon filing corrected forms, even if a statement is attached, the taxpayer must wait to receive the computer-generated proposed penalty notice before demonstrating reasonable cause to the IRS.

Recommendations

To encourage voluntary compliance and uniform application, *"safe harbor"* provisions must be developed. To provide consistency these provisions must contain clear guidance for abatement. Examples include:

- ***Expeditious Correction of Error Upon Discovery:*** Provide abatement of penalties in situations where the taxpayer is trying to comply with the Internal Revenue Code.

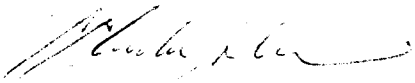
- ***First Time Filer***: Establish relief for taxpayers who previously had not been required to file a particular type of return or furnish a particular type of statement with respect to which the failure occurred.

- ***History of Compliance***: Provide relief if the taxpayer has an established history of compliance.

The "safe harbor" provisions must encourage taxpayer education. To advance compliance, taxpayers need to be fully educated on errors made in the past, as well as how these mistakes could have been avoided. An educational notice should be sent to the taxpayer upon abatement or assessment of a penalty.

Frontline IRS employees should be given the authority to resolve penalty issues. IRS culture should not encourage assessments of penalties as a first resort to encourage compliance. Instead, the thrust of encouraging voluntarily compliance should be toward educating taxpayers and increasing their understanding of their tax responsibilities.

Sincerely,



C. Clinton Stretch
Director of Tax Policy

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April 26, 1999

APR 26 1999

Lindy Paull, Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515-6675

Dear Ms. Paull:

On behalf of the signatories to the attached letter, we respectfully submit a copy of a letter sent today to IRS Commissioner Charles Rossotti for your consideration in the Joint Committee on Taxation's study regarding administration and implementation of interest and penalty provisions of the Internal Revenue Code.

As organizations representing both business owners and payroll service providers, the signatories have sent this letter in an effort to offer constructive recommendations to improve the operation of the Electronic Federal Tax Payment System (EFTPS), and, in general, to improve the working relationship between the IRS and business owners in relation to federal tax deposit requirements and the imposition of penalties.

We appreciate the Joint Committee's consideration of the recommendations set forth in this letter and look forward to working with you on these matters. Please feel free to contact either of us at any time.

Sincerely,

John J. Salmon

Andrew W. Kentz

cc: Barry L. Wold, Esq.

Enclosure

April 26, 1999

The Honorable Charles Rossotti
Commissioner, Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Rossotti:

As organizations representing both business owners and payroll service providers, we are writing in the continued interest of promoting an efficient working relationship between the Internal Revenue Service and business. To this end, we applaud your recent proposal to increase the threshold for determining businesses required to use the Electronic Federal Tax Payment System (EFTPS) for federal depository tax payments.

Although this change would alleviate many of our concerns with regard to the operation of EFTPS, we remain concerned with some aspects of the law and current administrative practice governing the payment of federal tax deposits by business owners. Specifically, we believe that there must be adequate notification provided to taxpayers who are required to use EFTPS. We also believe that there must be a rationalization of penalties imposed on taxpayers who make timely payments but fail to use EFTPS. Additionally, we believe a mechanism under EFTPS must be put in place that would allow payroll service providers, who provide tax payment services covering roughly one-third of the private sector workforce, to make necessary data adjustments after deposits are made on key deposit dates. Finally, we believe that improvements must be made in notifying taxpayers who are required to make semi-weekly deposits and fail to do so. We recommend the following:

1. **Taxpayers that Exceed the EFTPS-Mandate Threshold Should be Notified of their Mandate Status in a Timely Manner**. Taxpayers that will be subject to penalties for failing to file using EFTPS should receive notification from the IRS before penalties go into effect. Although fewer businesses would be required to make deposits using EFTPS under the Proposed Regulation, it is likely that, even under the increased threshold, some business owners will not realize that they are EFTPS-mandated. Additionally, the modification in the threshold would not mean that the requirement would affect only "large" businesses. For example, a small, labor-intensive business (e.g., a service industry business) or a small business with substantial excise tax payments both could easily exceed the proposed $200,000 EFTPS-mandate threshold. Moreover, the proposed $200,000 threshold should be

indexed for inflation; without such indexing the threshold will become less significant over time.

2. **EFTPS-Mandated Taxpayers that Inadvertently Fail to Use EFTPS Should be Notified of this Error in a Timely Manner**. Under the current system, an EFTPS-mandated business that fails to use EFTPS may not be notified of this failure until as long as five months after penalties first begin to accrue. A taxpayer who is not notified of this problem and who continues to deposit taxes by an improper method would accrue penalties of ten percent of the total amount of taxes paid by the wrong method during that period. This delay in notification would result in an accrual of penalties that could cripple a business. For any taxpayer who is EFTPS-mandated and pays by a method other than EFTPS, the IRS should notify them of their error as soon as possible after the error occurs.

3. **The Ten Percent EFTPS Penalty Should be Reduced**. The ten percent penalty for failing to file using EFTPS should be reduced to a level more appropriate to the violation. For any business that makes such a mistake, a ten percent penalty, whether accruing for one month or for as long as five months, is disproportionately harsh. The penalty amount be reduced to the cost of interest plus an administrative fee, not to exceed one percent.

4. **An EFTPS Data Adjustment Window Should be Provided to Allow for Necessary Payroll Data Corrections by Payroll Service Providers**. Payroll adjustments are often necessary after tax deposit due dates to reflect compensation and benefits that are not ascertainable until after the end of the quarter, such as employee bonuses, meals and lodging, third-party sick pay, personal use of company vehicles, and prizes and awards. Because such adjustments often indicate increased tax liability after the due date, businesses commonly overpay tax deposits in order to avoid penalties. Historically payroll service providers have prevented the issuance of penalty notices to businesses by over-paying lump-sum final tax deposits for each quarter, and utilizing the five-day magnetic tape adjustment window to reconcile related taxpayer deposits and data. Under EFTPS, there is no similar mechanism available for payroll service providers in the normal course of business to estimate and overpay tax deposits so that necessary post-deposit date adjustments can be made without penalty. This creates additional administrative expenses and will result in unnecessary penalty assessments for routine and unavoidable payroll adjustments. In the same way that adjustments can be made currently under EFTPS emergency back-up procedures, the IRS should allow an EFTPS data adjustment window as standard procedure for key quarterly deposit dates.

5. **Taxpayers that are Required to Make Semi-Weekly Deposits and Fail to Do So Should be Notified of this Error in a Timely Manner**. Although the IRS currently sends notices to all employers whose deposit schedule will change in the subsequent year, it is unrealistic to assume that such notices always end up in the proper hands, or that all business owners properly understand IRS instructions to change their deposit frequency.

Under the current system, businesses that make tax deposits under the wrong schedule often will not receive notice of this error from the IRS for as long as five months after penalties have first begun to accrue. As with EFTPS non-compliance, a taxpayer -- and their service provider -- should be notified as soon as the IRS is able to detect that the taxpayer is using the wrong deposit schedule. In addition, a service provider should be able to receive deposit schedule information from the IRS for all of its clients upon request.

We believe that the suggestions above offer constructive improvements that, in conjunction with an increased EFTPS-mandate threshold, would enhance the acceptance of electronic filing, and would reduce administrative and other costs associated with errors in tax deposit payments for business owners, payroll service providers, and the IRS. We appreciate your consideration of our views and look forward to continued productive exchanges with you on these matters.

Sincerely,

American Payroll Association
American Society for Payroll Management
National Federation of Independent Business
National Retail Federation
Service Bureau Consortium
Small Business Legislative Council
U.S. Chamber of Commerce
UWC -- Strategic Services on Unemployment & Workers' Compensation

cc: The Honorable Bill Archer
The Honorable Charles B. Rangel
The Honorable William V. Roth, Jr.
The Honorable Daniel P. Moynihan

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106-0279 (Archer)

9/28/1998

HON. BILL ARCHER, CHMN.
WAYS AND MEANS COMMITTEE
& JOINT TAXATION COMMITTE
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515
SENATOR WILLIAM V. ROTH, CHMN.
SENATE FINANCE COMMITTEE
U.S. SENATE
WASHINGTON, DC 20515

DEAR SIRS,

I HAVE KNOWN BOTH FOR YOUR TREMENDOUS LEADERSHIP IN THE CONGRESS OVER THE YEARS, AND THEREFORE I BRING THIS MATTER FOR YOUR CONSIDERATION AND ACTION IN THE NEAR FUTURE.

WHEN A TAXPAYER PAYS ALL THE TAX LIABILITY ON TIME , IT DOES NOT MAKE LOGICAL SENSE FOR THE CONGRESS TO KEEP AN AGE OLD LAW WHICH REQUIRES IRS TO SLAP AN ESTIMATED TAX PENALTY, EVEN FOR THE RETIRED DRAWING SOCIAL SECURITY AND THEIR PENSION.

THIS OUTDATED PROVISION:

1. COSTS TIME AND MONEY TO IRS IN COLLECTING SMALL PENALTIES (LESS THAN FEW HUNDRED DOLLARS) OF PENALTY WITH LETTERS AND CONSUMER PHONE CALLS
2. WASTES IRS TIME-SPENT ON COLLECTING SUCH SMALL AMOUNTS, AND IT COULD BE BETTER SPENT ON COLLECTING LARGER UNPAID TAXES
3. MAKES NO BUSINESS SENSE SINCE ON-TIME PAYMENTS OF ANY BUSINESS LIABILITIES NEVER ACCRUE PENALTIES
4. UNNESSARILY BURDENS TAXPAYERS WITH PAPERWORK AND QUESTIONS ETC.

WITH MY PH.D., I STILL CANNOT FATHOM THE INTENT OF CONGRESS IN WRITING THIS PROVISION FOR REGULAR ON-TIME TAX PAYERS, IT MAY MAKE SENSE TO APPLY PENALTIES FOR NON-ON-TIME TAX PAYERS.

IN SUMMARY IT IS SINCERELY REQUESTED THAT YOU AND YOUR STAFF REWRITE (RATHER THAN MINOR REVISION OF LAST YEAR) THIS ESTIMATED TAX PENALTY PROVISION TO HELP IRS IMPROVE ITS EFFICIENCY, AND ALSO BENEFIT TAX PAYER AS WELL THE TREASURY. IT IS PARTICULARLY ILLOGICAL FOR ON-TIME TAX PAYING RETIRED PERSONS.

THANK YOU VERY MUCH.

SINCERELY

DR. HARRY S. HAYRE

CP2

Billy Burnwold
4561 IRS
Ste. 100

CC: IRS CONSUMER AFFAIRS, 1111 CONSTITUTION AVE.NW, DC 20224
:SENATORS PHIL GRAMM, AND KAY BAILEY HUTCHINSON

KPMG

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Telephone 202 467 3800
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MAR 1 6 1999

February 26, 1999

Internal Revenue Service
1111 Constitution Avenue, N.W.
Attn: CC:DOM:CORP:T:R:IT&A (Branch 4)
Room 5228
Washington, D.C. 20224

Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth
Washington, D.C. 20515

Re: Comments on Penalty and Interest Provisions in Response to Notice 99-4

Dear Sir or Madam:

We are writing in response to Notice 99-4, 1999-3 I.R.B. 1, in which you requested comments on the penalty and interest provisions of the Internal Revenue Code (the "Code"). These comments were requested pursuant to section 3801 of the IRS Restructuring and Reform Act of 1998, which requires the Joint Committee on Taxation and the Secretary of the Treasury to conduct separate studies on the administration and implementation of the interest and penalty provisions. We strongly support the initiative to improve the fairness and efficacy of the penalty and interest regime for all taxpayers.

We believe that significant improvements should be made both to the structure of the penalty and interest provisions and to the ways in which they are administered. While some taxpayers may factor penalties and interest into the calculation when choosing not to comply with tax filing or payment requirements, we believe that, in most instances, the cause of noncompliance is the complexity of the law, or the result of unique events and circumstances. The cost of penalties imposed by the Internal Revenue Service (the "IRS" or "Service"), as well as the cost of responding to proposed penalty assessments as a result of examinations or through IRS notices, is staggering.

We believe that assessing penalties on taxpayers who have a good history of compliance is counterproductive. Assessing penalties against these taxpayers often contributes to the perception that the system is unfair and may not be conducive to encouraging voluntary compliance. Taxpayers with good track records generally should not automatically be subjected to penalty assessments. Additionally, first time filers also should be considered for some type of preassessment relief. In such instances, the IRS should forego automatic assessment of penalties and, instead, furnish taxpayers with an educational notice that clearly apprises them of their responsibilities under the relevant tax laws. These and other matters are described more fully below.

KPMG LLP. KPMG LLP, a U.S. limited liability partnership, is a member of KPMG International, a Swiss association.

The complexity inherent in calculating interest, particularly in large scale multi-year examinations, almost always results in errors by taxpayers and the IRS. Taxpayers and the government may be losing thousands of dollars (or more) due to such errors. Interest calculations must be simplified.

1. Whether the penalty and interest provisions of the Code encourage voluntary compliance (i.e., whether they are effective deterrents to noncompliance, tax avoidance, and fraud).

In general, the penalty and interest provisions of the Code, *when properly administered*, should encourage voluntary compliance by taxpayers. For the most part, taxpayers understand that basic failures to comply with the Code – e.g., failure to file an income tax return or to pay tax in a timely manner – will result in the imposition of penalties and interest, and taxpayers will try to comply with the law to avoid those adverse consequences. It should be noted, however, that frequently the events or circumstances that create late filing, late deposits, or late payments, for example, are unique events in the life of a taxpayer or business. Too heavy a sanction for an inadvertent failure to comply, especially when the burden of compliance is heavy, may have the unintended effect of undermining faith in the fairness of the system and discouraging future compliance.

The fair application of the penalty provisions necessarily involves a trade-off between administrative ease and fairness to the taxpayer. While more objective or "black and white" standards may facilitate administering the law, more subjective criteria that take into account the facts and circumstances of a taxpayer's particular situation also play an important role in promoting fairness. As noted in response to question 3, below, we recommend that, in some situations, a penalty be modified to include an alternative in which objective factors (e.g., safe harbor provisions) are used to narrow the group of taxpayers to which a penalty applies, with the Service then allowed to make a subjective determination about the appropriateness of asserting a penalty with respect to any taxpayer outside the "safe harbor."

Sections 6038A and 6038C provide examples of penalty provisions that do not encourage voluntary compliance. Sections 6038A and 6038C impose reporting requirements on foreign-owned corporations. Under these provisions, certain transactions with related parties must be reported on Form 5472. The penalties imposed for failure to comply with these reporting requirements are substantial – an initial penalty of $10,000 per form and an additional $10,000 for each month (or fraction thereof) if the reporting requirements are not met more than 90 days after the Service sends notice to the corporation. The penalty can be avoided if the corporation can show, to the satisfaction of the Secretary, that there was reasonable cause for failing to provide the required information, but it is unclear whether the reasonable cause exception would apply, for instance, in cases where the taxpayer did not know that the Form 5472 was required. These penalty rules would more likely encourage voluntary compliance (and comport with basic notions of fairness) if the

penalties did not apply as long as the taxpayer corrected the error before the error was discovered by the IRS. This could be achieved by incorporating into the foreign reporting context a rule similar to the "qualified amended return rule" in effect for purposes of the accuracy-related penalty. *See* Reg. Sec. 1.6664-2(c)(3) (if an error is discovered and corrected before the IRS contacts the taxpayer, no accuracy-related penalty can be imposed). A similar qualified amended return rule should also apply to transactions required to be reported on Forms 5471.

2. Whether administration of these provisions by the Service encourages voluntary compliance.

The administration of the penalty provisions does not necessarily encourage voluntary compliance. As noted above, we understand that there necessarily is a balance between simplicity and fairness. The system nevertheless should be such that good faith mistakes will not result in penalties. Also, to the extent possible, penalties should be enforced uniformly. At a minimum, we suggest that existing flexible standards be coupled with meaningful and clear "safe harbors."

Additionally, taxpayers, especially unrepresented taxpayers, often do not know that it is possible to have penalties abated. Voluntary compliance with the tax laws is based in part upon a shared understanding that the law is being administered in the same way for everyone. If some taxpayers have penalties abated and other, similarly situated, taxpayers do not because they did not know that they could, the system will be perceived as unfair. We applaud the recent legislation requiring the IRS to put contact numbers on penalty notices and clarifying the content of these notices. These measures will promote fairness in the administration of the penalty provisions. We recommend, however, that additional information be provided in these notices, as noted in response to question 3, below.

Penalties should be imposed based solely on the principle that to do so would enhance voluntary compliance. They should not be imposed to raise revenue or to punish a taxpayer arbitrarily. If a taxpayer did not know of, and could not have easily learned of, an obligation, a penalty should not be imposed on that taxpayer for the first year in which the obligation arose. Subsequent failures by this taxpayer to comply with the obligation, however, generally would subject the taxpayer to a penalty. The basic threshold question that should be asked is, given this taxpayer's previous history of compliance, should the taxpayer receive an educational notice versus a proposed or actual assessment. One recent example that we encountered was the assertion of a late filing penalty on a foreign based taxpayer who inherited property and income from a person within the United States. The taxpayer was initially given poor advice, but once he learned that he had a filing requirement, he took prompt corrective action without IRS intervention. The IRS Service Center refused the request for abatement of the late filing penalty. While the taxpayer subsequently prevailed at Appeals, the additional cost to do so was high.

Another practice our clients encounter during an examination is the use of penalties by IRS examiners as bargaining chips in negotiations. This occurs when the examiner attempts to achieve an agreed-to examination by offering to drop penalties in exchange for an agreement. Although IRS policy clearly prohibits the use of penalties as bargaining chips, this policy should be effectively communicated to examiners and then strictly enforced. Using penalties as bargaining chips undermines everyone's confidence in the integrity of the system by conveying the insidious message that the merits of the taxpayer's case do not matter. Taxpayers also should be given the name of the examiner's supervisor and should be able to contact that person if he or she believes that penalties are being applied contrary to IRS policy.

We also believe that taxpayers should be afforded greater protection from penalties in the situations in which there is an absence of guidance on how a particular tax provision applies. For example, we would recommend that either reliance on well-reasoned treatises (or other publications), or the Service's failure to provide guidance on a tax law provision, should be taken into account in determining whether the taxpayer qualifies for the reasonable cause exception to the accuracy-related penalty.

3. Whether the penalty and interest provisions are designed in a manner that promotes efficient and effective administration by the Service.

Penalties

We do not believe that the penalty provisions are generally designed in a manner that promotes efficient and effective administration by the Service. In addition to a subjective "reasonable cause" standard to abate penalties, there should be an objective standard (i.e., one or more "safe harbors") for determining whether the penalty should apply in the first instance. Given the significant number of penalties that are abated under current law, objective standards should be designed to narrow the group of taxpayers to which a given penalty applies in a manner that corresponds to how the particular penalty has been administered historically. The subjective standard could be used as a supplementary measure to ensure that each penalty is being administered equitably and fairly. This two-pronged approach may very well result in more judicious *initial* application of penalties, which would be far preferable to the current process of proposing or assessing penalties and then abating a large number of them when protests are received. As noted in response to question 2, above, an educational notice also may be more helpful and appropriate than a penalty in certain situations.

We are hopeful that section 6751, added by section 3306(a) of the IRS Restructuring and Reform Act of 1998, will improve somewhat the effective administration of the penalty provisions. Section 6751, which applies to penalty notices issued after December 31, 2000, requires information in the notice identifying the type of penalty and how it was computed. Section 6751 should be amended to require that the penalty notice include the

rationale for imposing the penalty and an analysis of how it applies to the particular taxpayer. Section 6751 also requires supervisory approval before a penalty is assessed. A key to the sound administration of this section will be ensuring that the supervisory approval does not become a perfunctory or "rubber stamp" process. This provision should help ensure that penalties are applied fairly to all taxpayers. This provision, however, is not effective for almost two years. We recommend that the Service be encouraged to use the standards reflected in section 6751 at the earliest possible date.

We also think the efficient administration of the penalty provisions could be greatly enhanced by modifying the rules relating to payroll service providers. Companies hire payroll service providers to help comply with the filing and deposit requirements related to payroll taxes. Payroll service providers are responsible for the timely payment of billions of dollars in withholding taxes to the U.S. Treasury on a daily basis. Despite this contribution, the IRS frequently fails to recognize the unique role such companies play. In view of the assistance payroll service providers provide to taxpayers and the Treasury, consideration should be given to developing a rule that the use of a competent payroll services company presumptively qualifies for reasonable cause (or "safe harbor") relief from penalties. The presumption could be rebutted by proof of action by the taxpayer that was inconsistent with reasonable cause and good faith.

One of the specific problems faced by the use of payroll service providers is the lack of established, customer friendly procedures for handling "mass penalty assessments" based on some type of error by the payroll service provider. Payroll service providers handle the filing requirements for substantial numbers of companies. If there is an error on the part of the payroll service provider, penalties may be generated for each company. This may affect thousands of taxpayer entities. Since the Service frequently requires that these be dealt with at the company/taxpayer level, and because it is not always possible for the payroll service provider to obtain a power of attorney from each company, if reasonable cause exists, letters must be prepared for each company. This may result in thousands of letters being generated. To further complicate matters, the information required to resolve the issues is often in the hands of the payroll service provider, rather than the individual company. We recommend that an administrative process be developed that would allow the Service to deal directly with the payroll service provider, rather than with each individual company in such circumstances. We would be happy to provide you with additional comments and suggestions on developing an effective and fair unified PSP (payroll service provider) proceeding if you think that would be helpful.

Interest

Recent significant litigation involving how interest is calculated illustrates the complexity of this area. *See, e.g.*, *Fluor Corp. v. United States*, 126 F.3d 1397 (Fed. Cir. 1997); *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996). The last comprehensive guidance issued by the Service with respect to the calculation of interest, including

restricted interest, is contained in Rev. Proc. 60-17, 1960-2 C.B. 942. At a minimum, the Service should issue updated comprehensive guidance that takes into account both the legislative and judicial changes that have occurred since 1960.

Moreover, the Service's administration of the current interest provisions does not appear to be efficient and effective. The service centers, appeals offices, and district counsel are taking inconsistent approaches to interest computations. We think this problem may be somewhat alleviated for individuals after December 31, 2000, when the Service will be required to provide individual taxpayers with notices containing computations of interest. *See* section 6631 (added by section 3308(a) of the IRS Restructuring and Reform Act of 1998). We believe, however, that *all* taxpayers should receive a computation of interest, along with an explanation of how the interest was determined. In the light of changes made by section 3301(a) of the IRS Restructuring and Reform Act of 1998 to allow interest netting, we think that the notices regarding interest should also show the periods for which the zero net rate applies. Guidance also is needed on the effective date of the new rules, as it currently is unclear to which periods those rules apply. Moreover, until January 1, 2001, the details of the Service's interest computations will often remain a mystery to taxpayers. We urge the Service to provide guidance and establish meaningful notice procedures, including complete computations to *all* taxpayers, as expeditiously as possible.

4. Whether and how the Service's penalty and interest administration should be simplified or the burden modified on taxpayers and other third parties such as tax return preparers.

As we have stated previously, it may be advisable to create "safe harbors" that, in effect, automatically waive the penalties for taxpayers who have a long history of compliance or who are faced with a new tax obligation that they might not fully understand. In these situations, automatically waiving the penalty in the first instance would encourage voluntary compliance in subsequent years. This approach, when coupled with reasonable cause relief based on all facts and circumstances, should lead to more responsible penalty assertions while preserving necessary flexibility for non-automatic (i.e., reasonable cause) waivers based on the exigencies of the particular case.

Penalties relating to information returns might be applied more effectively and fairly if one location, preferably the Martinsburg Computing Center ("MCC"), administered the notices for these penalties. Currently, all magnetic filing of information returns is done with Martinsburg. As a result, the employees in the MCC have a greater understanding of the intricacies and complexities related to these filings. Assuming they have, or can be given, immediate access to the history of each taxpayer, they would have the information needed to determine initially whether a penalty and/or waiver of a penalty is appropriate.

In addition, in some situations, the Service attempts to collect the trust fund penalty imposed under section 6672 while the penalty is being contested administratively or judicially. It would ease the burden on taxpayers if collection efforts were stayed pending completion of the administrative and/or judicial proceeding.

As noted in response to question 3, above, the effective dates for the interest netting rules should be clarified.

5. Whether the penalty and interest provisions are designed to operate, and are administered by the Service fairly, such that similarly situated taxpayers are treated alike.

We appreciate that the inordinate complexity of the tax law and the scope of the Service's responsibilities preclude perfectly consistent application of penalty and interest provisions to all taxpayers. Nevertheless, as discussed above, we believe much greater effort must be directed to designing and administering the laws in a manner that promotes uniform treatment of taxpayers and encourages voluntary compliance. Unfortunately, we are aware of numerous instances in which taxpayers with similar fact patterns have received completely different penalty treatment by the Service.

The section 6651(a) failure to pay penalty leads to particularly unfair results. For example, this penalty is imposed when an individual taxpayer files a timely return but fails to pay the full amount of the tax shown on the return. The failure to pay penalty is not imposed, however, when the taxpayer files a Form 4868 and pays at least 90 percent of the tax due. The individual taxpayer who files timely and the taxpayer who files an extension will only be treated equally if there is a 10 percent safe harbor for the failure to pay penalty. The safe harbor should apply until the extension date (i.e., August 15). Thus, if an individual taxpayer files a timely return, pays at least 90 percent of the tax due on April 15, and pays the remaining 10 percent by August 15, no failure to pay penalty should be imposed. In order to treat individual taxpayers uniformly, the penalty should not attach until after August 15. A similar rule applies to corporate taxpayers (*see* Reg. Sec. 301.6651-1(c)(3), (4)). As noted in response to question 6, below, however, we believe that the failure to pay penalty no longer serves its intended purpose and should be repealed.

As noted above, we also believe coupling "safe harbor" relief provisions with more flexible facts and circumstances relief provisions will reduce the extent to which similarly situated taxpayers are treated dissimilarly for penalty purposes. Fairness also would be enhanced by suspending administrative collection while a penalty appeal is pending and by including a phone number for the local taxpayer advocate contact on the penalty notice.

As noted in response to question 3, above, we also believe the various functional groups (examinations, appeals, service centers, etc.) of the IRS take different approaches to

calculating and imposing interest and that improvements should be made in this area to increase fairness.

6. Whether the current penalty and interest provisions allow taxpayers to generate overpayments or underpayments in order to take advantage of disparities between commercial borrowing rates and the rates imposed by section 6621.

Although, in the past, some taxpayers would generate overpayments and underpayments to take advantage of disparities between commercial borrowing rates and the section 6621 rates, it has been our experience that this is no longer a significant issue. In response to the interest rate disparity that existed before 1986, Congress enacted the failure to pay penalty. The purpose of this penalty was to compensate the government for the fact that the interest rates on underpayments were substantially less than the commercial rates. When the interest rates were so structured, taxpayers were "encouraged" to put off paying their taxes for as long as possible. The interest rates, however, are now tied to the market interest rates and the original purpose for this penalty has disappeared. The government is now adequately compensated for the use of its money. The failure to pay penalty has outlasted its usefulness and should be repealed.

7. Whether communications from the Service to taxpayers provide an adequate explanation of why penalties and interest were imposed so that taxpayers can avoid penalties and interest in the future.

Penalties

Current communications from the Service do not provide adequate explanations of penalties and interest. A 30-day letter involving the accuracy-related penalty typically contains boilerplate language announcing that "[s]ince all or part of the underpayment of tax" for the relevant tax year is attributable to "one or more of" the accuracy-related penalties for negligence or disregard of rules or regulations, a substantial understatement of income tax, or a valuation misstatement, a 20% "addition to the tax is charged as provided by section 6662(a) of the Internal Revenue Code." This type of notice is totally unhelpful. It sets forth no rationale or analysis justifying the penalty and, indeed, does not even tell the taxpayer which component of the accuracy-related penalty is at issue.

As noted in the response to question 3, above, section 6751, when it becomes effective, may help address this issue, but still would not (unless changed) require including the rationale for imposing the penalty and an analysis of how the penalty applies to the particular taxpayer under the particular circumstances. Until section 6751 becomes effective, the Service should be encouraged to include in its 30-day letters an explanation of exactly which penalty or penalties are being imposed, why they are being imposed and how they have been calculated. These letters also should do a better job of informing taxpayers of their options – e.g., of explaining how to obtain relief from penalties on

reasonable cause grounds – as well as of informing taxpayers of what they did incorrectly and of how to avoid the penalty in the future. Under the current system, a taxpayer may have to hire a tax practitioner to understand how to obtain a waiver of the penalty and how to avoid the penalty in subsequent tax periods. Voluntary compliance would be greatly enhanced if taxpayers were better apprised of their rights and responsibilities.

Interest

The Service should provide interest calculations, including the base on which the interest is applied, the interest rate, and the period during which the interest has accrued. Interest calculations should also include the overlapping overpayment and underpayment periods during which the Service is applying the net zero rate of interest. Because interest computations generally are more complex for taxpayers that are not individuals, section 6631 should be amended to require the Service to include comprehensive interest computations on notices issued to *all* taxpayers.

8. The sources and scope of the Commissioner's authority to waive or not enforce penalties, and whether such authority should be modified.

The reasonable cause and good faith exception to various penalties (such as the section 6664(c) exception to the section 6662 and 6663 accuracy-related and fraud penalties) is one source of the Commissioner's authority to waive or not enforce penalties. There are some penalties, however, that do not have a reasonable cause and good faith exception. For example, there is no reasonable cause exception for estimated tax penalties imposed under section 6654 (with the exception of newly retired or disabled individuals) and section 6655. Another example is section 7519, which imposes extremely harsh penalties with no reasonable cause exception. We recommend that there be a reasonable cause and good faith exception to *all* penalties.

We would also include financial hardship as an exception to any penalty imposed on the failure to pay a tax or estimated tax. In some cases, paying the tax due could result in a loss of the taxpayer's business. In cases where the taxpayer can demonstrate such financial hardship, and where the taxpayer is otherwise cooperative with the Service in establishing a payment plan for the taxes, the penalty should be waived.

In certain cases, rather than the Service assessing a penalty and then abating it if the taxpayer protests, we have recommended that educational notices be used for first-time offenders. A notation could be made to the master file to ensure that educational notices are only issued for the first offense. In such a situation, the Service should inform the taxpayer of the amount of the penalty and interest if the penalty had been assessed. The notice should also contain information on what steps the taxpayer should take in the future to avoid the penalty. A subsequent delinquency would result in a penalty (unless special facts and circumstances in the subsequent year justified reasonable cause relief).

We recommend adding a specific Code section that would allow the Commissioner or National Taxpayer Advocate to waive or abate any penalty or addition to tax if it is in the interest of tax administration. Currently, Department of the Treasury Order No. 150-10 gives the Commissioner broad authority in the administration of the tax law. This Treasury Order can be used to waive penalties. The waivers of the estimated tax penalty noted in News Releases IR 88-39 (waiver of estimated tax penalties for farmers who did not receive information returns from Department of Agriculture by Feb. 15, 1988) and IR 88-62 (automatic IRS waiver of estimated tax penalties on retirement income for 1987) are examples of the Commissioner's broad authority.

9. Whether the Commissioner's authority to abate interest under section 6404 should be modified.

We recommend amending section 6404 to allow the Service to abate interest in situations that do not necessarily involve a ministerial or managerial act, but that warrant abatement on grounds of equity and good conscience. The "ministerial" and "managerial" requirements are unnecessarily limiting, vague, and do not focus on the equities of the case. In addition, we recommend modifying the Commissioner's abatement authority to include the abatement of interest on all taxes, such as employment taxes. Section 6404(e) only allows the abatement of interest on taxes subject to the deficiency procedures. Because employment and other taxes are not subject to the deficiency procedures, interest on those taxes is not subject to abatement. *See Woodral v. Commissioner*, 112 T.C. No. 3 (1999). There can be situations, however, when interest on employment taxes should be abated because of unreasonable errors or delays by the Service. Section 6404(e) could be easily modified to account for these situations.

10. Whether the Service's administration of its penalty waiver and interest abatement authority is accomplished uniformly and fairly and the effect of the Service's administration of its penalty waiver and interest abatement authority (including the effect on compliance).

Penalties

As set forth in our responses to several of the preceding questions, we believe that numerous improvements should be made to the ways in which the penalty rules are administered to make these rules more fair and effective.

Interest

Interest abatement authority at this time is more uniform because there are some standards for determining when interest is to be abated (i.e., unreasonable delays on the part of the Service in performing a ministerial or managerial act). As noted in the response to

question 9, above, we think the abatement authority should be expanded to include situations where the imposition of interest would go against equity and good conscience. The net worth requirements for Tax Court review of the Service's failure to abate interest may also result in some inequity. We do believe the IRS should aggressively abate interest in situations where delays in IRS decisions or case actions have contributed to large interest assessments in relation to the tax owed. The IRS should take the lead in abating the interest assessment rather than requiring the taxpayer to raise affirmatively the issue as a condition to abatement.

Additionally, the legislative history to section 6621(d) states that the Service is required to implement the most comprehensive interest netting provisions. We would suggest, as a simple way of meeting that goal, that interest rates for specific overlapping interest periods be adjusted in such a way as to effectuate a zero net rate. For example, assume the Service has refunded an overpayment, plus interest, and the limitations period has expired for that year. If there is an underpayment that accrued interest for at least a portion of the time that the overpayment was accruing interest, and the limitations period is still open with respect to the underpayment, interest on the underpayment would be the lower overpayment rate during the period of overlap. Thus, although the overpayment interest could not be recovered, the underpayment interest would be calculated in such a way as to effectively provide for the zero net interest rate. We would be glad to work with Service personnel in developing comprehensive netting procedures that would give taxpayers the benefit of the zero net rate while adequately compensating the government for the use of its money.

11. Whether certain provisions of the Code should be clarified to identify whether they impose a penalty or tax (given that the characterization may effect the determination of when interest accrues thereon).

Section 6601(e)(2) sets forth the general rules for imposing interest on penalties and additions to tax. It is not clear, however, whether and when penalties other than those imposed by chapter 68 are subject to interest – e.g., the penalties imposed by sections 5761, 6038A, 6038C, and 7261-7273. It is also unclear how interest accrues on certain "taxes" – e.g., the tax imposed by section 4979 on excess contributions to a retirement plan. We recommend that these issues be clarified in a manner that encourages compliance (i.e., that does not unnecessarily "stack" sanctions).

Certain interest rules act primarily as penalties and their application may result in the impermissible stacking of penalties. For example, the "hot interest" provision in section 6621(c) on large corporate underpayments compensates the government for the use of its money and effectively penalizes the taxpayer an additional two percent. In addition, before 1990, section 6621(c) imposed a 120 percent interest rate on tax-motivated transactions. This section was repealed for returns due after 1989, but the higher interest rate continues to apply to tax-motivated transactions that occurred in earlier years. Not

only does this provision act as a hidden penalty, but it also results in the dissimilar treatment of similarly situated taxpayers.

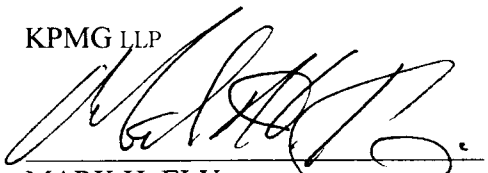
Interest should be imposed on underpayments as compensation for the use of the government's money. Any amount above the underpayment rate is a penalty and should be treated as such in the Code.

12. Whether different entities should be subject to different penalty regimes; and whether penalty regimes should align with the four operating units of the Service's future structure.

In order to promote uniformity and fairness, taxpayers generally should be subject to a similar penalty regime. Although it would be reasonable to have penalties administered by each of the four operating units of the Service's future structure, safeguards must be instituted to ensure that each such unit administers the penalties in a manner that is consistent with the way each other unit administers the penalties. In view of the potential for dissimilar treatment, we recommend that there be a National Office level function to oversee the administration of penalties and to ensure that it is uniform and fair.

Sincerely,

KPMG LLP



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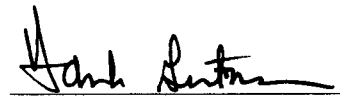

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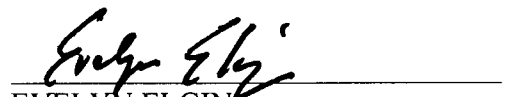

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March 26,1999

Mr. Kenneth Meissner
Joint Committee on Taxation
Study on Interest and Penalties
1015 Longworth Building
Washington, D.C. 20515

Re: Tax Penalty Provisions and Tax Protests by Conscientious Objectors

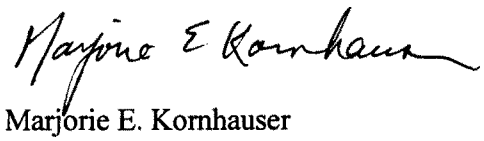
Dear Mr. Meissner:

In connection with your study of the various tax penalty and interest provisions, I urge you to recommend the exclusion from these penalties of taxpayers who incur them because of their conscientious objection to war. Such treatment would be consistent with this country's long tradition of respect for conscientious objectors.

The enclosed statement briefly explains why these taxpayers merit exclusion from the usual treatment of interest and penalties.

If you have any questions or I may be of further assistance, please feel free to contact me.

Sincerely,



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Conscientious Objectors and Interest and Penalty Provisions in the Tax Code

By
Marjorie E. Kornhauser*

Taxpayers who refuse to pay all or part of their taxes because of their conscientious objections to war currently incur tax penalties and interest as a result of these actions just as other tax protesters do. These war tax resisters, as they are commonly called, are different, however, from the other types of tax protesters. As part of a long and cherished tradition, grounded in this country's respect for religious freedom, they merit special consideration that could include exemption from interest and penalties.

The history of conscientious objection in the United States pre-dates the founding of this country. Many settlers, in fact, initially came to this country in search of religious freedom, including the freedom to follow their pacifist convictions.[1] A logical outgrowth of the rejection of war and a refusal to physically participate in it is a refusal to personally contribute in any way to military efforts. Consequently, some conscientious objectors also refuse to pay taxes that further military efforts. This practice is perhaps most famously illustrated by Henry David Thoreau's night in jail because of his refusal to pay a poll tax in protest of slavery and the Mexican-American War. War tax resisters, however, have existed throughout American history—from the Revolutionary War to the war in Vietnam.[2]

The tradition of toleration and respect for conscientious objection also pre-dates the American Revolution as evidenced by an exemption for pacifists in the draft laws of some colonies. Our respect for religious freedom—often the source of conscientious objection-- is embodied in the first amendment that constitutionally protects religious beliefs. Although this amendment may not require accommodation to conscientious objectors, it supports an environment that encourages such accommodation whenever possible. Indeed, our draft laws, consistently have contained exemptions for those who oppose participation in war in any form, based on religious grounds.[3]

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* Professor of Law, Tulane Law School. © Marjorie E. Kornhauser 1999.

[1] An excellent history of conscientious objection in this country up to World War I may be found in PETER BROCK, PACIFISM IN THE UNITED STATES: FROM THE COLONIAL ERA TO THE FIRST WORLD WAR (1968).

[2] The House Hearings on the Peace Tax Fund Bill of 1992 contain testimony from many individuals and groups about the history of conscientious objection to war and how payment of taxes that fund the military would violate their beliefs. *Miscellaneous Tax Bills and the Peace Tax Fund,* H.R. No. 102-98, May 21, 1992.

[3] The statute exempts those who object on religious grounds, but the Supreme Court has broadly interpreted this religious exemption to include those who object on non-religious grounds so long as "the beliefs which prompted his objection occupy the same place in his life as the belief in a traditional deity...." United States v Seeger, 380 U.S. 163 (1965).

Tax laws also accommodate religion. State and local laws, for example, exempt religious groups from property taxes. The Internal Revenue Code, also makes many accommodations to religion. For example, religious organizations are tax-exempt (§501), ministers may exclude from income the rental value of homes provided to them (§107), and certain taxpayers are exempt from FICA taxes on religious grounds (§§1402(g) and 3127).

Despite these provisions in other areas of the tax law, the Code currently does not accommodate a taxpayer whose conscience forbids him from paying taxes that finance the military. As a consequence, war tax resisters are compelled to either withhold a portion of their taxes equal to the percentage of the budget that goes to the military, claim extra exemptions to lower their taxes, or not pay their taxes at all so that the government will have to collect them via levies. Since the Code treats war tax resisters in the same manner as other types of protesters, conscientious objectors are subject to the usual interest and penalties for late filing and payment etc. as other taxpayers as well as to sections such as §6702 which were specifically enacted to target "frivolous" taxpayer protests, including war tax protests.

As a rule, tax protesters should be subject to interest and penalties because non-payment of taxes, in general, must be treated seriously. Tax protesters threaten the viability of a tax system based on voluntary compliance by threatening the flow of revenue and undermining a sense of fairness engendered when everyone pays his fair share. War tax resisters, however, are different from other tax protesters and therefore different treatment is justified. Unlike most other tax protesters they do not protest the legality of the tax or of the government's right to tax them. They do not claim that the sixteenth amendment is not valid, that wages are not income, or that they are citizens of some state but not the United States. Rather, they fully acknowledge the legality of the income tax and their own personal federal tax liability; they are willing to pay their entire share of taxes but are unable to do so voluntarily because it violates their consciences.[4] They violate the law only because they cannot violate their consciences.

The reason conscientious objectors do not pay their taxes is part of a long standing, well-recognized tradition in this country that many people respect even if they do not agree with it. Courts also may sympathize with these beliefs even while holding that the first amendment does not protect them. As the court in *U.S. v. Philadelphia Yearly Meeting of the Religious Society of Friends*, stated:

> It is ironic that here in Pennsylvania, the woods to which Penn led the Religious Society of Friends to enjoy the blessings of religious liberty, neither the Constitution nor its Bill of Rights protects the policy of that Society not to

[4] If a peace tax fund, for example, were enacted that would allow their full tax payments to be applied only to non-military functions they would willingly pay all their taxes. A World Peace Tax Fund Bill was first introduced in 1958 by Representative Edith Green of Oregon in the House (H.R. 12310) and Senator Hubert Humphrey of Minnesota in the Senate (S. 4181). Since 1975 a Peace Tax bill has been introduced in every Congress. In the 105th Congress, H.R. 2660 was introduced in October, 1997 and a bill is scheduled to be introduced into this Congress on April 15th.

> coerce or violate the consciences of its employees and members with respect to their religious principles, or to act as an agent for our government in doing so. More than three hundred years after their founding of Philadelphia, and almost two hundred years after the adoption of the First Amendment, it would be a "constitutional anomaly" to the Supreme Court . . . if the Religious Society of Friends were allowed to respect decisions of its employee-members bearing witness to their faith.[5]

Courts' unwillingness to affirmatively support a religious exception in tax cases rests on a belief that such an exception would undermine the tax system by opening a proverbial floodgate of taxpayers claiming exemptions from taxes that support functions of which they disapprove. This is the rationale given in 1982 by the Supreme Court in *United States v. Lee*[6] and cited approvingly by many courts thereafter. Despite the fact that the Court held that the first amendment did not require protection of religiously based claims to tax exemptions, Congress reacted sympathetically and enacted section 3127 that specifically granted the religious exception denied by the Court. No floodgates have resulted, nor will one occur if an exception is created for war tax resisters.

An exception to interest and penalties for conscientious objectors is, in fact, less radical than the section 3127 exception and therefore less likely to cause a landslide of claims to similar treatment by others. First, an exception for conscientious objectors is clearly distinguishable from other claims for exceptions due to the unique nature of the claim. Killing human beings is distinctly different and more extreme than other human actions. Our society has long recognized this as evidenced in its laws concerning murder and the history of conscientious objectors, as previously described.

Second, an exception to interest and penalties is less drastic and causes less of a drain on the tax system than an exemption from the taxes themselves. Third, the Code already provides for exceptions to interest and penalties. For example, §6651(a) prohibits penalties for failure to file or pay taxes when the failure is due to "reasonable cause," and

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[5] 735 Fed. Supp. 1300, 1305 (E.D. Pa. 1990)(first amendment does not protect employer who religiously objects to coercing its employees to violate their consciences from complying with levy against wages of employee who conscientiously refused to pay the portion of his taxes that went to the military).

Although many taxpayers have argued that the first amendment and the Religious Freedom Restoration Act require that the tax system must accommodate religious beliefs, courts have not so held. See, U.S. v. Lee, 455 U.S. 252 (1982).("Because the broad public interest in maintaining a sound tax system is of such a high order, religious belief in conflict with the payment of taxes affords no basis for resisting the tax."). Adams v Comm'r U.S. Court of Appeals, 3rd Cir., Advance court opinion, LEXIS FEDTAX, TNT, headline (1999-8963)(March 4, 1999)(RFRA does not exempt a Quaker from federal income tax).

[6] 455 U.S. 252 (1982)(section 1402(g) exception to FICA for self-employed taxpayers who religion prohibited the payment of social security taxes or receiving benefits did not extend to employers or employees). Although this case involved social security taxes, the Court stated the same rationale for the income tax. Id. at 260.

§6654(e) waives the penalty for failure to pay estimated taxes in "unusual circumstances". Although the courts have been unwilling to extend "reasonable cause" or "unusual circumstances" to include the failure to file or pay due to conscientious objection to war, Congress can easily do so, just as it extended its religious exception to FICA taxes when the Court refused to do so. Although courts have ruled that neither the first amendment nor the Religious Freedom Restoration Act protects conscientious objectors, they certainly fall within the shadows and merit consideration whenever possible.

Most taxpayers who protest or shirk their taxes undermine the tax system not just because they interrupt the steady flow of revenues that any government needs to survive, but because they serve the narrow interests of the individual taxpayer not those of the greater society. This is not true of conscientious objectors. Their ultimate goal, a world without war, is a worthy goal which all can recognize. As Rep. Andy Jacobs Jr. of Indiana said during the 1992 Peace Tax Hearings: "[I]f I am not a pacifist, that does not mean that I cannot applaud the efforts of those who honestly are pacifists.[7] War tax resisters act on their lofty ideals despite the monetary and personal toll a lengthy battle with the IRS often entails. In a sense, then, it is not they who demean the tax system but the IRS's treatment of them in the same manner as a taxpayer who cheats on his return because he just wants to save some money. A statutory exception to interest and penalties for conscientious objectors would not open floodgates. What it would do is restore some dignity to the tax collection process and free IRS resources to pursue taxpayers who truly are undermining the system.

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[7] Miscellaneous Tax Bills and the Peace tax Fund. Hearing before the Subcommittee on Select Revenue Measures of the Committee on ways and Means, House of representatives, 102nd Cong., 2nd Sess., Serial 102-98 (1992) 132. (Rep. Andy Jacobs Jr. of Indiana speaking)(Jacobs was a prime sponsor of the Peace Tax Fund bill even though he is not a pacifist. In fact at 18 he went to Korea as a Marine and has a 10-percent disability.)

Tulane

Marjorie E. Kornhauser
Professor of Law

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April 6, 1999

Mr. Kenneth Meissner
Joint Committee on Taxation
Study of Interest and Penalties
1015 Longworth Building
Washington, D.C. 20515

Re: Addendum to Conscientious objector status as good cause exception to interest and penalties

Dear Mr. Meissner:

Please accept this as an addendum to an earlier comment I sent you concerning conscientious objectors. In it I provide an example of the way in which Congress could easily provide an exception without impairing the tax system.

CO objectors, unlike other protesters, are more than willing to pay their full tax liability if they could do so without violating their consciences. Consequently, collection of their taxes would be no problem so long as these beliefs were respected. Perhaps the best way to accomplish this, as I mentioned before, would be a Peace Tax Fund that would allow conscientious objectors tax dollars from going to military purposes. Since that is beyond the scope of your study, I won't address that now.

The "good cause" exception is merely a fallback position. Even though the first amendment generally may not require accommodation to a religious belief, the Supreme Court has stated that if the law has provided for a system of "individualized exemptions, it may not refuse to extend that system to cases of 'religious hardship' without compelling reason." *Employment Div. Department of Human Resources of Ore. v Smith* 494 U.S. 872, 884 (1990) (quoting *Bowen v Roy*, 476 U.S. 693, 708 (1986)). Some courts have held that the "reasonable cause" or "unusual circumstances" of the penalty provisions do not create such a system of individualized exemptions. *See, e.g., Adams v Comm.*, n. 10 (3rd Cir, 1999). LEXIS, FEDTAX, TNT, Doc. 1999-8963 (advanced court opinion). Nevertheless, arguably, they are the same. Certainly it is an "appealing" argument, as even the Adams court recognized. *Id.* at ¶20. Although a court may be reluctant to read such an appealing argument into an ambiguous law, such should not be the case for a legislature that has a history of writing religious exceptions into the law and that has passed a Religious Freedom Restoration Act.

John Giffen Weinmann Hall
Tulane Law School
New Orleans, Louisiana 70118-6231

Creating such an exception should not be difficult. One way of handling it might be to add a new line on the 1040 to check CO status, accompanied by an affidavit so testifying. This would give the IRS timely notice so that it could immediately initiate collection proceedings, including garnishing wages and levying bank accounts. Many war tax resisters would not contest this collection of the underlying tax so long as interest and penalties were waived. For example, in *Rosa C. Packard* 7 F. Supp. 2d 143 (D. Conn., 1998), the taxpayer protested only the interest and penalties, not the underlying tax. Uncontested collection by these routine methods thus would be speedier and less costly than currently occurs. Taxpayers who submit affidavits that ultimately turn out to be false could be fined an additional amount.

Conscientious objection is a form of civil disobedience that has a long and honorable history in this country. Historically, it has generally involved accepting the penalties associated with that behavior. Penalties are not appropriate in this case, however, because conscientious objection to war taxes differs from the ordinary civil disobedience in two respects. First, most of the protesters are willing to comply with the law and pay their taxes if such beliefs can be accommodated. The accommodations I have mentioned can be accomplished relatively easily. Second, there is a long history of accommodating religion generally and conscientious objectors specifically. This is evidenced specifically by the draft law exemptions and more generally by a multitude of statutes and cases that permissively accommodate religion even when not mandated to do so. Religious accommodations even occur throughout the tax law (§§ 1402(g), 3127, and 501 for example).

Adding conscientious objection as a reasonable or good cause exemption from interest and penalties would merely be a continuation of a long tradition of accommodation rather than an embarkation onto an unknown path. It would also, not incidentally, improve the collection process.

Thank you for this opportunity to comment. I would be glad to provide any further information you may need.

Sincerely,

Marjorie E. Kornhauser
Professor of law

JUDY M. MORELL
CERTIFIED PUBLIC ACCOUNTANT

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OLIVE BRANCH, MS 38654

MAR 03 1999

February 23, 1998

Department of Treasury
Internal Revenue Service
Washington, D. C. 20224

Joint Tax Committee:

I am writing to express my concerns regarding the tax penalty and interest provisions that taxpayers and small business owners must deal with in attempting to comply with the tax law.

These provisions are overly burdensome and complex. I have many small business owners who attempt to operate a business, but soon give up after two or three years when they run into complex filing requirements of wage reports and other information returns. They must retain an accountant to deal with these matters. The penalty and interest they incur, many times innocently, because they simply do not know these rules exist, are too costly.

Small employers are the backbone of this society and they must have some relief from the cumbersome burden IRS puts on their business.

Respectfully,

Judy M. Morell

Judy M. Morell, CPA

HUGH O. MUSSINA
ATTORNEY AT LAW

6338 TOWN HILL LANE
DALLAS, TEXAS 75214

TELEPHONE
AREA CODE 214
368-3407

JAN 26 1999

January 21, 1999

Joint Tax Committee
1015 Longworth
House Office Bldg.
Washington, D. C. 20515

Gentlemen:

A recent item in the Wall Street Journal reported that your Committee is seeking public comments on tax-penalty and interest provisions of the Internal Revenue Code. I offer the following example of an actual case to illustrate the overly burdensome, complex and frequently unfair results of the application of the current tax code, or possibly, the misapplication of the provisions thereof.

In the case I will describe, the Taxpayer was making investments in an effort to be financially secure in retirement. Instead, because of the onerous penalties and exorbitant interest rates exacerbated by the unreasonable delay of the Tax Court and the unjustified penalties, she is facing severe financial hardship if not ruin in her retirement years due to a tax deficiency of $11,587.00 on her Form 1040 Income Tax Return timely filed for the year 1982, with the deficiencies, interest and penalties balloon to a total in excess of [redacted]. This is unfair.

FACTS

My client is a [redacted] widow retired from her practice as an [redacted] and living in a very modest country home [redacted]. In the year 1982 she invested [redacted] as a limited partner in a Limited Partnership named [redacted] The Partnership was formed for the purpose of cultivating the [redacted] plant at a location in Arizona. The idea was somewhat new and some experiments had to be made. In the year 1982 (apparently the first year), a substantial portion of the amounts available were expended by the Partnership for the required facilities, including irrigation and related costs. The entire cost thereof was claimed as a deduction on the 1982 Partnership Income Tax Return for "Research and Development". The Partnership issued its K-1 for 1982 to Taxpayer reflecting Taxpayer's share of such Partnership income and deductions for 1982 as being a loss of [redacted]. This amount was duly reported by Taxpayer on her Form 1040 filed for 1982, all as required by current tax law.

In 1984, my client's 1982 Income Tax Return was examined by the Internal Revenue Service and accepted, as filed, except for a small overassessment and for which Taxpayer received a refund on a matter unrelated to the Partnership.

The next communication received by Taxpayer from the Internal Revenue Service was a copy of "Notice of Final Partnership Administrative Adjustment", dated June 29, 1987, copy of which is attached, as Exhibit "A". It is noted that nowhere in the "Notice" is there any mention of any proposed adjustment to Taxpayer's Form 1040, nor the amount by which it would be affected by the Partnership adjustment. Taxpayer did nothing in response to the communication.

The second communication from Internal Revenue Service was dated October 13, 1998 and reflects the apparent outcome of the Tax Court judgment on the [redacted] issue, and is attached hereto as Exhibit "B". This communication gives no reason for the 14 year delay in making this determination.

The third communication, dated December 7, 1998 attached hereto and marked Exhibit "C", is a demand for payment of [redacted] tax and interest of [redacted].

The latest communication from the Internal Revenue Service is dated December 18, 1998, marked Exhibit "D" and attached hereto and represents a proposed assessment of a penalty of 50% of the interest charged on the original deficiency (Section 6653(A)(2) I. R. C., a negligence penalty of 5% of the understatement of tax Section (6653(a)), I. R. C. and a substantial understatement penalty of 25% of the understatement of tax. Section (6661) I. R. C.

In summary, the Internal Revenue Service proposes the following adjustments to Taxpayer's 1982 income tax return:

Additional income resulting from disallowance of a loss sustained by the Partnership [redacted]
Income tax thereon
Regular interest
Tax Motivated Interest Penalty (20% of regular interest (effective 1-1-95)
Substantial understatement Penalty
Negligence Penalty
Interest Penalty of 50% of interest on deficiency

DISCUSSION:

It is noted that the proposed deficiency of tax is [redacted] while the interest thereon is [redacted] and the penalties are [redacted]. The penalties are duplicative in nature, being asserted for practically the same offense-in this case for a deficiency for which this Taxpayer is in no wise to blame. She only reported on her income tax return for 1982 the amount which, by law, she was required to report. She did not in any way, have anything to do with the deductions reported on the Partnership return; however she is being penalized an amount over 3 times the amount of the additional tax. Penalties are being

grossly abused, and it is urged that substantial relief be granted by eliminating duplicate penalties for the same offense. Of particular note are the penalties of 50% of the interest on the deficiency and for a penalty of 20% of the regular interest for a tax motivated deduction.

It is further noted that, for some unknown reason, it has taken 14 years to obtain a final decision in this matter. During this time interest has continued to run until it has reached an amount almost 4 times the original tax liability. The reason for the delay is not apparent. Correspondence from the counsel representing the Partnership would indicate it was transferred in 1985 to an [redacted] Tax Court where the government purportedly had more attorneys to represent it in such Tax Court litigation. Apparently, the [redacted] Tax Court had a very heavy docket based on the time it took within which to reach a decision. It would appear that additional Tax Courts are needed, or that interest on deficiencies should be in some way limited, where delay unreasonably enhances the interest owed on a deficiency not unreasonably contested.

I would note that the Statute of Limitations has been extended on an individual's tax return, not on the rate normally charged to the individual, but instead being based on the limitations of a partnership and over which the Partner has very little control. I would urge that the Statute of Limitation for an individual as presently provided continue to be effective and without regard to the Statute of Limitations of a partnership, or at least that a partner be given a notice of his proposed deficiency in such language that he can deposit a sum of money to cover his share of a partnership deficiency, but that upon the rejection of the disallowance of a change proposed by the Internal Revenue Service, the individual will be allowed interest on the deposit he has made with the Internal Revenue Service to cover his share of the adjustment asserted by the Internal Revenue Service.

I would note that the Internal Revenue Service uses interest rates which are comparable with the rates usually being charged in business with one exception. Interest is compounded daily. This has the effect of increasing the interest rate by approximately one percentage point. I know of no other entity which compounds interest on a daily basis. I urge that consideration be given to compounding interest on an annual basis in conformance with the rates normally charged by other entities. The method followed by the Internal Revenue Service, would eliminate the ability of the average person to make the calculation of interest.

I suggest that serious consideration be given to some method to limit duplicate penalties on the same transaction and to limiting the interest rates being charged on deficiencies.

The changes which I have suggested are consistent with

treating taxpayers in a fair and equitable manner. It would cause some loss of income to the Internal Revenue Service, but could go far toward curing some inequities in the Internal Revenue Code.

Thanking you in advance for your consideration in reviewing these ideas which I feel would improve the Internal Revenue Code.

Yours very truly,

Hugh O. Mussina

NOTE: ATTACHMENTS DELETED BECAUSE OF CONFIDENTIAL TAXPAYER INFORMATION

Lindy L. Paull
Chief of Staff, Joint Committee on Taxation
1015 Longworth HOB
Washington, DC 20515

JAN 21 1999

Dear Ms. Paull:

This letter is in response to the request for comments on simplification of the penalty system. While my employer, TimeValue Software, is the leading non-governmental provider of tax interest and penalty calculation software, I am submitting these comments in my individual capacity.

Proposal: Repeal the section 6651(a)(2) failure to pay amount shown penalty. The (a)(2) penalty is extremely complex, has perverse effects on compliance, and is the source of significant conflict between the IRS and taxpayers. If the Congress wants to encourage prompt payment of amounts shown on a return, the interest rate on underpayments should be increased.

Perverse effect on compliance. If improving voluntary compliance means increasing the likelihood that a taxpayer will file an accurate return, the (a)(2) penalty does not improve compliance, because it only applies to amounts shown on a return. In fact, the (a)(2) penalty rewards non-compliance in that a taxpayer can avoid the penalty by not reporting the amount. That's right, the taxpayer that reports an item is subject to the penalty, but the taxpayer that doesn't report the item is not. While underreporting may subject the taxpayer to other penalties, the (a)(2) penalty actually provides an incentive for non-compliance.

Complexity: The (a)(2) penalty is extremely complex. The penalty runs at either 0.5% per month or 1.0% per month, depending upon various circumstances. The penalty is subject to a 25% cap. The penalty also interacts with the 6651(a)(1) failure to file penalty.

Not only is this penalty confusing to taxpayers, how many tax practitioners understand the circumstances under which this penalty runs for 0.5% for some months, then 1.0% for some months, and then in some cases drops back to 0.5% for a final month?

Source of taxpayer-IRS conflict. As a former IRS official, I understand the difficulty of the task given to IRS employees. After all, the tax administrator has the delicate task of separating people from their money. But we would all agree that the IRS's job could be made easier if the tax compliance rules were reasonable and understandable. The (a)(2) penalty fails this simple test.

If the Congress wants to encourage payment of amounts shown, the interest rate on underpayments should be increased. In my experience, taxpayers that are accustomed to seeing 18% rates on credit cards do not complain about an IRS underpayment rate that is currently at 7%. At the same time, these taxpayers are incensed and outraged at the thought of paying a "penalty" for unpaid tax amounts.

The (a)(2) penalty is subject to abatement for reasonable cause. While the reasonable sounds attractive, the abatement procedure produces uneven results and carries significant costs. How many tens of thousands of hours are devoted to the submission, evaluation, and resolution of these reasonable cause requests? And to what end? The resources that are devoted to these battles could be spent on more constructive endeavors.

The repeal of the (a)(2) penalty would be a significant step in improving IRS taxpayer relations.

Tom E. Persky
4 Jenner Street #100
Irvine CA 92618

NATIONAL TAX CONSULTANTS, INC.

WILLIAM STEVENSON,* ED.D., E.A., CFP RICHARD J. GREBINGER, CPA

January 28, 1999

FEB 02 1999

Ms. Lindy L. Paull, Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, DC 20515

Dear Ms. Paull:

The National Society of Accountants asked that I respond to you regarding input relative to penalty and interest provisions of the Internal Revenue Code. This is an incredibly busy time for practitioners like me; therefore, I won't be able to give you as complete a presentation that I'd like had we had more time.

In addition to responding to parts of your outline, I am attaching three different real life case studies. These down to earth situations should give you a feel for the impact that penalties have on normally compliant citizens.

Your first question relates to the matter of equity and whether penalties encourage compliance with the tax laws. When I served on the Commissioner's Advisory Group, we worked on a study of payroll tax penalties. The study revealed that most of the penalties where being levied on normally compliant taxpayers. While the threat of penalties may keep some businesses on the straight and narrow, the true fact is that the threat of penalties don't affect businesses in financial trouble.

The businesses that run into financial hard times see payroll trust funds and other taxes as simply just another bill. The fact is, all of the resources are deployed to attempt to keep the business and their personal lives afloat. In most cases, the money that should be used to pay taxes is not diverted to a Swiss bank account. All of the penalties that can be thought of will not stop a business in trouble from using the funds for bills other than tax liabilities.

One solution to the timely paying of payroll taxes, while politically unpopular, is to have the taxes electronically transmitted on the day that the wages are paid. This practice would eliminate a great many problems. Naturally, the Service would need to follow-up rather quickly if a business didn't make its transfer.

The penalties for individuals are also levied on a great many normally compliant individual taxpayers. They usually are the result of an honest oversight or a simple error. For example, many people get an underpayment penalty for failure to pay timely estimated taxes. However, some of these folks may have received a capital gain or other type of payment at the end

*Admitted to practice before the United States Tax Court

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of the year. Some tax preparers don't overcome the penalty with an annualization because it is quite a nuisance even with sophisticated computers programs.

When an elderly person receives a penalty, even for a small amount, the reaction is rather heated. These individuals would rather pay $100 in tax than $10 in penalties. Most penalties for these folks stem from the underpayment of estimated taxes.

Individuals who fall out of compliance and owe huge sums of money generally find their liability doubled or tripled due to interest and penalties. Most of them won't be able to pay the underlying taxes much less the interest and penalties. Is it worth having such a protracted and abusive penalty structure if we find that the system isn't serving its purpose? We must assume that the reason for the penalty structure is to encourage compliance and not to act as a tool to raise revenue.

You ask whether or not communications from the Service to taxpayers provide an adequate explanation of why penalties and interest were imposed. This query would only be appropriate if there was a real legitimacy for most of the penalties. What happens to most notices is not what the IRS thinks happens. When a taxpayer receives a notice, a telephone call is made to the practitioner. It is up to the practitioner to figure out and explain the reason for the penalty.

Probably the cruelest penalty of all is the 10% premature withdrawal assessment for those needy individuals that dip into their IRA's. If someone is desperate for funds, generally, the 10% penalty will not get in the way of obtaining the money and liquidating the retirement account. It is for that reason, I will discourage some young adults from starting an IRA.

You ask about the impact of the Commissioner's authority to waive penalties and abate interest. You need to deal with this matter in several sections. First the entire penalty concept needs to be reviewed. Hopefully, the Service will come to the conclusion that most penalties are levied on typically compliant taxpayers. If so, then the system will be changed and penalties minimized.

If the Service implements a new penalty philosophy coupled with a new system then it must set up a program to deal with the penalties that were levied prior to the new program. In that case, people empowered to address individual taxpayer issues will have to be trained in the concept of equity vis a vi the actual law. It's a tough call, but the program must begin somewhere.

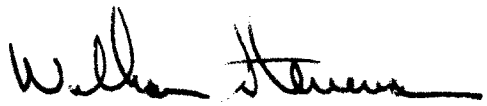
Using funds that should be earmarked for the payment of taxes is a problem of opportunity. The Service must minimize the opportunity of the business or the taxpayer to not pay the funds. As stated earlier, it is my judgement that payroll taxes should be paid at the time the salaries are paid. With the new

electronic transfer system, this problem is a lot simpler than it was in the past.

Another way of improving compliance could be to change the way the Division of Collections is organized. For example, in the best of all worlds, let's say that the Service agrees with my contention that the Offer in Compromise program should be administered by a Division other than Collections. Once an Offer is agreed to, then the taxpayer should be put into tax probation and assigned to a Revenue Officer for monitoring. The concept that I'm trying to put forward is to concentrate on prevention and maintenance rather than punishment. I think that you'll agree that when all is said anad done, we'll get a lot more bang for our tax buck!

At this time I do not have the personal assets to devote to the overhauling of the interest and penalty program on my own. However, I'd be pleased to continue to provide insights from the practitioner point of view.

Sincerely,



William Stevenson, EA
National Tax Consultants

copy: Bernie Phillips, Tax Manager
National Society of Accountants

Note: Attachments deleted because of confidential taxpayer information.

Tax Executives Institute, Inc.

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April 21, 1999

APR 2 1 1999

Lindy Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: ***Interest and Penalty Study***

Dear Ms. Paull:

In response to your December 23, 1998, request, I am pleased to enclose the Institute's comments on the administration and implementation of the penalty and interest provisions of the Internal Revenue Code. I am also enclosing a diskette in a Wordperfect 8.0 format.

If you have any questions or need additional copies, please do not hesitate to call Mary L. Fahey of the Institute's professional staff at (202) 638-5601, ext. 308.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

Lester D. Ezrati
International President

Enclosures

Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

The Penalty and Interest Study

submitted to

The Staff of the Joint Committee On Taxation

and

The Internal Revenue Service

April 21, 1999

On December 23, 1998, the staff of the Joint Committee on Taxation and the Internal Revenue Service requested comments on penalty and interest issues in conjunction with a study required by section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 STAT. 782. The IRS's request (Notice 99-4) was published in the January 19, 1999, issue of the INTERNAL REVENUE BULLETIN (1999-3 I.R.B. 9). The Joint Committee staff's request was in the form of a letter to TEI.

I. BACKGROUND

Tax Executives Institute is the preeminent association of business tax executives in North America. Our approximately 5,000 members represent 2,800 of the leading corporations through 52 chapters in the United States, Canada, and Europe. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is administrable and that taxpayers can comply with in a cost-efficient manner.

Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the Internal Revenue Service and provisions of the tax law relating to the operation of business enterprises. We believe that the diversity and professional training of our members enable us to bring an important, balanced, and practical perspective to the issues raised by the penalty and interest provisions of the Internal Revenue Code.

In their requests, the Joint Committee staff and the IRS ask for comments on penalty and interest issues, as well as specific recommendations on ways to (i) simplify the current penalty and interest regimes; (ii) make tax administration more efficient; (iii) reduce inequities and burdens on taxpayers; and (iv) deter noncompliance, tax avoidance, and fraud. Comments were specifically requested on 13 penalty and interest issues, including —

- Whether the provisions encourage voluntary compliance;
- Whether the provisions permit taxpayers to generate overpayments or underpayments to take advantage of disparities between commercial borrowing rates and the rates imposed by section 6621;
- Whether IRS communications provide an adequate explanation of why penalties and interest were imposed; and
- Whether the IRS's authority to waive penalties or abate interest should be modified.

TEI is pleased to respond to these requests.

II. PENALTIES

A. Overview

Ten years ago, Congress completed a major overhaul of the penalty provisions of the Code. The resulting legislation, styled the Improved Penalty and Compliance Tax Act, aimed to revise and streamline several penalty provisions. Congress made the changes because it concluded that —

> [T]he number of different penalties that relate to accuracy of a tax return, as well as the potential for overlapping among many of these penalties, causes confusion among taxpayers and leads to difficulties in administering these penalties by the IRS. Consequently, the [House Ways and Means] committee has revised these penalties and consolidated them. The committee believes that its changes will significantly improve the fairness, comprehensibility, and administrability of these provisions.

H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1388 (1989).

A decade later, we face the same Sissyphean task — reforming the Code's penalty provisions. Rather than learning from the past — that penalties should be simple, fair, and easy to administer — Congress, sometimes at the IRS's and Treasury Department's urgings, has piled penalty upon penalty, targeting specific areas such as transfer pricing and corporate tax shelters in perhaps well-intentioned, but mishandled efforts to encourage compliance. Rather than being simple, direct, and effective, penalties have become almost as complicated as the underlying provisions they seek to enforce. Dangerously, too, the enactment of new or racheting up of existing penalties deprives the system of proportionality while representing a politically expedient way of raising revenues without increasing "taxes."

Tax Executives Institute believes that in order to achieve a penalty framework that is comparatively fair, simple, and easy to administer, the first step is to affirm the proper role of penalties in the tax system. The issue is not whether taxes or interest are due and owing. Rather, the focus is only whether a penalty should be imposed owing to a taxpayer's failure or inability to report the correct tax liability or file an accurate information return. TEI believes that four principles should drive the establishment of an effective and fair penalty regime that encourages voluntary compliance.

First and foremost, penalties should be used to punish intentional or negligent noncompliance — essentially purposeful acts — not inadvertent errors or omissions. The current structure does not effectively distinguish between the two, putting taxpayers who unintentionally fail to meet some requirement in the same category with those who willfully

decide not to comply. The taxpayer's history of compliance with the tax laws should therefore be considered in determining whether to impose a penalty.

Next, each penalty should be capable of being abated within the IRS subject to a reasonable cause standard. In other words, there should be no automatic, strict liability, or mechanically imposed penalties. Penalties — such as those for the failure to pay estimated tax penalties under sections 6654 (individuals) and 6655 (corporations), to comply with the reporting requirements under sections 6038A and 6038C (relating to foreign corporations), or to comply with the transfer pricing documentation rules under section 6662(e) — should be revised to include a reasonable cause exception. The IRS should also be given the discretion to waive any penalty in appropriate circumstances. In addition to considering the taxpayer's history of compliance in determining whether a penalty should be imposed, the IRS should weigh the effect of the lack of guidance on an issue and the taxpayer's size and sophistication.

Third, penalties should encourage disclosure. As a general matter, no penalty should be asserted where the taxpayer has fully disclosed the item or transaction. Some penalties — such as the corporate tax shelter penalty of section 6662(d)(2)(C)(iii) — actually discourage disclosure of return positions. These provisions should effect a waiver of the penalty where the position is fully disclosed. In addition, more provisions such as the "qualified amended return" rule set forth in Treas. Reg. § 1.6664-2(c)(3) — providing that errors detected and corrected before the IRS contacts the taxpayer will not result in an accuracy-related penalty — should be adopted.

Finally, penalties should not be used to raise revenue. This principle is closely linked to the first, *i.e.*, that penalties should be used solely to punish intentional misconduct. Hence, penalties should be structured, interpreted, and applied to encourage voluntary compliance and facilitate the orderly administration of the tax laws (*e.g.*, by encouraging disclosure); legislation implementing penalties should not be revenue-based. Moreover, penalties should not be used as "bargaining chips" in audit negotiations. To do so undermines taxpayer belief in the fairness of the tax system.

TEI's comments on specific aspects of the current penalty regime follow. The comments focus on current law and do not discuss issues such as the proposed corporate tax shelter penalties set forth in the Clinton Administration's FY2000 Budget. The issues raised by these proposals will be addressed in a separate submission.

B. Clear Standard of Conduct

Penalties should not be imposed where the required standard of conduct is not clearly defined or communicated. Both Congress and the IRS bear responsibility in this area. Congress has the responsibility for enacting legislation that clearly defines what is required of taxpayers. The IRS also bears responsibility for defining requirements and, perhaps more important, for communicating these requirements to taxpayers in a simple, timely, and understandable manner.[1] Consistent with its new mission, the IRS should continue to seek

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[1] Such guidance must be readily available to *all* taxpayers. Many taxpayers, particularly small businesses, lack expertise and sophistication in tax matters. For these taxpayers, the compliance requirements can be extremely difficult, especially if they are unfamiliar with revenue procedures, rulings, or regulations. The lack of knowledge imposes a responsibility on the IRS to issue prompt and clear guidance to taxpayers in a manner that is readily available to all.

to inform taxpayers of their tax obligations through a variety of means, including the posting of guidance on the IRS's website. The IRS's efforts in this latter regard are commendable.

The IRS's recent actions regarding the Electronic Federal Tax Payment System (EFTPS) provide an example of how the IRS should work cooperatively with taxpayers to achieve compliance (rather than simply punish). Because the requirements were not well known and because of problems encountered by taxpayers in striving to comply, the IRS has repeatedly delayed the imposition of penalties for failing to use EFTPS. It opted instead for outreach programs to better educate the public. This approach encourages voluntary compliance.

C. Encouraging Voluntary Compliance

The current penalty regime may well discourage voluntary compliance by subjecting any error or omission, intentional or not, to a penalty. We need to move away from a regime where penalties are proposed for *every* error, followed by a cumbersome waiver or abatement process. TEI sincerely believes that if taxpayers knew that they could correct errors without the risk of penalty, more errors would be corrected. If penalties were imposed only where there is some evidence of intentional disregard or willful neglect, taxpayers would be more likely to resolve omissions caused by oversights and failure to understand the requirements.[2]

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[2] This is particularly true for small taxpayers. Consider the self-employed individual who may not learn of a reporting requirement until he meets with his accountant after the close of the taxable year. Does he file the return later and seek a waiver of the penalty or does he continue in his noncompliance in the hope the IRS never notices?

D. Consistent Application of Penalty Standards

Our members' experience has shown that the standards for imposing penalties are not applied consistently (*e.g.*, in respect of the failure-to-deposit penalty) across the IRS's Service Centers. What is accepted as reasonable cause by one center may be rejected by another, though the facts are substantially identical. To further the goal of consistency, TEI recommends that some form of coordinated review of penalty application be established, perhaps in conjunction with the new IRS business units.

E. Specific Penalties

(i) Substantial Understatement Penalty. Section 6662(a) imposes a 20-percent penalty on the portion of an underpayment attributable to any of the following: (i) negligence or disregard of rules or regulations; (ii) a substantial understatement of income tax; (iii) a substantial valuation overstatement; (iv) a substantial overstatement of pension liabilities; or (v) a substantial estate or gift tax valuation understatement. The accuracy-related penalty was enacted in 1989 to replace several other penalties, including the negligence, substantial understatement, and valuation overstatement penalties. The penalty is generally not imposed with respect to any portion of the underpayment for which there is reasonable cause if the taxpayer acted in good faith. I.R.C. § 6664(c)(1).

For corporations, an understatement for any taxable year is substantial if it exceeds the greater of $10,000 or 10 percent of the tax required to be shown on the taxpayer's return.

I.R.C. § 6662(d)(1).[3] An exception to the penalty is provided for items in respect of which there is substantial authority for or adequate disclosure of the taxpayer's position. For this purpose, "authority" includes statutes, regulations (final, temporary, and proposed), court decisions, revenue rulings and procedures, private letter rulings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices, and tax treaties and their official explanations. Legislative history (including committee reports and floor statements by the bill's managers) is also authority, as is the general explanation of tax legislation prepared by the staff of the Joint Committee on Taxation. Substantial authority does not, however, include a treatise, though the authorities listed in the treatise may satisfy the substantial authority test.

The rules for determining whether an authority is "substantial" are fraught with ambiguity. For example, Treas. Reg. § 1.6662-4(d)(3)(ii) requires a taxpayer to be able to effectively critique the legal analysis of different courts of law in determining whether there is "substantial authority" for a return position. The regulation states that a court opinion simply stating a conclusion is to be given less weight than one reaching its conclusion by cogently relating the applicable law to pertinent facts. Thus, an appeals court decision may arguably not support a taxpayer's position where a different conclusion has been reached by a district court or the Tax Court, depending upon the quality of the opinion and the depth of its analysis. The regulations thus place a premium on the ability to assess the legal analyses and conclusions of different courts. These uncertainties reduce the effectiveness of section

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[3] These thresholds can be easily exceeded, especially in respect of taxpayers with substantial net operating losses.

6662(d) in encouraging voluntary compliance. Taxpayers should be permitted to rely on all court opinions, especially courts of appeal, without engaging in the complicated weighing of all authorities.

Additional confusion is created by Treas. Reg. § 1.6662-4(d)(3)(iv)(B), which provides that the applicability of district court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is *not* taken into account in determining whether there is substantial authority for the tax treatment of an item. Stated bluntly, this does not make sense in a jurisdiction where the authority supports the taxpayer's position, especially since the focus here is not the correctness of the taxpayer's treatment of an item (whether the taxpayer owes additional tax), but whether the taxpayer should be penalized for adopting the position that a federal judge in the taxpayer's community has ruled is correct. Hence, if a taxpayer resides in a jurisdiction in which a tax issue has been favorably decided, the taxpayer should be able to cite that decision as substantial authority, even if district courts in other jurisdictions have reached a contrary conclusion.[4]

In addition, in the absence of other guidance, taxpayers should be permitted to rely on well-known treatises (such as Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders*; Peel, *Consolidated Tax Returns*; or McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners*).

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[4] Treas. Reg. § 1.6662-4(d)(3)(iv)(B) does provide that there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a U.S. court of appeals to which the taxpayer has a right of appeal with respect to the item. This provision is limited, however, to appellate decisions and does *not* address district court decisions — a distinction TEI believes should be eliminated.

(ii) *Tax Shelter Penalties.*[5] The Taxpayer Relief Act of 1997 amended section 6662(d)(2)(C)(iii) of the Internal Revenue Code to provide a new definition of "tax shelter" for purposes of the substantial understatement penalty.[6] Under this definition, a tax shelter includes any entity, investment, plan, or arrangement with a *significant* purpose of avoiding or evading federal income tax. Under prior law, a plan was a tax shelter only if tax avoidance or evasion was a *principal* purpose. The change is effective in respect of transactions entered into after August 5, 1997. The definition also affects the scope of section 6111(d)(1)'s registration requirements for confidential corporate tax shelters, which was also addressed by the 1997 legislation. (The registration provision becomes effective after promulgation of final Treasury Regulations.)

TEI appreciates Congress's desire to discourage abusive tax-motivated transactions. Whether amending the section 6662 penalty and extending the section 6111 registration provisions were the most efficacious way of accomplishing this goal, however, is open to debate. In our view, too many penalties combined with too vague substantive standards are a recipe not for enhanced compliance but for uncertainty and frustration by both taxpayers and IRS personnel. Moreover, because disclosure of the tax shelter item does not insulate a taxpayer from assertion of the section 6662 penalty, the statute has the perverse effect of

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[5] This section does not discuss the Clinton Administration's recent proposals concerning tax shelters.

[6] The substantial authority and disclosure exceptions provided in the substantial understatement penalty do not apply — and, hence, the existence of substantial authority or a taxpayer's disclosure has no effect — in respect of any item attributable to a corporate "tax shelter." Thus, if a corporation has a substantial understatement attributable to a tax shelter item, the penalty applies with respect to that understatement, unless the reasonable cause exception of section 6664(c)(1) is satisfied.

discouraging taxpayers from disclosing aggressive tax-planning positions on their returns. Thus, we question whether an additional penalty for tax shelters is appropriate or effective.

If the penalty is retained, however, we recommend a return to the "principal" purpose standard. The significant purpose standard of current law is so broad that it threatens to reach legitimate tax planning. Taxes are always a significant consideration for any corporation evaluating a transaction. Indeed, companies and tax directors ignore the tax law at their peril. The significant purpose test is too nebulous and should be discarded.[7]

(iii) *Information Reporting Penalties.* Current law typically provides that information-reporting penalties will not be imposed if the error is due to reasonable cause and not due to willful neglect. *See, e.g.*, I.R.C. § 6652. Too often, the latter part of that standard ("not due to willful neglect"), which should be incorporated in the interpretation of reasonable cause, is ignored.

Considering the complexity of the tax rules and the rapid pace at which changes are made, errors will undoubtedly occur, particularly with the increased reliance on automated processes. Automation allows taxpayers to accomplish a variety of routine compliance tasks efficiently. Unfortunately, this efficiency sometimes comes at a price, as subtle design flaws in the program may produce errors that are not always detected in testing. This could result in a taxpayer missing a filing or payment deadline, with the errors not being discovered until

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[7] Transactions that the significant purpose test were intended to reach — such as stepped-down preferred stock or liquidating REITs — would also have been covered under the more established principal purpose test. Thus, we question whether the new standard is necessary to address these transactions.

the first notice is received from the IRS. Such an error hardly rises to the level of "willful neglect." For this reason, penalties should not be proposed automatically in every situation where a taxpayer fails to comply with an information-reporting requirement. The IRS should respond to errors with an initial notice describing the problem and explaining how to correct and prevent it. Repeated failures to comply could then be deemed willful neglect.

Such an approach is similar to the process used in many states (such as Texas, Wisconsin, and Connecticut). In many cases, when a state conducts an audit, an assessment for tax will be issued along with an interest assessment to compensate for the use of money. Although the auditor has the discretion to do so, penalties will generally not be proposed. Penalties are only applied where the taxpayer has taken some action that clearly shows the noncompliance was intentional. Such a standard should be applied to federal penalties as well.

This approach would reduce the administrative burden not only on taxpayers — who must respond to penalty notices — but also on the government — which must process the notices and the requests for waivers.

(iv) *Tiered Penalty Structure.* Several areas within the current penalty regime use some form of tiered penalty structure, under which the rate of penalty increases the longer the infraction goes uncorrected. For example, the penalty imposed for failure to deposit taxes under section 6656 imposes a 2-percent penalty if the deposit is 1-5 days late, a 5-percent penalty if the deposit is 6-15 days late, a 10-percent penalty if the deposit is more than 15

days late. Although the tiered system may make conceptual sense, its compressed time period prevents it from operating equitably. Hence, the 10-percent penalty for a payment that is three weeks late is equivalent of an annual interest rate of more than 200 percent — an excessive penalty we suggest. Such a result is inequitable and does not encourage compliance.

TEI recommends that the tiered system be based not merely on the passage of time but on the number of instances of errors within a given time frame. For example, under the failure-to-deposit penalty structure, if a taxpayer had complied with the deposit requirements within, say, the last year, no penalty would be imposed on the taxpayer's first failure in the current year. A second failure, however, might trigger a penalty at a low rate, if the taxpayer's actions warranted it. The rate of penalty would increase for additional failures, since this might indicate an intentional disregard of the requirements. For this purpose, a group of failures occurring at the same time for the same reason would be regarded as a single error. Thus, if a taxpayer attempts to upgrade its computer system (perhaps to become Y2K compliant), but a programming error prevents the timely filing of its information returns, the taxpayer's history of compliance should be considered in determining whether a penalty should be imposed.

A tiered structure with penalty rates that increase with the frequency of failures would encourage voluntary compliance and punish those taxpayers who make little or no effort to meet the filing requirements. No penalty should be imposed on the first one or two failures.

(v) *Cascading Failure-to-Deposit Penalties.* Under current rules, if a taxpayer makes a tax deposit that is less than the amount required, the IRS will make up the shortfall by applying funds from the next deposit. For employment tax deposits that are made frequently, a single underdeposit within a return period can affect all future deposits as each subsequent deposit has a portion applied to the previous one. This causes the taxpayer to incur a penalty for multiple deposits, though the error occurred in respect of only one.

Recognizing this problem, the IRS Restructuring Act contained provisions permitting taxpayers to specify the application of deposits to specific periods upon receipt of a penalty notice. In addition, after 2001, the IRS will automatically apply all deposits to the most recent period, then apply any excess to prior periods. This equitable change to the application of deposits should be made as soon as possible, rather than waiting to 2002. This would eliminate a significant amount of unnecessary work on the part of taxpayers and the IRS in resolving the proper application of deposits and prevent taxpayers from being penalized for what, in essence, is a single error.

F. Miscellaneous Issues

(i) *Clarity of Notices.* Notices of proposed penalties can be significantly improved. All notices should clearly indicate the type of penalty, the reason for its proposed imposition, and, most important, the actual calculation. This information is critical to permit taxpayers to determine the validity of the proposed assessment and to identify the cause of

the problem. While the IRS has a mandate to begin providing this information for notices issued after 2000, this change should be implemented as soon as possible.

(ii) *Prompt Processing of Taxpayer Responses.* The IRS must improve the timeliness of its processing of taxpayer responses to penalty notices. In some cases, taxpayers will submit a written response to a notice within the required time frame, but the response is not processed timely, generating a second notice and a second taxpayer response. This is inefficient and places an unnecessary burden on taxpayers.

(iii) *Third-Party Responses to Penalty Notices.* More and more, businesses are outsourcing functions to third parties. In these cases, the third party may have the most relevant information regarding the cause of any failure that generated a proposed penalty. The third party may be a service bureau completing certain functions on behalf of its clients or a reporting agent authorized to file based on Form 8655. This makes the third party the appropriate entity to respond to the penalty notice, a process that the IRS prefers to have take place by telephone rather than in writing.

The IRS will generally not discuss any matter with anyone other than the taxpayer without a valid power of attorney (Form 2848) on file. Obtaining a power of attorney simply to clarify a matter of which the third party clearly has knowledge can be time consuming, burdensome, and many times difficult to coordinate. In other cases, the IRS insists the caller be an officer of the company, not simply an employee. In large companies, officers are generally far removed from the day-to-day operations and may have little, if any, knowledge

of the facts surrounding a specific penalty. Requiring an officer to respond personally to a notice is an exercise in futility in many instances.

The reasons underlying the IRS's current rules are laudable — preserving taxpayer confidentiality — but the current rules are time-consuming and burdensome. A mechanism is needed to identify third parties who can provide an oral response to the IRS and receive information in return. Based on reports from our members, TEI understands that at least one District Office has experimented with including a unique identifying number on each notice of proposed penalty. If a caller responds to the notice and provides the name and employer identification number (EIN) of the taxpayer and the identifying number, the IRS assumes the caller is authorized to discuss the matter, eliminating the need for a power of attorney and providing a swift resolution of any questions. TEI recommends that such a procedure be implemented permanently and universally.

Moreover, a mechanism should be developed to identify on the return the third party authorized to respond to questions. For example, at least one state income tax return asks the taxpayer whether information contained in the return can be discussed with the designated paid preparer. This statement is signed by the taxpayer when the return is filed. A similar mechanism at the federal level would allow the IRS to discuss information submitted with the parties having the knowledge about how the information was developed.[8]

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[8] Taxpayers should receive a copy of all notices sent to third parties.

(iv) *TIN Verification System.* One key to proper information reporting is to ensure the payee's name and identification number match IRS and Social Security Administration records. This process could be significantly improved with a system to verify taxpayer identification numbers (TIN) for large-volume filers. Some programs currently exist, but they do not easily handle verification of large numbers of TINs from a single filer at one time.

A TIN verification system was in place on a pilot basis several years ago at the Martinsburg, West Virginia, Service Center. Unfortunately, the equipment supporting the process was destroyed by fire and has never been replaced. Congress and the IRS should heed taxpayers' calls and allocate sufficient funds to create a TIN verification system for large-volume filers as soon as possible.

III. INTEREST

A. *Interest Rate Differential*

Section 6621 of the Code establishes the rate of interest to be paid on over and underpayments of tax. The rate on overpayments of tax by a corporation is the federal short-term rate plus *two* percentage points; the underpayment rate is the federal short-term rate plus *three* percentage points. "Large corporate underpayments" are subject to an interest equal to the federal short-term rate, plus *five* percentage points (the so-called "hot interest" provision).[9] Thus, the rate of interest the government charges corporate taxpayers on tax

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[9] The higher large corporate underpayment interest rate applies only to periods after the "applicable date." The calculation of the applicable date differs. If the deficiency procedures apply, the

deficiencies is higher than the rate of interest the government pays on refunds. TEI submits that the provision is both inequitable to taxpayers and ill-advised. The interest rate differential for corporations should be eliminated. (The IRS Restructuring and Reform Act of 1998 eliminated the differential in respect of individual taxpayers.)

The legislative history of the interest rate differential states that the provision was necessary because "[f]ew financial institutions, commercial operations, or other entities, borrow and lend money at the same rate." H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 849 (1985) (hereinafter cited as the "1985 House Report"); S. Rep. No. 99-313, 99th Cong., 2d Sess. 184 (1986) (Pub. L. No. 99-514) (hereinafter cited as the "1986 Senate Report"). There was also a concern that the differential between the tax interest rate and the market rate might "cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate." 1985 House Report at 849; 1986 Senate Report at 184.

TEI believes that the statements of congressional intent evidence a misapprehension of the reasons taxpayers overpay their taxes and a lack of appreciation for the effect of legislative changes that were made in the 1980s. Perhaps more fundamentally, we believe the differential reflects a congressional proclivity to use interest provisions as a penalty or

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applicable date is the 30th day following the earlier of the date on which (a) the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in IRS's Office of Appeals, or (b) the statutory notice of deficiency is sent by IRS. If the deficiency procedures do not apply, the applicable date is 30 days after the date on which IRS sends the first letter or notice that notifies the taxpayer of the assessment or proposed assessment.

a disguised tax to raise revenue — policy decisions that in our view have spawned disrespect for the fairness of the tax system.

When the tax interest rate was determined only once every two years (as was the case before the Economic Recovery Tax Act of 1981 was enacted), it was quite possible — especially in times of frequent and substantial interest rate fluctuations — that the spread between the section 6621 rate and the market rate would be substantial. With the changes made first by ERTA (requiring the annual adjustment of the rate and the daily compounding of interest), then by the Tax Equity and Fiscal Responsibility Act of 1982 (requiring the semi-annual adjustment of the rate), and finally by the Tax Reform Act of 1986 (requiring quarterly adjustments), the potential for any significant differential was limited. Indeed, inasmuch as TEFRA also changed the rules relating to when interest on refunds would commence running, the limited ability of taxpayers to "overpay to take advantage of an excessively high rate" was essentially eliminated. Thus, contrary to the implication in the congressional reports, taxpayers do not deliberately "lend" money to the government. If such practices ever occurred, they were effectively put to an end by the amendments since 1982.

The interest rate differential is not only grossly unfair, but counterproductive. By giving the government an unfair advantage insofar as its obligation to pay corporate taxpayers interest, the provision undermines efforts to restore faith in the integrity and fairness of the tax system. Adequate safeguards are now in place to prevent manipulation of payments.

To suggest that a differential interest rate is justified because "financial institutions" and "commercial operations" borrow and lend money at different rates is to miss the point: the government should neither view itself nor strive to be viewed by taxpayers as a financial institution. Taxpayers have no freedom to negotiate interest rates and terms with the government, as they might with a commercial lender (or borrower). References to financial institutions and to arm's-length negotiations are simply not appropriate.

As previously explained, the IRS Restructuring and Reform Act eliminated the interest rate differential for individuals, but not corporations. The rates on corporate over- and underpayments should be uniform. Any difference in rate acts as a penalty and should be scrupulously avoided.

B. Interest Netting

The current regime of differential interest rates for overpayments and underpayments, coupled with the differences for large corporations, is chiefly responsible for recent enactment of legislation permitting interest netting. The situation arises when taxpayers both owe money to and are owed money by the government (but the debts bear interest at different rates) and is a common occurrence for large corporations that may have overpayments and underpayments of different taxes for several years as the result of multi-year and overlapping audits. (An IRS determination, say in Year 8, that a taxpayer should have deducted an expense in Year 1 instead of Year 2 could trigger an adjustment owing to the interest-rate differential, even though the taxpayer was a net creditor of the government during the entire period.) In 1998, Congress passed legislation, establishing a net interest

rate of zero where interest is payable on equivalent amounts of overpayments and underpayments of tax.[10]

Returning to one rate of interest — which approximates the "real world" market rate — for both under- and overpayments would greatly reduce or eliminate the need for netting. In the absence of such a change in the law, we believe that the IRS should institute the most comprehensive netting system possible. Regrettably, the IRS's most recent guidance on the issue, Rev. Proc. 99-19, signals an intent to deny taxpayers a full measure of relief.[11] For example, although it is possible to interpret the rules to permit netting when the statute of limitations is open for either the year of the overpayment or the underpayment, the revenue procedure requires the statutes of limitations for both the underpayments and overpayments be open in order to qualify for transitional relief. Such an approach continues the inequity of the current law and should be eschewed. If a taxpayer-favorable interpretation under the current law is not possible, then the IRS and Treasury should seek a legislative solution.

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[10] The provision applies to interest for periods beginning after July 22, 1998. In addition, the provision applies if: (i) the statute of limitations has not expired with respect to either the underpayment or overpayment; (ii) the taxpayer identifies the overlapping periods for which the zero rate applies; and (iii) the taxpayer requests the netting before December 31, 1999.

[11] TEI is in the process of preparing comments on Rev. Proc. 99-19, which will be submitted as soon as possible.

C. Computation of Interest

The complexity of the Code's interest provisions hinders efficient administration. One way to simplify the calculations would be to provide for the use of simple, rather than compound, interest.

In addition, under current law, errors in calculation by the IRS are common, especially where the taxpayer has executed a waiver on assessment of the deficiency (Form 870 or 4549). For example, the IRS commonly fails to recognize a waiver date and allows interest to accrue to the assessment date. The IRS may also fail to recognize a payment made, especially a cash bond or similar payment. The IRS's computer system also leads to errors and delays in computations.

For this reason, taxpayers mistrust the IRS's interest calculations and frequently incur significant expense in hiring outside consultants to review interest charges — often without the benefit of a print-out of the IRS calculations. Although we recognize that the IRS is working to replace its computer system, it can assist taxpayers now by providing copies of interest calculations.[12]

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[12] Section 6631 of the Code (added by the IRS Restructuring and Reform Act) provides that *individual* taxpayers must be provided with interest calculations after December 31, 2000. This provision should apply to *all* taxpayers and should be implemented as soon as possible.

D. Abatement of Interest

Under section 6404(e) of the Code, the IRS is granted the discretion to abate the assessment of all or any part of interest due for any period on (i) a deficiency attributable in whole or part to any unreasonable error or delay by an IRS officer or employee acting in an official capacity when performing a ministerial or managerial act, or (ii) a tax payment, to the extent that any unreasonable error or delay in such payment is attributable to an IRS employee or officer acting in an official capacity being erroneous or dilatory in performing a ministerial or managerial act. An error or delay may be taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved, and after the IRS has contacted the taxpayer in writing with respect to such deficiency or payment. There is also limited authority to abate interest in respect of erroneous refunds or reliance on erroneous written advice of IRS personnel.

TEI believes that IRS's authority to abate interest is too circumscribed. The "unreasonable errors or delay" and "ministerial or managerial" language creates complex factual issues that can lead to audit disputes and litigation. The legislative history of the interest-abatement provision indicates that Congress did not intend the provision to be used routinely to avoid payment of interest, but rather in instances where the denial of abatement would be widely perceived as grossly unfair. 1985 House Report at 844-45; 1986 Senate Report at 208-09. There may well be instances where the denial of an abatement request may be unfair, but the situations do not meet the standards now set forth in the statute. We therefore recommend that the IRS seek and be granted the authority to abate interest on equitable grounds and in respect of all taxes (including employment taxes).

E. Tax Court Jurisdiction

Section 6404(i) of the Code provides the Tax Court with jurisdiction over actions brought by a taxpayer who meets certain requirements to review the IRS's refusal to abate interest on underpayments of tax. Section 7430(c)(4)(A)(ii) establishes net worth tests for using the procedure. An individual's net worth may not exceed $2 million; all other taxpayers (including corporations) may not have a net worth exceeding $7 million or more than 500 employees.

The ability to litigate an inequitable assessment of interest without first paying the amount should not be limited. All taxpayers are similarly situated in respect of interest on a tax liability and should be permitted to contest their disputes with the IRS in the Tax Court. Therefore, section 6404(i) should be amended to permit the Tax Court to hear the claims of all taxpayers relating to the IRS's refusal to abate interest.

IV. ESTIMATED TAX

A. Safe Harbor

Current law effectively requires large corporations to overpay their estimated taxes, without the benefit of interest, in order to avoid an underpayment penalty under section 6655 of the Code. This Hobson's choice does not confront other taxpayers because they may generally avoid the section 6655 penalty by availing themselves of a statutory safe harbor. The corporate estimated tax rules thus operate as a "non-penalty penalty."

Specifically, under section 6655, corporate taxpayers are effectively subject to a penalty if they fail to estimate their tax liability and make quarterly deposits equal to either (i) 100 percent of their actual tax liability, or (ii) 100 percent of their prior year's tax liability. The "prior year's tax" option is not available to so-called large corporations — roughly corporations whose taxable income is $1 million or more in any of the preceding three years.

Because they are not permitted to utilize the prior year's tax rule, large corporations must base their quarterly deposits on estimates of their current year's tax liability. The existing task is literally impossible in light of the complexity of the tax laws, the rapidity with which they have been changed in recent years, and the fact that the numerous adjustments to financial income can accurately be done only annually. Consequently, the large corporate taxpayer faces the following choice:

- paying a penalty (under section 6655) for underestimating its liability, *or*
- overpaying its taxes (in order to avoid the penalty).

The second option — which large corporations are generally required to choose not only by internal business conduct policies but by the desire to avoid penalties — does not come without cost. The cost is the effective denial of interest on the amount of the compelled overpayment by operation of section 6611(e), which provides that interest on an overpayment will not begin to run until the filing of a claim for refund.[13]

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[13] The filing of a tax return could constitute a claim for refund, but most calendar-year large corporations will not file returns until close to September 15 (the extended due date of their return), though an outstanding tax would have to be paid no later than March 15. Thus, there could be, at a minimum, a six-

TEI suggests that a reform of the corporate estimated tax provisions of the Code is long overdue. "Large corporations" should be permitted to use the prior year's tax rule under section 6655.[14] (Alternatively, the government could pay interest on the overpayment of tax.)

B. Foreign Sales Corporations

A related issue involves the "penalty" effect of the estimated tax provisions on foreign sales corporations (FSCs) and their related suppliers. In general, a portion of a FSC's income is exempt from tax if certain conditions are met. The exemption is available with respect to income allocated to the FSC under special transfer-pricing rules based on either optional administrative rules or the arm's-length pricing rules under section 482 of the Code.[15] A decrease in the FSC's taxable income will almost invariably increase the income of its related supplier and *vice versa*. Thus, any overpayment of tax by a FSC will be offset by an underpayment of tax by its related supplier.

Although FSCs must file U.S. tax returns, as foreign corporations they cannot join their U.S. parent in filing a consolidated return. Thus, a FSC must separately file a corporate

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month period during which no interest would be paid on the amount of the overpayment.

[14] The estimated tax rules provide an annualization method that may be employed to avoid any penalties. Determining annualized tax liability and quarterly estimated payments under section 6655(e), however, remains far from simple. This process effectively requires taxpayers to prepare *five* "mini" returns for their estimated tax payments plus their final return. By reinstating the prior year's liability safe harbor, Congress could remove the uncertainty associated with the determination of tax liability from the quarterly estimating and payment process.

[15] Under the administrative pricing rules, transfer prices must be set so that the FSC's taxable income will not exceed the greater of (i) 23 percent of the combined taxable income (CTI) of the FSC and its related supplier (generally its U.S. parent) attributable to foreign trading gross receipts derived from the sale of property by the FSC, or (ii) 1.83 percent of the gross receipts derived from the sale of property by the FSC.

tax return. The estimated tax rules effectively operate as a "Catch-22" for FSCs and their related suppliers.

The problems in the FSC estimated tax area are twofold. First, combined taxable income (CTI) is often not susceptible to accurate calculation until after the close of the taxable year, particularly if grouping or marginal costing is used. Temp. Reg. § 1.925(a)-1T(e)(4) permits a FSC and its related supplier to recalculate the amount of foreign trading gross receipts at any time prior to the expiration of the statute of limitations for the taxable year. If this provision is utilized, CTI will obviously change after year-end — long after estimated tax payments would have been made.

A similar problem exists with respect to the tax payments required to accompany extension of time requests for filing income tax returns. Under Treas. Reg. § 1.6081-3, a taxpayer (including a FSC) may receive an automatic six-month extension to file its tax return, if at least 90 percent of the tax liability is paid by the original due date. Because of the problems inherent in calculating CTI, it is difficult (if not impossible) to accurately determine the amount of tax owed by a FSC by the original due date of the return. Any underpayment of tax by the FSC will invariably be offset by a reciprocal overpayment by its related supplier, and *vice versa*. There is thus no policy or revenue basis for penalizing the underpaying entity.

TEI believes that the estimated tax provision should be amended so that no estimated tax penalties, failure-to-pay penalties, or interest charges would be imposed if no such

penalties and interest would be due on a net basis with respect to FSC commissions when the payments of both the FSC and its related supplier are taken into account.[16]

V. CONCLUSION

Tax Executives Institute appreciates this opportunity to present our views on Notice 99-4, relating to the IRS's penalty and interest study. If you have any questions, please do not hesitate to call Stephen W. Boocock, chair of TEI's IRS Administrative Affairs Committee, at (412) 394-2828, or Mary L. Fahey of the Institute's professional staff at (202) 638-5601.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

Lester D. Ezrati
International President

---

[16] We recognize that matching estimated tax payments of FSCs and their related suppliers may complicate the processing of the returns by the IRS. We suggest, however, that a simplified procedure could be developed that would not require the IRS to physically "match" the returns of the FSC and its related supplier. For example, Form 2220 (Underpayment of Estimated Tax by Corporations) could be revised to permit the FSC or supplier to show an overpayment of estimated tax by the other entity.

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February 25, 1999

MAR 0 2 1999

Senator William V. Roth, Jr.
Joint Tax Committee
204 Dirksen Senate Office Building
Washington, D.C. 20510

Attention: Lindy Paull, Staff Director

RE: Public Comment - Late Payment Penalty

Dear Senator Roth:

We thank you for giving us an opportunity to participate in the public comments and discussion of the tax, penalty and interest provisions of the tax code. It is our understanding that you are seeking to relieve taxpayers of overly burdensome and complex procedures. We commend you for this endeavor.

Our comments will be on the failure to pay penalty. This penalty which applies to all classes of tax except estimated taxes imposes a penalty of one-half of one percent per month, increasing to 1% per month as identified in Sec. 5172.22 with a maximum of 25%. IRC 6651(a)(2) provides that any failure to pay an amount shown as tax on the return is subject to the penalty and will be computed from the due date of the return.

The tax system functioned for most of its existence without a late payment penalty imposed in addition to interest charges. The financial penalty imposed on a taxpayer for not paying his taxes on time was to impose an interest charge. The late payment penalty is almost thirty years old and owes its origin to the desire of Congress to make it more expensive to pay taxes late but sensing that raising interest rates would be politically unpopular. The result was the late payment penalty which accumulates very much like the interest rate. The late payment penalty was a hidden increase in interest rates charged on taxes overdue.

Our first solution offered for consideration is to eliminate the late payment penalty and simply increase the interest rate to a level Congress thinks appropriate to secure the necessary revenue and to induce taxpayers to pay on time. This would simplify the tax computations when payments are being made late. It would save the Internal Revenue Service the time and cost of this penalty computation and would be welcomed by the general population who do not understand why they must pay both interest and penalty on delinquent taxes due.

Should eliminating the late payment penalty and raising interest rates be still politically unacceptable to Congress and the Treasury Dept., let us offer a suggestion as to how to modify the penalty making it more effective as a penalty. The purpose of a penalty is to further compliance with the law rather than as a revenue raising mechanism. When the taxpayer owes taxes to the Internal Revenue Service, it is the desire of the Service that he pay the taxes in full or if this is not possible, to pay in installments. This is the behavior we wish to foster. In cases where the taxpayer comes forward and wants to pay his taxes but does not have the means to pay in full at once the Service will consider entering into a partial payment plan. Why don't we make it financially beneficial to the taxpayer to agree to a payment plan? We suggest when the taxpayer has agreed with the Internal Revenue Service on a formal part payment agreement using Form 433D Installment Agreement and as long as the taxpayer conforms to the plan, the accumulation of the late payment penalty will be stopped. Steps have already been taken in this direction by the Service because currently the late payment penalty is reduced to .025 during a part payment agreement. We suggest no late payment perhaps while a written installment agreement is in effect.

This change in the penalty provisions would benefit taxpayers and the Service. It would not only be an inducement for taxpayers to make arrangements to pay but would be an inducement to keep the terms of the agreement. The taxpayer would be acting now not only out of fear of the collection enforcement powers of the Internal Revenue Service but also out of his own best financial interest. The loss of revenue by the Government would be offset to some degree by reducing the expense and time inducing taxpayers to begin paying their taxes and from the reduction in the number of defaulted payment agreements. The most positive benefit would be a public who better understands the purpose of this penalty. The current penalty is very difficult to explain to taxpayers in a reasonable manner and results in a further alienation of the taxpayers.

How would this change be implemented? The termination of the accumulation of the late payment penalty will only occur if there is a formal, written installment agreement on Form F433D duly approved by the Internal Revenue Service. Verbal promises to pay would not be acceptable in terminating the penalty. The date of approval of the plan by the Internal Revenue Service would be the date the suppression of the penalty would begin. An appropriate transaction code would be input to IDRS. There will be a need to reprogram the computation of the penalty. In cases where the agreement is defaulted, we suggest a letter to the taxpayer notifying him of the amount of his default and allowing the taxpayer thirty days to submit evidence that he is not in default or to pay up the defaulted amount. If the taxpayer fails to do either, at the end of the thirty days the late payment penalty will again begin to accumulate and collection action may begin to collect the tax due. An approximate transaction code would be input to resume the accumulation of the late payment penalty. It would be our suggestion that in cases of defaulted agreements, the Service not seek to recover the amount of the late payment penalty suspended while the taxpayer was faithful to his agreement. Defaults in agreements often are caused by circumstances beyond the control of the taxpayer, e.g., unemployment, sickness in the family, injury, etc.

The taxpayer should have a right to request a Form 433D Installment Agreement if he verbally promises to pay and the Internal Revenue Service agrees to the promise provided the period of payment will exceed sixty days. The Internal Revenue Service would not be required to reduce promises to pay exceeding sixty days to a formal plan unless explicitly requested to do so by the taxpayer. The suppression of the late payment penalty would only be implemented when a written agreement on Form 433D has been signed and agreed to by both parties.

We are sure there are other procedural measures that you will need to examine, however, we discussed some of the possible procedures that might be implemented in order to show that the change would not be costly to institute nor complex to administer. The benefits and fairness to the taxpayer would be the most outstanding result of acceptance of this change to current administration of the late payment penalty.

If the elimination of the late payment penalty was accepted and interest rates were increased to make up the revenue lost from elimination of the penally, we suggest that the interest rate be reduced once the taxpayer has an approved installment agreement. The same benefits would accrue to the Government and to the public as noted above with the suppression of interest

during an approved payment agreement. Let's try to induce compliance through financial inducements rather than threats of hostile collection action.

Very truly yours,

JPC/cjk

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February 24, 1999

FEB 25 1999

Lindy Paull
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Dear Lindy:

Please find enclosed comments submitted for the purpose of the Joint Tax Committee study reviewing the administration and implementation of the penalty and interest provisions of the Internal Revenue Code. These comments are offered with respect to the penalty provisions that apply to charitable remainder trusts ("CRTs"). Specifically, we offer comments with respect to section 664(c), which taxes the entire income of a CRT if any amount of unrelated business income is earned, and section 6652(c), which imposes penalties for the failure of a CRT to file its annual information return.

We will soon be contacting your office to follow up this submission with a meeting. Thank you for your attention to these comments.

With best regards,

Sincerely,

Bob

Robert Rozen

Mark

Mark Weinberger

Penalty Provisions Affecting Charitable Remainder Trusts

Section 664 of the Internal Revenue Code ("the Code") provides rules with respect to the treatment of charitable remainder trusts ("CRTs"). Charitable remainder trusts are trusts established for the purposes of paying a stream of income to individuals for life (or for a period of years) with the remainder interest going to a charitable organization or educational institution. Section 6652 of the Code provides rules with respect to the penalties that apply for failure to file certain information returns. This paper comments on the application of these two sections to CRTs and the extent to which current law produces inequitable results and discourages voluntary compliance.

Unrelated Business Taxable Income Under Section 664(c)

Under section 664(c) of the Code, CRTs are not subject to income tax unless they earn unrelated business taxable income ("UBTI"). In that event, the entire income of the CRT is subject to taxation. This is a draconian rule that can be highly inequitable to the beneficiaries of the CRT. Unlike other exempt organizations which simply pay tax on the portion of their income that is UBTI, CRTs are taxed on all of their income if they earn any UBTI. This rule applies regardless of how minor the UBTI and whether it is earned entirely by mistake. Thus, for example, if a CRT earns $50,000 of annual income, the CRT is not subject to tax on any of its income. If the CRT were to inadvertently earn $1.00 of UBTI, however, the entire $50,001 of income would be subject to taxation. There is no indication in the legislative history that suggests why such a draconian result is necessary.

Section 512 of the Code defines unrelated business taxable income. In the case of a CRT, the rules generally prevent the trust from earning income from active business operations. And as defined in section 514 of the Code, unrelated business income includes any debt financed income. Although, on their face, these rules appear easy to apply, in practice, they are particularly problematic due to the absence of guidance regarding the classification of certain types of investment income. Thus, even for those CRTs that have no intention of engaging in an active trade or business, there is still the risk of incurring a *de minimis* amount of UBTI which would taint all of the CRTs earnings for the year. For example, for a long period of time before the IRS issued clarifying guidance, CRTs avoided short sales of equity securities because there had not been any definitive pronouncement that income from such investments did not generate UBTI. Although this short sale issue was clarified, other passive investments needlessly remain off limits because the law is not clear or because — in the case of pass-through investments — the CRT cannot obtain certainty that that the pass-through entity will not generate even an insignificant amount of UBTI income that, in turn, would be allocated to the CRT.

Because the penalty is so great if even a minor amount of UBTI is earned, complying CRTs must go to great lengths to avoid investments which have any potential for generating UBTI. Often the charitable beneficiary has the responsibility of managing the assets of the trust and, as a result of this onerous rule, must establish elaborate procedures to manage its CRT assets separately from its other assets. It is particularly problematic for a trustee to invest in a venture capital or private equity fund. The risk is that in spite of agreements to the contrary, the managing partner may earn what are considered advisory fees for its services to a start-up company. Or it may earn breakup fees in connection with a failed acquisition agreement. Both fees could be considered UBTI which if earned, could be catastrophic to the CRT. Even the simple purchase of stock by a CRT creates potential dangers if for some reason there is a processing mistake during the settlement process that causes the purchase price not to be deposited in a timely manner. If the broker clears the trade pending the receipt of payment from the CRT, this margin may inadvertently create indebtedness that would result in UBTI as pursuant to section 514 of the Code.

By imposing such a draconian sanction on the receipt of just one dollar of UBTI, current law forces the investment manager (which is generally either the charity itself or a separate trustee) to incur substantial costs to determine if it is permitted to make an investment that it may view as financially advantageous. Indeed, because the UBTI rules are often very complicated, CRTs are forced either to make less advantageous investments or have nearly all their potential investments approved by tax accountants and/or lawyers to ensure that the investments will not lead to UBTI. These unproductive, inefficient costs directly reduce the funds that would otherwise be paid to the charities that hold the remainder interests. The question is, what public policy is served by imposing such burdens on CRTs?

Although section 664(c) is not *per se* a penalty provision in the Code, the severe consequences of its application means it operates more as a penalty provision than a tax. The enormous effective tax that it could impose on unrelated business income makes this appropriately a part of the Joint Tax Committee mandate to study penalty and interest provisions. In the words of the Joint Tax Committee press release inviting comment on the penalty and interest provisions, section 664(c) "produces inequitable results" that impose "undue hardships for taxpayers" which "result in inefficient or ineffective tax administration." The tax policy against CRTs having UBTI is not in question. That policy can be preserved without imposing such drastic consequences on a CRT such that its trustees must go to such burdensome lengths to avoid realizing any UBTI.

Failure to File Information Returns Under Section 6652

Under section 6652(c) of the Code, exempt organizations and certain trusts are subject to penalty for failure to file information returns. Section 6652(c)(1), which applies to exempt organizations required to file under section 6033, imposes a penalty of $20 a day, not to exceed the lesser of $10,000 or 5 percent of the gross receipts of the organization. In the case of exempt organizations with gross receipts over $1 million for any year, the penalty is $100 a day, not to exceed $50,000. This is a sizeable penalty which serves as an effective

means of ensuring that exempt organizations comply with the filing requirements of the tax laws. However, in the case of trusts required to file under section 6034, including CRTs, the maximum penalty for a failure to file information returns is only $5,000 regardless of the annual income of the CRT. Because the penalty for failure to file is so small, relative to the size of some CRTs, reasonable concern arises whether the penalty is sufficient to encourage voluntary compliance. There does not seem to be any public policy reason why exempt organizations should be subject to a failure to file penalty far greater than CRTs.

Recommendations on Ways to Reduce Inequities and Burdens of Taxpayers

Section 664(c). The Code should continue to discourage CRTs from earning UBTI but it should not excessively penalize CRTs that earn a small amount of such income. Until UBTI amounts to more than 5 percent of the income of CRT, the CRT should only be taxed on its UBTI, the same rule that applies generally to exempt organizations. If UBTI represents more than 5 percent but less than 25 percent of the CRT's income, the CRT should be subject to a tax that equals four times the tax that would be imposed on the UBTI only. If UBTI represents 25 percent or more of the CRT's gross income, the CRT should be subject to tax on all of its income. The effect of this proposal would be to phase-up to a penalty that would be the same as under current law if UBTI amounts to 25 percent or more of CRT income. This proposal would continue to discourage strongly the receipt of UBTI to a CRT but it would remove an excessive penalty that imposes an inequitable compliance burden on taxpayers seeking to avoid the receipt of UBTI. As amended, the law would continue to discourage the receipt of UBTI, but not impose an excessive penalty for the receipt of small amounts of such income.

Section 6652(c). The Code should be amended to treat CRTs like exempt organizations with respect to the penalty for failure to file an information return. CRTs should be subject to a potential penalty of $20 a day, not to exceed the lesser of 5 percent of annual gross receipts, or $10,000. CRTs with annual gross income in excess of $1 million should be subject to a penalty of $100 a day, not to exceed $50,000. This should increase compliance with the information return requirements applicable to CRTs, giving the IRS more information with which to audit their activities.

Conclusion

Under current law, CRTs are subject to unreasonable rules which impose an excessive penalty on the receipt of any amount of UBTI. This causes many CRTs to go to burdensome lengths adopting stringent procedures to ensure even a minor amount of inadvertent UBTI is earned. Meanwhile, an anomaly in the failure to file penalty provisions may encourage other CRTs to avoid the UBTI rules simply by not filing an information return. Both laws should be changed; first to impose more reasonable taxes and penalties on the UBTI of CRTs; second to encourage all CRTs to file the information returns necessary to ensure a higher level of compliance with the law.

III. REPRINT OF GAO REPORTS

The following two documents are reprints of GAO reports prepared in connection with the Joint Committee staff study.

United States General Accounting Office

GAO

Report to the Joint Committee on Taxation

June 1999

TAX ADMINISTRATION

IRS' Abatement of Assessments in Fiscal Years 1995-98

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-280532

June 4, 1999

The Honorable Bill Archer
Chairman
The Honorable William V. Roth, Jr.
Vice Chairman
Joint Committee on Taxation

Each year, the Internal Revenue Service (IRS) abates tens of billions of dollars in tax, penalty, and interest assessments.[1] That is, IRS reduces these assessments on taxpayers' accounts. Abatements are important because they can correct tax, penalty, and interest amounts that have been overassessed due to errors by IRS or taxpayers. For some types of abatements, however, the assessments are correct, but IRS abates them for various other reasons. For example, penalties are abated for taxpayers who can prove they had reasonably relied on written advice from IRS.

Because IRS has not developed comprehensive information on the number and amount of various types of past abatements, you asked us to provide such information, which might help the Committee fulfill a requirement in the IRS Restructuring and Reform Act of 1998 that it report on the administration of penalty and interest assessments by July 22, 1999. On the basis of your February 2, 1999, request, our objectives were to determine for individual and business tax returns (1) the number and amount of various types of tax, penalty, and interest abatements made during fiscal years 1995 through 1998 and (2) selected characteristics of the abatements, such as the tax years of abated assessments, taxpayers' use of paid tax preparers, and IRS' actions–such as audit or collection actions–before abating assessments.[2]

Results

Our analysis of IRS records on individual and business abatements in fiscal years 1995 through 1998 showed that the number and amount of abatements of tax, penalty, and interest assessments stayed fairly constant. Each year, IRS abated, on average, about 10 million assessments worth about $30 billion. (See tables in app. I; unless noted otherwise,

[1]Taxpayers essentially assess themselves when they voluntarily report the amount of taxes owed on a tax return. IRS may assess additional taxes owed, as well as penalty and interest amounts, as a result of an enforcement program, such as auditing tax returns that appear to have misreported income, deductions, credits, exemptions, or other tax issues.

[2]As also requested in this letter, we are developing a separate report on IRS' basic abatement processes and any IRS efforts to improve these processes.

tables in the appendixes include abatements of tax, penalty, and interest assessments.)

To illustrate the types of analysis we did on individual and business abatements, for just the individual taxpayers, IRS abated 7.1 million assessments in fiscal year 1998[3]—2.5 million tax, 2.4 million penalty, and 2.2 million interest assessments. These abatements totaled about $7.8 billion—$5.5 billion in tax, $1.5 billion in penalty, and $0.8 billion in interest assessments.[4] For the 2.4 million penalty abatements, 1.4 million were failure-to-pay penalties. Of the $1.5 billion in penalty abatements, $676 million were miscellaneous civil tax penalties.[5]

A variety of characteristics were associated with the abatements for individuals and businesses during fiscal years 1995-98. For example, the 7.1 million individual abatements in fiscal year 1998 were associated with the following characteristics:

- About 80 percent of the 7.1 million abatements (as well as the abated amounts) involved individuals who predominantly reported nonbusiness income, such as wages, rather than business income from self-employment.
- The 7.1 million abatements were associated with 4.3 million filed returns. Of these returns, 52 percent were joint returns and 54 percent used a paid preparer.
- Of the 7.1 million abatements, about 19 percent were associated with a tax return with an additional assessment after the one originally reported and about 78 percent were associated with a previous collection action.
- Of the 7.1 million abatements, 64 percent involved assessments for tax years after 1995, while 9 percent involved assessments for tax years before 1992.

Appendixes II and III provide detailed information for all 4 years on the number and amount of abatements for individual and business returns. Appendixes IV and V provide information about the characteristics of abatements for individual and business returns during fiscal years 1995

[3]It is important to recognize that an individual taxpayer could receive multiple abatements in a fiscal year, such as when an abated tax assessment also leads to abated penalty and interest assessments.

[4]IRS data extracts that we used did not allow us to link specific abatements to related assessments. As a result, we could not determine how much of the various types of assessments had been abated.

[5]These miscellaneous penalties include the trust fund penalty that applies when a business does not properly deposit its employment taxes. IRS is to assess the penalty against all responsible individuals associated with that business until these taxes are deposited.

through 1998. Appendixes VI and VII provide information about abatements on tax returns associated with one of two IRS activities—creating substitute returns for nonfilers and making additional assessments.

Background

Section 6404 of the Internal Revenue Code (IRC) authorizes IRS to abate an assessment under certain conditions. For example, IRS can abate an erroneous assessment, which can be caused by either IRS or the taxpayer. IRS does not have automated data available on the root causes of these errors. Some examples of errors follow.

- A taxpayer made an error on the original return, such as underreporting a deduction, and filed an amended return. If IRS verified the correctness of the amended return, it would abate the overassessed portion of the original tax reported.
- In an audit, IRS did not find adequate support for certain deductions and ultimately assessed additional taxes. Afterward, the taxpayer challenged this assessment by providing documentation to support the deductions.[6] If IRS found the documentation valid, IRS would abate the overassessment.
- IRS might assess taxes on the basis of evidence that IRS had received about income paid to an individual who had not filed an income tax return. IRS would then notify the taxpayer of the assessment. If the taxpayer then filed a return with a lower tax liability and IRS confirmed this new liability, IRS would abate any overassessment.

In addition, IRS can abate unnecessary assessments of the correct amount in special situations. That is, IRS has made the assessment multiple times, knowing that any unnecessary assessments will eventually be abated. In these situations, IRS knows that a tax is owed from among multiple taxpayers. IRS would assess each of these taxpayers and then abate any unnecessary assessments after the tax is paid.

IRS also abates correct assessments for other reasons. For example, IRS abates certain penalties when a taxpayer provides a reasonable cause (such as a nonfinancial hardship, or incorrect IRS written advice) for not meeting a tax responsibility, such as paying an assessment. Or, a taxpayer

[6]Before IRS assesses additional taxes that an audit recommends, a taxpayer can dispute the recommended assessment through IRS' Office of Appeals. Also, upon receiving notice of a proposed assessment, a taxpayer has 90 days (150 days if outside the United States) to file a petition with the Tax Court for a redetermination of the proposed adjustment. Some taxpayers, for whatever reasons, bypass these options, which result in the recommended taxes being assessed, along with any related penalty and interest amounts.

can claim a deduction by carrying back net operating losses incurred in other tax years to reduce the liability for a previous tax year. And IRS may abate an assessment for unpaid taxes that involved the correct amount but was made after the time period allowed for assessing additional tax liabilities.

Regardless of the reason, when IRS abates a tax or penalty assessment, its computers generally abate any other associated penalty and interest assessments. IRS records data on abatements (as well as other tax activity, such as assessments and payments) in a taxpayer's account on IRS' masterfile. IRS maintains both an individual and a business masterfile.

Scope and Methodology

For both objectives, we requested data extracts from IRS' individual and business masterfiles to identify the abatements received during fiscal years 1995 through 1998 by individuals and businesses. These IRS data identified the number and dollar amounts for each type of tax, penalty, or interest abatement. The data included specific characteristics about each abatement, such as the type and year of the tax return, the income level and filing status of the taxpayer, the taxpayer's use of a paid preparer, and the IRS actions taken on the tax return that had an assessment abated, such as an audit or collection action.

The masterfile data extracts we received had 43 million abatement transactions that totaled $120 billion for the 4 fiscal years. Using the results of our various analyses, we created a series of tables on the number and amount of abatements as well as the characteristics associated with the abatements. The tables for these 4 fiscal years are provided in appendixes I through VII to this report.[7]

We did not attempt to verify the reliability of the masterfile data. However, we talked to IRS National Office officials on data abnormalities we found. To the extent that these abnormalities affected our analyses, we identified them in footnotes to the tables in this report. Further, IRS' data extracts did not allow us to link specific abatements to the related assessments in various years. As a result, we could not determine how much of the various types of assessments had been abated, particularly by year. Nor

[7]We also did limited analyses on transactions that we did not include in our abatement totals but that reduced the taxes owed. In general, these transactions forgave or eliminated an unpaid tax amount even though the assessment was correct. These transactions included eliminating a tax debt because the statutory period (generally 10 years) for collecting the debt had expired or because the taxpayer had gone through bankruptcy. Our analyses of these "other" transactions are separate from our abatement analyses and are reported in app. VIII.

could we analyze why an assessment was abated or whether the abatement was valid.

We performed our audit at IRS headquarters in Washington, D.C., and IRS' Kansas City Service Center. Our work was done between January and May 1999 in accordance with generally accepted government auditing standards.

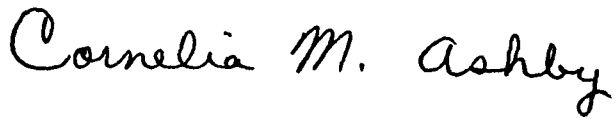
Agency Comments

We requested comments on a draft of this report from the Commissioner of Internal Revenue. On May 21, 1999, we received written comments from IRS' Chief Operations Officer. (See app. IX.)

IRS' letter indicated an agreement with our draft report. The letter said that the statistical tables in our report were consistent with IRS' abatement data. Further, the letter commented that the report provides good information on aspects of abatements.

We are sending copies of this report to Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means, and Senator Daniel P. Moynihan, Ranking Minority Member, Senate Committee on Finance. We are also sending copies to the Honorable Jacob Lew, Director, Office of Management and Budget; the Honorable Robert E. Rubin, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; and other interested parties. We will also send copies to those who request them.

The major contributors to this report are listed in appendix X. If you or your staff have any questions concerning this report, please contact me or Tom Short, Assistant Director, on (202) 512-9110.



Cornelia M. Ashby
Associate Director, Tax Policy and
Administration Issues

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Abbreviations

IRC	Internal Revenue Code
IRS	Internal Revenue Service

Overview of Abatements of Tax, Penalty, and Interest Assessments on Individual and Business Returns

Table I.1: Number and Amount of Abatements by Fiscal Year of Abatement–Individual and Business Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	2,641,271	$20,820	4,386,838	$4,925	3,074,732	$2,647	**10,102,841**	**$28,393**
1996	2,443,001	22,489	4,390,416	6,009	3,216,721	3,195	**10,050,138**	**31,692**
1997	3,431,358	22,119	4,251,869	5,540	3,507,147	2,788	**11,190,374**	**30,447**
1998	3,098,672	22,240	4,705,481	4,795	3,532,125	2,137	**11,336,278**	**29,172**
Total	**11,614,302**	**$87,668**	**17,734,604**	**$21,269**	**13,330,725**	**$10,767**	**42,679,631**	**$119,704**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table I.2: Number and Amount of Abatements by Type of Return and Fiscal Year of Abatement–Individual and Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Type of return	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Individual income tax	**5,559,952**	**$6,773**	**5,410,556**	**$6,848**	**6,840,701**	**$7,433**	**7,088,933**	**$7,676**	**24,900,142**	**$28,731**
Business										
Corporate income tax	430,927	$12,753	435,554	$15,325	430,671	$13,142	432,161	$12,649	**1,729,313**	**$53,870**
Employment tax[a]	3,499,256	4,783	3,272,151	5,693	3,145,880	6,472	3,173,406	5,812	**13,090,693**	**22,760**
Estate tax and gift tax	26,838	536	30,170	590	33,940	730	37,942	711	**128,890**	**2,568**
Excise tax	39,698	586	31,834	197	28,035	346	26,477	343	**126,044**	**1,471**
Other business tax[b]	546,170	2,962	869,873	3,039	711,147	2,323	577,359	1,980	**2,704,549**	**10,303**
Subtotal	**4,542,889**	**$21,619**	**4,639,582**	**$24,844**	**4,349,673**	**$23,014**	**4,247,345**	**$21,496**	**17,779,489**	**$90,973**
Total	**10,102,841**	**$28,393**	**10,050,138**	**$31,692**	**11,190,374**	**$30,447**	**11,336,278**	**$29,172**	**42,679,631**	**$119,704**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Includes abatements on Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

[b]Includes numerous types of returns, such as partnerships, fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

Source: GAO compilation of IRS data.

Table I.3: Number of Returns and Taxpayers Receiving Abatements by Fiscal Year of Abatement–Individual and Business Tax Returns

Dollars in Millions	Number of			Amount of
Fiscal year of abatement	Returns	Taxpayers	Abatements	abatements
Individuals				
1995	3,199,052	2,738,481	5,559,952	$6,773
1996	3,097,806	2,677,106	5,410,556	6,848
1997	4,163,197	3,739,809	6,840,701	7,433
1998	4,333,950	3,881,536	7,088,933	7,676
Total–individuals	**14,794,005**	**13,036,932**	**24,900,142**	**$28,731**
Businesses				
1995	2,198,715	1,535,164	4,542,889	$21,619
1996	2,235,219	1,622,569	4,639,582	24,844
1997	2,062,189	1,506,461	4,349,673	23,014
1998	1,994,723	1,454,992	4,247,345	21,496
Total–businesses	**8,490,846**	**6,119,186**	**17,779,489**	**$90,973**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Abatements of Tax, Penalty, and Interest Assessments on Individual Returns

Table II.1: Number and Amount of Abatements by Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	1,906,198	$4,392	1,955,572	$1,454	1,698,182	$927	5,559,952	$6,773
1996	1,794,074	4,699	1,898,792	1,330	1,717,690	820	5,410,556	6,848
1997	2,848,535	5,266	1,888,977	1,352	2,103,189	816	6,840,701	7,433
1998	2,548,559	5,468	2,373,303	1,452	2,167,071	756	7,088,933	7,676
Total	**9,097,366**	**$19,824**	**8,116,644**	**$5,588**	**7,686,132**	**$3,319**	**24,900,142**	**$28,731**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table II.2: Number and Amount of Abatements by Income Level and Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Income level reported on original return	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Individual nonbusiness										
1040A TPI<$25,000	1,481,991	$1,492	1,591,084	$1,663	1,823,081	$1,904	1,672,770	$1,849	**6,568,926**	**$6,908**
Non1040A TPI<$25,000	458,750	213	465,754	115	520,143	155	556,092	149	**2,000,739**	**633**
TPI $25,000<$50,000	980,674	450	942,286	490	1,498,650	662	1,542,657	708	**4,964,267**	**2,311**
TPI $50,000<$100,000	766,314	647	758,053	517	1,255,983	832	1,261,964	791	**4,042,314**	**2,788**
TPI $100,000 or more	640,105	1,929	575,294	2,124	594,952	2,253	678,185	2,403	**2,488,536**	**8,710**
Subtotal	**4,327,834**	**$4,732**	**4,332,471**	**$4,911**	**5,692,809**	**$5,807**	**5,711,668**	**$5,900**	**20,064,782**	**$21,350**
Individual business[a]										
C-TGR < $25,000	213,312	$75	196,803	$83	226,007	$46	274,196	$140	**910,318**	**$344**
C-TGR $25,000<$100,000	384,942	320	338,061	226	372,204	188	463,272	269	**1,558,479**	**1,003**
C-TGR $100,000 or more	295,709	697	262,473	687	253,573	558	316,995	612	**1,128,750**	**2,554**
F-TGR<$100,000	34,198	22	30,081	15	23,220	13	22,569	12	**110,068**	**63**
F-TGR $100,000 or more	43,220	86	37,281	103	29,780	90	27,690	70	**137,971**	**350**
Subtotal	**971,381**	**$1,200**	**864,699**	**$1,113**	**904,784**	**$896**	**1,104,722**	**$1,104**	**3,845,586**	**$4,314**
Income level not available[b]	260,737	$841	213,386	$824	243,108	$730	272,543	$672	**989,774**	**$3,067**
Total	**5,559,952**	**$6,773**	**5,410,556**	**$6,848**	**6,840,701**	**$7,433**	**7,088,933**	**$7,676**	**24,900,142**	**$28,731**

Legend
1040A = Nonbusiness returns filed by individuals.
TPI = Total positive income (income reported as a positive on tax return tables)
C-TGR = Form 1040 Schedule C (profit or loss from business) total gross receipts
F-TGR = Form 1040 Schedule F (profit or loss from farming) total gross receipts

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Returns with Schedules C or F may be categorized as nonbusiness rather than business if the reported primary source of income was wages, investments, and other nonbusiness income.

[b]Income level was not always available on certain penalties.

Source: GAO compilation of IRS data.

Table II.3: Number of Abatements by Tax Year and Fiscal Year of Abatement–Individual Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	7,896	4,393	2,114	1,971	**16,374**
1980-84	144,898	75,544	47,387	39,141	**306,970**
1985-89	812,576	495,186	348,975	310,899	**1,967,636**
1990	384,622	227,516	163,028	132,451	**907,617**
1991	710,487	351,250	211,233	164,267	**1,437,237**
1992	754,631	749,391	407,611	240,113	**2,151,746**
1993	1,360,075	808,455	606,640	364,265	**3,139,435**
1994	1,383,326	1,362,464	633,248	470,812	**3,849,850**
1995	1,441	1,334,059	1,432,095	828,471	**3,596,066**
1996	[b]	2,298	2,985,836	2,028,495	**5,016,629**
1997	[b]	[b]	2,534	2,505,464	**2,507,998**
1998	[b]	[b]	[b]	2,584	**2,584**
Total	**5,559,952**	**5,410,556**	**6,840,701**	**7,088,933**	**24,900,142**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]The earliest tax year is 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table II.4: Amount of Abatements by Tax Year and Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$119	$66	$37	$27	**$249**
1980-84	604	349	335	197	**1,486**
1985-89	1,699	1,327	842	630	**4,498**
1990	794	471	342	255	**1,863**
1991	1,131	770	408	330	**2,639**
1992	759	1,272	845	444	**3,320**
1993	993	944	1,277	898	**4,113**
1994	672	986	796	1,044	**3,499**
1995	1	661	1,101	891	**2,655**
1996	[b]	1	1,449	1,356	**2,805**
1997	[b]	[b]	1	1,604	**1,605**
1998	[b]	[b]	[b]	1	**1**
Total	**$6,773**	**$6,848**	**$7,433**	**$7,676**	**$28,731**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatement amounts, not return amounts.

Amounts may not sum to totals because of rounding.

[a]The earliest tax year is 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table II.5: Distribution of Returns With Abatements by Filing Status and Fiscal Year of Abatement–Individual Tax Returns

		Filing status					
Fiscal year of abatement	Number of returns	Single	Married, filing jointly	Married, filing separately	Head of household	Widow(er) with dependent child	Total
1995	3,199,052	[a]	[a]	[a]	[a]	[a]	[a]
1996	3,097,806	[a]	[a]	[a]	[a]	[a]	[a]
1997	4,163,197	25.3%	54.5%	3.8%	16.4%	0.1%	100%
1998	4,333,950	28.2	52.4	4.3	15.0	0.1	100

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages may not sum to 100 because of rounding.

[a]IRS was unable to reconstruct the filing status data from its historical files within the time frames of our review.

Source: GAO compilation of IRS data.

Table II.6: Distribution of Returns With Abatements by Selected Characteristic and Fiscal Year of Abatement–Individual Tax Returns

		Selected characteristic			
Fiscal year of abatement	Number of returns	Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	3,199,052	10.9%	7.5%	57.5%	4.1%
1996	3,097,806	10.8	8.7	55.8	4.6
1997	4,163,197	8.6	5.9	51.1	4.4
1998	4,333,950	8.9	4.4	53.9	5.2

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table II.7: Distribution of Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement–Individual Tax Returns

		Selected IRS activity[a]						
Fiscal year of abatement	Number of abatements	Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	5,559,952	9.7%	13.6%	25.8%	1.7%	76.7%	5.4%	0.2%
1996	5,410,556	10.8	15.6	27.8	0.8	78.4	3.3	0.1
1997	6,840,701	8.7	10.8	20.6	0.2	75.0	1.8	0.1
1998	7,088,933	9.6	7.6	18.6	0.1	78.3	2.2	0.1

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table II.8: Distribution of Amount of Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions		Selected IRS activity[a]						
Fiscal year of abatement	Amount of abatements	Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	$6,773	30.9%	14.8%	37.6%	5.1%	74.4%	14.4%	2.7%
1996	$6,848	35.1	17.8	40.6	2.2	74.1	9.8	3.0
1997	$7,433	31.3	16.9	35.7	0.7	71.3	7.1	1.8
1998	$7,676	32.1	15.0	31.6	0.4	70.6	5.8	1.0

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process- open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Abatements of Tax, Penalty, and Interest Assessments on Business Returns

Tables in this appendix show information on the number and amount of tax, penalty, and interest abatements for business tax returns. Tables on corporate income tax, employment tax, and other business tax returns, generally, are subsets of the table titled business tax returns.

Table III.1: Number and Amount of Abatements by Fiscal Year of Abatement–Business Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	735,073	$16,428	2,431,266	$3,471	1,376,550	$1,720	**4,542,889**	**$21,619**
1996	648,927	17,790	2,491,624	4,680	1,499,031	2,375	**4,639,582**	**24,844**
1997	582,823	16,853	2,362,892	4,188	1,403,958	1,972	**4,349,673**	**23,014**
1998	550,113	16,772	2,332,178	3,343	1,365,054	1,381	**4,247,345**	**21,496**
Total	**2,516,936**	**$67,843**	**9,617,960**	**$15,682**	**5,644,593**	**$7,448**	**17,779,489**	**$90,973**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table III.2: Number and Amount of Abatements by Fiscal Year of Abatement–Corporate Income Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	176,869	$11,131	136,643	$379	117,415	$1,243	**430,927**	**$12,753**
1996	174,559	12,560	140,810	881	120,185	1,883	**435,554**	**15,325**
1997	175,228	11,501	137,183	342	118,260	1,299	**430,671**	**13,142**
1998	171,244	11,260	138,160	477	122,757	912	**432,161**	**12,649**
Total	**697,900**	**$46,452**	**552,796**	**$2,079**	**478,617**	**$5,338**	**1,729,313**	**$53,870**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data

Table III.3: Number and Amount of Abatements by Fiscal Year of Abatement–Employment Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	504,336	$2,794	1,910,252	$1,770	1,084,668	$219	**3,499,256**	**$4,783**
1996	389,604	3,014	1,822,060	2,381	1,060,487	298	**3,272,151**	**5,693**
1997	352,694	3,772	1,759,338	2,264	1,033,848	436	**3,145,880**	**6,472**
1998	326,281	4,082	1,786,956	1,491	1,060,169	239	**3,173,406**	**5,812**
Total	**1,572,915**	**$13,662**	**7,278,606**	**$7,907**	**4,239,172**	**$1,192**	**13,090,693**	**$22,760**

Notes: Includes abatements on Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table III.4: Number and Amount of Abatements by Fiscal Year of Abatement–Other Business Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	53,868	$2,504	384,371	$1,322	174,467	$258	**612,706**	**$4,083**
1996	84,764	2,216	528,754	1,417	318,359	193	**931,877**	**3,826**
1997	54,901	1,580	466,371	1,582	251,850	237	**773,122**	**3,399**
1998	52,588	1,430	407,062	1,374	182,128	230	**641,778**	**3,035**
Total	**246,121**	**$7,729**	**1,786,558**	**$5,695**	**926,804**	**$918**	**2,959,483**	**$14,343**

Notes: Includes numerous types of tax returns, such as estate, gift, partnerships, fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table III.5: Number and Amount of Abatements by Asset Size and Fiscal Year of Abatement–Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Asset size reported on balance sheet	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Small corporation										
No balance sheet[a]	13,318	$1,061	14,394	$543	16,179	$392	16,175	$710	**60,066**	**$2,706**
Assets < $250,000	199,034	155	209,144	196	209,476	214	209,255	218	**826,909**	**782**
$250,000 < $1 million	100,653	234	104,849	286	102,841	306	104,050	320	**412,393**	**1,145**
$1 million < $5 million	56,867	384	57,639	458	55,639	549	56,289	563	**226,434**	**1,955**
$5 million < $10 million	14,551	216	11,126	240	10,479	266	10,878	315	**47,034**	**1,036**
Subtotal	**384,423**	**$2,050**	**397,152**	**$1,722**	**394,614**	**$1,726**	**396,647**	**$2,127**	**1,572,836**	**$7,625**
Large corporation										
$10 million < $50 million	12,446	$785	12,959	$794	12,705	$895	12,605	$937	**50,715**	**$3,412**
$50 million < $100 million	3,333	533	3,498	489	3,322	480	3,193	611	**13,346**	**2,113**
$100 million < $250 million	3,427	773	3,476	841	3,231	971	3,366	883	**13,500**	**3,468**
$250 million or more	5,765	7,971	6,098	11,121	5,912	8,557	5,968	7,963	**23,743**	**35,612**
Subtotal	**24,971**	**$10,061**	**26,031**	**$13,246**	**25,170**	**$10,903**	**25,132**	**$10,393**	**101,304**	**$44,604**
Asset size not available[b]	21,533	$641	12,371	$357	10,887	$513	10,382	$129	**55,173**	**$1,640**
Total	**430,927**	**$12,753**	**435,554**	**$15,325**	**430,671**	**$13,142**	**432,161**	**$12,649**	**1,729,313**	**$53,870**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

We could not provide the asset size for businesses on noncorporate business returns because the information is only available for corporate income tax returns.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Taxpayer did not provide, or it was missing.

[b]Asset size was not available on returns transferred from IRS' historical files or non-master file and on special types of assessments.

Source: GAO compilation of IRS data.

Table III.6: Number of Abatements by Tax Year and Fiscal Year of Abatement–Business Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	20,715	21,996	24,308	26,024	**93,043**
1980-84	11,823	6,873	4,678	2,515	**25,889**
1985-89	119,722	72,276	51,808	35,396	**279,202**
1990	84,901	38,029	22,156	14,219	**159,305**
1991	345,527	90,237	39,297	21,689	**496,750**
1992	335,753	288,718	77,206	33,325	**735,002**
1993	591,763	365,124	268,941	73,296	**1,299,124**
1994	2,630,280	690,742	306,757	187,091	**3,814,870**
1995	402,405	2,603,722	652,783	294,065	**3,952,975**
1996	[b]	461,865	2,440,383	677,947	**3,580,195**
1997	[b]	[b]	461,356	2,331,806	**2,793,162**
1998	[b]	[b]	[b]	549,972	**549,972**
Total	**4,542,889**	**4,639,582**	**4,349,673**	**4,247,345**	**17,779,489**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year is 1961.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table III.7: Amount of Abatements by Tax Year and Fiscal Year of Abatement–Business Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	$1,098	$776	$1,099	$653	**$3,626**
1980-84	1,975	1,450	1,578	736	**5,740**
1985-89	3,024	3,202	3,179	2,115	**11,520**
1990	2,574	2,426	1,151	436	**6,588**
1991	3,673	2,157	472	611	**6,914**
1992	2,146	3,957	1,147	564	**7,814**
1993	2,889	2,437	3,592	1,324	**10,241**
1994	3,202	2,371	2,437	3,372	**11,381**
1995	1,039	5,340	3,352	3,038	**12,769**
1996	[b]	728	4,647	3,751	**9,126**
1997	[b]	[b]	360	4,024	**4,384**
1998	[b]	[b]	[b]	871	**871**
Total	**$21,619**	**$24,844**	**$23,014**	**$21,496**	**$90,973**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatement amounts, not return amounts.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year is 1961.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table III.8: Distribution of Abatements on Returns With Selected IRS Activity by Fiscal Year of Abatement–Business Tax Returns

		Selected IRS activity[a]						
Fiscal year of abatement	Number of abatements	Audit indicator[b]	6020b[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	4,542,889	3.4%	3.7%	9.8%	0.1%	78.6%	1.3%	[i]
1996	4,639,582	3.6	2.6	8.9	0.1	80.2	1.1	[i]
1997	4,349,673	3.7	3.1	8.0	[i]	81.4	1.0	[i]
1998	4,247,345	3.7	3.6	5.9	[i]	81.6	1.1	[i]

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Percentages should not be totaled because the abatement could have been preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]6020b, a substitute for return prepared by IRS for nonfilers of employment tax returns.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in a refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

[i]Less than one-tenth of 1 percent.

Source: GAO compilation of IRS data.

Table III.9: Distribution of Amounts of Abatements on Returns With Selected IRS Activity by Fiscal Year of Abatement–Business Tax Returns

Dollars in Millions		Selected IRS activity[a]						
Fiscal year of abatement	Amount of abatements	Audit indicator[b]	6020b[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	$21,619	60.7%	1.0%	35.9%	0.1%	47.1%	6.3%	0.4%
1996	$24,844	62.3	0.8	30.7	[f]	54.2	11.6	0.1
1997	$23,014	57.4	1.1	35.8	[f]	48.7	8.5	0.3
1998	$21,496	59.7	1.4	25.1	[f]	37.9	5.7	0.2

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Percentages should not be totaled because the abatement could have been preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]6020b, a substitute for return prepared by IRS for nonfilers of employment tax returns.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in a refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Abatements of Penalty and Interest Assessments on Individual and Business Tax Returns

Table IV.1: Number and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Individual and Business Tax Returns

	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Failure to file (6651(a)(1))	825,233	18.8	822,298	18.7	835,604	19.7	821,156	17.5	826,073	18.6
Estimated tax (6654 and 6655)	278,063	6.3	261,128	5.9	244,436	5.7	244,042	5.2	256,917	5.8
Failure to make tax deposit (6656)	866,594	19.8	809,347	18.4	773,695	18.2	740,374	15.7	797,503	18.0
Failure to furnish taxpayer identification number (6723)	504	[a]	432	[a]	237	[a]	101	[a]	319	[a]
Daily delinquency (6652(c)(2)(A))[b]	39,644	0.9	39,829	0.9	38,905	0.9	58,106	1.2	44,121	1.0
Miscellaneous civil-trust fund (6672)[c]	229,630	5.2	187,250	4.3	222,502	5.2	255,453	5.4	223,709	5.0
Miscellaneous civil-other (6721(e) and others)[d]	86,833	2.0	81,081	1.8	61,747	1.5	71,880	1.5	75,385	1.7
Incomplete partnership return (6698)	4,661	0.1	3,321	0.1	3,077	0.1	2,339	[a]	3,350	0.1
Failure to pay (6651(a) (2)-(3))	1,991,945	45.4	2,138,238	48.7	2,034,711	47.9	2,475,955	52.6	2,160,212	48.7
Bad check (6657)	13,170	0.3	13,331	0.3	13,766	0.3	20,024	0.4	15,073	0.3
Tip income (6652(b))	2,569	0.1	3,113	0.1	2,562	0.1	1,729	[a]	2,493	0.1
Fraud (6663)	1,593	[a]	1,166	[a]	1,012	[a]	837	[a]	1,152	[a]
Negligence (6662(c))[e]	46,399	1.1	29,882	0.7	19,615	0.5	13,485	0.3	27,345	0.6
Total penalty abatements	**4,386,838**	**100.0**	**4,390,416**	**100.0**	**4,251,869**	**100.0**	**4,705,481**	**100.0**	**4,433,651**	**100.0**
Interest abatements	**3,074,732**	**100.0**	**3,216,721**	**100.0**	**3,507,147**	**100.0**	**3,532,125**	**100.0**	**3,332,681**	**100.0**
Total	**7,461,570**	**100.0**	**7,607,137**	**100.0**	**7,759,016**	**100.0**	**8,237,606**	**100.0**	**7,766,332**	**100.0**

Note: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

[a]Less than one-tenth of 1 percent.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for 54 percent of all other miscellaneous civil penalty abatements over the 4 years. The remaining 46 percent of abatements were spread among numerous types of other miscellaneous civil penalties.

[e]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.2: Amount and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Individual and Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Failure to file (6651(a)(1))	$928	18.8	$1,278	21.3	$1,339	24.2	$1,363	28.4	$1,227	23.1
Estimated tax (6654 and 6655)	182	3.7	208	3.5	188	3.4	282	5.9	215	4.0
Failure to make tax deposit (6656)	1,831	37.2	2,493	41.5	2,182	39.4	1,343	28.0	1,962	36.9
Failure to furnish taxpayer identification number (6723)	[a]	[b]	[a]	[b]	[a]	[b]	[a]	[b]	[a]	[b]
Daily delinquency (6652(c)(2)(A))[c]	55	1.1	58	1.0	55	1.0	110	2.3	70	1.3
Miscellaneous civil-trust fund (6672)[d]	722	14.7	635	10.6	668	12.1	621	13.0	662	12.4
Miscellaneous civil-other (6721(e) and others)[e]	631	12.8	607	10.1	590	10.7	596	12.4	606	11.4
Incomplete partnership return (6698)	125	2.5	67	1.1	22	0.4	7	0.2	55	1.0
Failure to pay (6651(a) (2)-(3))	322	6.5	576	9.6	389	7.0	380	7.9	417	7.8
Bad check (6657)	2	[b]	2	[b]	4	0.1	10	0.2	5	0.1
Tip income (6652(b))	1	[b]	1	[b]	1	[b]	1	[b]	1	[b]
Fraud (6663)	37	0.7	27	0.5	40	0.7	27	0.6	33	0.6
Negligence (6662(c))[f]	89	1.8	57	0.9	62	1.1	56	1.2	66	1.2
Total penalty abatements	**$4,925**	**100.0**	**$6,009**	**100.0**	**$5,540**	**100.0**	**$4,795**	**100.0**	**$5,317**	**100.0**
Interest abatements	**$2,647**	**100.0**	**$3,195**	**100.0**	**$2,788**	**100.0**	**$2,137**	**100.0**	**$2,692**	**100.0**
Total	**$7,572**	**100.0**	**$9,204**	**100.0**	**$8,328**	**100.0**	**$6,932**	**100.0**	**$8,009**	**100.0**

Note: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

[a]Less than $1 million.

[b]Less than one-tenth of 1 percent.

[c]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[d]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[e]Abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for 78 percent of all other miscellaneous civil penalty abatement amounts over the 4 years. The remaining 22 percent of abatement amounts were spread among numerous types of other miscellaneous civil penalties.

[f]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.3: Percent of Penalty and Interest Abatements Computed Manually and by Computer by Fiscal Year of Abatement—Individual and Business Tax Returns

	Fiscal year of abatement							
	1995		1996		1997		1998	
Penalty (IRC section)	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**
Failure to file (6651(a)(1))	55.3	44.7	53.3	46.7	51.5	48.5	48.8	51.2
Estimated tax (6654 and 6655)	87.1	12.9	84.8	15.2	83.2	16.8	82.0	18.0
Failure to make tax deposit (6656)	57.7	42.3	55.1	44.9	50.8	49.2	49.4	50.6
Failure to furnish taxpayer identification number (6723)	100.0	0	100.0	0	100.0	0	100.0	0
Daily delinquency (6652(c)(2)(A))[a]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-trust fund (6672)[b]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-other (6721(e) and others)[c]	100.0	0	100.0	0	100.0	0	100.0	0
Incomplete partnership return (6698)	0	100.0	0	100.0	0	100.0	0	100.0
Failure to pay (6651(a) (2)-(3))	15.4	84.6	12.4	87.6	12.1	87.9	13.9	86.1
Bad check (6657)	99.3	0.7	99.3	0.7	99.1	0.9	99.5	0.5
Tip income (6652(b))	100.0	0	100.0	0	100.0	0	100.0	0
Fraud (6663)	100.0	0	100.0	0	100.0	0	100.0	0
Negligence (6662(c))[d]	100.0	0	100.0	0	100.0	0	100.0	0
Percent of total penalty abatements	**43.9**	**56.1**	**39.3**	**60.7**	**38.4**	**61.6**	**36.8**	**63.2**
Percent of interest abatements	**4.9**	**95.1**	**2.7**	**97.3**	**1.3**	**98.7**	**4.2**	**95.8**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

IRS employees manually make decisions on abatements when taxpayers establish that penalty assessments are in error or they had reasonable cause for being delinquent. IRS computers automatically abate all or portions of penalty and interest assessments when IRS reduces associated tax or other penalty assessments or applies timely payments to taxpayers' accounts.

[a]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[b]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[c]Abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for 54 percent of all other miscellaneous civil penalty abatements over the 4 years. The remaining 46 percent of abatements were spread among numerous types of other miscellaneous civil penalties.

[d]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.4: Percent of Amount of Penalty and Interest Abatements Computed Manually and by Computer by Fiscal Year of Abatement—Individual and Business Tax Returns

	Fiscal year of abatement							
	1995		1996		1997		1998	
Penalty (IRC section)	Manual	Computer	Manual	Computer	Manual	Computer	Manual	Computer
Failure to file (6651(a)(1))	63.6	36.4	60.7	39.3	69.2	30.8	69.3	30.7
Estimated tax (6654 and 6655)	94.6	5.4	93.1	6.9	92.2	7.8	93.9	6.1
Failure to make tax deposit (6656)	83.7	16.3	84.9	15.1	77.7	22.3	72.0	28.0
Failure to furnish taxpayer identification number (6723)	100.0	0	100.0	0	100.0	0	100.0	0
Daily delinquency (6652(c)(2)(A))[a]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-trust fund (6672)[b]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-other (6721(e) and others)[c]	100.0	0	100.0	0	100.0	0	100.0	0
Incomplete partnership return (6698)	0	100.0	0	100.0	0	100.0	0	100.0
Failure to pay (6651(a) (2)-(3))	39.2	60.8	56.0	44.0	40.7	59.3	39.8	60.2
Bad check (6657)	92.9	7.1	99.7	0.3	99.8	0.2	99.9	0.1
Tip income (6652(b))	100.0	0	100.0	0	100.0	0	100.0	0
Fraud (6663)	100.0	0	100.0	0	100.0	0	100.0	0
Negligence (6662(c))[d]	100.0	0	100.0	0	100.0	0	100.0	0
Percent of total penalty abatement amounts	**80.4**	**19.6**	**79.8**	**20.2**	**78.9**	**21.1**	**78.1**	**21.9**
Percent of interest abatements	**54.6**	**45.4**	**50.8**	**49.2**	**51.2**	**48.8**	**43.1**	**56.9**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

IRS employees manually make decisions on abatements when taxpayers establish that penalty assessments are in error or they had reasonable cause for being delinquent. IRS computers automatically abate all or portions of penalty and interest assessments when IRS reduces associated tax or other penalty assessments or applies timely payments to taxpayers' accounts.

[a]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[b]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[c]Abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for 78 percent of all other miscellaneous civil penalty abatement amounts over the 4 years. The remaining 22 percent of abatement amounts were spread among numerous types of other miscellaneous civil penalties.

[d]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Tables IV.5-IV.27 show abatements of penalty and/or interest on individual tax returns, including returns with Schedule C, business income, and Schedule F, farm income.

Table IV.5: Number and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Individual Tax Returns

	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Failure to file (6651(a)(1))	436,914	22.3	446,479	23.5	443,776	23.5	445,699	18.8	443,217	21.8
Estimated tax (6654 and 6655)	251,326	12.9	232,023	12.2	212,444	11.2	207,312	8.7	225,776	11.1
Failure to make tax deposit (6656)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to furnish taxpayer identification number (6723)	504	[a]	432	[a]	237	[a]	101	[a]	319	[a]
Daily delinquency (6652(c)(2)(A))[b]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[c]	229,630	11.7	187,250	9.9	222,502	11.8	255,453	10.8	223,709	11.0
Miscellaneous civil-other (6662(d)-(h)) and others)[d]	23,015	1.2	18,666	1.0	18,273	1.0	23,853	1.0	20,952	1.0
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	953,200	48.7	969,139	51.0	958,255	50.7	1,413,773	59.6	1,073,592	52.9
Bad check (6657)	11,133	0.6	11,354	0.6	10,887	0.6	11,359	0.5	11,183	0.6
Tip income (6652(b))	2,569	0.1	3,113	0.2	2,562	0.1	1,729	0.1	2,493	0.1
Fraud (6663)	1,367	0.1	907	[a]	795	[a]	749	[a]	955	[a]
Negligence (6662(c))[e]	45,914	2.3	29,429	1.5	19,246	1.0	13,275	0.6	26,966	1.3
Total penalty abatements	**1,955,572**	**100.0**	**1,898,792**	**100.0**	**1,888,977**	**100.0**	**2,373,303**	**100.0**	**2,029,161**	**100.0**
Interest abatements	**1,698,182**	**100.0**	**1,717,690**	**100.0**	**2,103,189**	**100.0**	**2,167,071**	**100.0**	**1,921,533**	**100.0**
Total	**3,653,754**	**100.0**	**3,616,482**	**100.0**	**3,992,166**	**100.0**	**4,540,374**	**100.0**	**3,950,694**	**100.0**

Note: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]From fiscal year 1995 through 1998, abatements of accuracy penalties (section 6662(d)–(h)) accounted for an average of 89 percent of other miscellaneous civil penalty abatements. The remaining abatements, averaging 11 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.6: Amount and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Failure to file (6651(a)(1))	$322	22.2	$365	27.5	$362	26.8	$507	34.9	$389	27.9
Estimated tax (6654 and 6655)	106	7.3	86	6.5	84	6.2	97	6.7	93	6.7
Failure to make tax deposit (6656)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to furnish taxpayer identification number (6723)	[b]	[c]	[b]	[c]	[b]	[c]	[b]	[c]	[b]	[c]
Daily delinquency (6652(c)(2)(A))[d]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[e]	722	49.6	635	47.8	668	49.4	621	42.8	662	47.4
Miscellaneous civil-other (6662(d)-(h) and others)[f]	66	4.5	54	4.1	46	3.4	55	3.8	55	4.0
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	117	8.0	108	8.2	103	7.6	115	7.9	111	7.9
Bad check (6657)	1	0.1	2	0.1	2	0.1	3	0.2	2	0.1
Tip income (6652(b))	1	[c]	1	0.1	1	0.1	1	[c]	1	0.1
Fraud (6663)	32	2.2	24	1.8	37	2.8	25	1.8	30	2.1
Negligence (6662(c))[g]	87	6.0	54	4.1	49	3.6	27	1.9	55	3.9
Total penalty abatements	**$1,454**	**100.0**	**$1,329**	**100.0**	**$1,353**	**100.0**	**$1,452**	**100.0**	**$1,397**	**100.0**
Interest abatements	**$927**	**100.0**	**$820**	**100.0**	**$816**	**100.0**	**$756**	**100.0**	**$830**	**100.0**
Total	**$2,382**	**100.0**	**$2,150**	**100.0**	**$2,168**	**100.0**	**$2,208**	**100.0**	**$2,227**	**100.0**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Amounts may not sum to totals because of rounding.

[a]Does not apply.

[b]Less than $1 million.

[c]Less than one-tenth of 1 percent.

[d]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[e]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[f]From fiscal year 1995 through 1998, abatements of accuracy penalties (section 6662(d)–(h)) accounted for an average of 78 percent of abatement amounts for other miscellaneous civil penalty abatements. The remaining abatement amounts, averaging 22 percent, were spread over numerous types of other miscellaneous civil penalties.

[g]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.7: Percent of Penalty and Interest Abatements Computed Manually and by Computer by Fiscal Year of Abatement—Individual Tax Returns

	Fiscal year of abatement							
	1995		1996		1997		1998	
Penalty (IRC section)	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**
Failure to file (6651(a)(1))	62.1	37.9	58.9	41.1	51.7	48.3	47.7	52.3
Estimated tax (6654 and 6655)	88.1	11.9	85.0	15.0	83.2	16.8	81.3	18.7
Failure to make tax deposit (6656)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to furnish taxpayer identification number (6723)	100.0	0	100.0	0	100.0	0	100.0	0
Daily delinquency (6652(c)(2)(A))[b]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[c]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-other (6662(d)-(h) and others)[d]	100.0	0	100.0	0	100.0	0	100.0	0
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	19.3	80.7	15.8	84.2	14.4	85.6	16.1	83.9
Bad check (6657)	100.0	0	100.0	0	100.0	0	100.0	0
Tip income (6652(b))	100.0	0	100.0	0	100.0	0	100.0	0
Fraud (6663)	100.0	0	100.0	0	100.0	0	100.0	0
Negligence (6662(c))[e]	100.0	0	100.0	0	100.0	0	100.0	0
Percent of total penalty abatements	**50.6**	**49.4**	**45.5**	**54.5**	**43.3**	**56.7**	**38.6**	**61.4**
Percent of interest abatements	**7.4**	**92.6**	**3.9**	**96.1**	**1.4**	**98.6**	**6.0**	**94.0**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

IRS employees manually make decisions on abatements when taxpayers establish that penalty assessments are in error or they had reasonable cause for being delinquent. IRS computers automatically abate all or portions of penalty and interest assessments when IRS reduces associated tax or other penalty assessments or applies timely payments to taxpayers' accounts.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]From fiscal year 1995 through 1998, abatements of accuracy penalties (section 6662(d)–(h)) accounted for an average of 89 percent of other miscellaneous civil penalty abatements. The remaining abatements, averaging 11 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.8: Percent of Amount of Penalty and Interest Abatements Computed Manually and by Computer by Fiscal Year of Abatement—Individual Tax Returns

	Fiscal year of abatement							
	1995		1996		1997		1998	
Penalty (IRC section)	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**
Failure to file (6651(a)(1))	73.4	26.6	72.0	28.0	68.0	32.0	76.7	23.3
Estimated tax (6654 and 6655)	92.1	7.9	86.5	13.5	85.6	14.4	86.1	13.9
Failure to make tax deposit (6656)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to furnish taxpayer identification number (6723)	100.0	0	100.0	0	100.0	0	100.0	0
Daily delinquency (6652(c)(2)(A))[b]	0	0	0	0	0	0	0	0
Miscellaneous civil-trust fund (6672)[c]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-other (6662(d)-(h) and others)[d]	100.0	0	100.0	0	100.0	0	100.0	0
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	53.6	46.4	49.6	50.4	46.1	53.9	48.5	51.5
Bad check (6657)	100.0	0	100.0	0	100.0	0	100.0	0
Tip income (6652(b))	100.0	0	100.0	0	100.0	0	100.0	0
Fraud (6663)	100.0	0	100.0	0	100.0	0	100.0	0
Negligence (6662(c))[e]	100.0	0	100.0	0	100.0	0	100.0	0
Percent of total penalty abatement amounts	**89.8**	**10.2**	**87.3**	**12.7**	**86.4**	**13.6**	**86.9**	**13.1**
Percent of interest abatements	**49.6**	**50.4**	**36.7**	**63.3**	**27.5**	**72.5**	**18.0**	**82.0**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

IRS employees manually make decisions on abatements when taxpayers establish that penalty assessments are in error or they had reasonable cause for being delinquent. IRS computers automatically abate all or portions of penalty and interest assessments when IRS reduces associated tax or other penalty assessments or applies timely payments to taxpayers' accounts.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings

[d]From fiscal year 1995 through 1998, abatements of accuracy penalties (section 6662(d)–(h)) accounted for an average of 78 percent of abatement amounts for other miscellaneous civil penalty abatements. The remaining abatement amounts, averaging 22 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.9: Number and Amount of Penalty Abatements by Income Level and by Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions	Fiscal year of abatement									
Income level reported on	1995		1996		1997		1998		Total	
original return	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Individual nonbusiness										
1040A TPI < $25,000	588,579	$281	621,497	$304	574,650	$315	576,303	$339	**2,361,029**	**$1,239**
Non-1040A TPI < $25,000	131,526	17	144,810	12	138,390	17	182,419	13	**597,145**	**59**
TPI $25,000 < $50,000	249,616	36	251,466	28	268,271	26	389,746	36	**1,159,099**	**126**
TPI $50,000 < $100,000	182,982	43	194,341	36	213,875	39	295,568	43	**886,766**	**161**
TPI $100,000 or more	202,668	165	173,992	144	149,475	167	199,977	184	**726,112**	**660**
Subtotal	**1,355,371**	**$542**	**1,386,106**	**$524**	**1,344,661**	**$563**	**1,644,013**	**$616**	**5,730,151**	**$2,245**
Individual business[a]										
C-TGR < $25,000	90,291	$13	82,830	$28	87,814	$7	125,285	$89	**386,220**	**$138**
C-TGR $25,000 < $100,000	153,361	55	131,533	37	127,896	27	198,049	36	**610,839**	**156**
C-TGR $100,000 or more	104,699	94	93,384	76	87,281	70	131,299	73	**416,663**	**314**
F-TGR < $100,000	5,435	1	5,071	1	5,083	1	6,326	1	**21,915**	**4**
F-TGR 100,000 or more	7,023	5	5,291	4	8,443	4	7,111	4	**27,868**	**16**
Subtotal	**360,809**	**$169**	**318,109**	**$146**	**316,517**	**110**	**468,070**	**$203**	**1,463,505**	**$628**
Income level not available[b]	239,392	$743	194,577	$659	227,799	$680	261,220	$633	**922,988**	**$2,715**
Total penalty abatements	**1,955,572**	**$1,454**	**1,898,792**	**$1,330**	**1,888,977**	**$1,352**	**2,373,303**	**$1,452**	**8,116,644**	**$5,588**

Legend

1040A = Nonbusiness returns filed by individuals
TPI = Total positive income (income reported as a positive on tax return tables)
C-TGR = Form 1040 Schedule C (profit or loss from business) total gross receipts
F-TGR = Form 1040 Schedule F (profit or loss from farming) total gross receipts

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Returns with Schedules C or F may be categorized as nonbusiness rather than business if the reported primary source of income was wages, investments, and other nonbusiness income.

[b]Income level was not available on certain miscellaneous civil penalties.

Source: GAO compilation of IRS data.

Table IV.10: Number and Amount of Interest Abatements by Income Level and by Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions	Fiscal year of abatement									
Income level reported on original return	1995		1996		1997		1998		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Individual nonbusiness										
1040A TPI < $25,000	484,237	$349	514,806	$349	557,349	$383	509,310	$385	**2,065,702**	**$1,467**
Non-1040A TPI < $25,000	157,246	27	171,338	14	181,239	18	190,116	12	**699,939**	**71**
TPI $25,000 < $50,000	298,861	44	299,003	39	448,283	31	474,163	28	**1,520,310**	**142**
TPI $50,000 < $100,000	217,128	54	227,703	34	377,843	34	391,470	36	**1,214,144**	**158**
TPI $100,000 or more	232,091	214	206,216	168	186,352	225	210,826	158	**835,485**	**765**
Subtotal	**1,389,563**	**$688**	**1,419,066**	**$604**	**1,751,066**	**$692**	**1,775,885**	**$619**	**6,335,580**	**$2,603**
Individual business[a]										
C-TGR < $25,000	76,600	$13	79,089	$11	98,780	$6	102,707	$8	**357,176**	**$39**
C-TGR $25,000 < $100,000	116,553	48	111,696	31	139,782	19	159,651	27	**527,682**	**125**
C-TGR $100,000 or more	88,756	124	83,745	88	87,724	68	104,220	73	**364,445**	**353**
F-TGR < $100,000	6,442	3	5,808	1	6,790	1	7,177	1	**26,217**	**6**
F-TGR 100,000 or more	6,766	6	6,045	8	7,038	8	7,733	3	**27,582**	**24**
Subtotal	**295,117**	**$195**	**286,383**	**$139**	**340,114**	**$101**	**381,488**	**$112**	**1,303,102**	**$546**
Income level not available[b]	13,502	45	12,241	77	12,009	23	9,698	25	**47,450**	**169**
Total interest abatements	**1,698,182**	**$927**	**1,717,690**	**$820**	**2,103,189**	**$816**	**2,167,071**	**$756**	**7,686,132**	**$3,319**

Legend

1040A = Nonbusiness returns filed by individuals
TPI = Total positive income (income reported as a positive on tax return tables)
C-TGR = Form 1040 Schedule C (profit or loss from business) total gross receipts
F-TGR = Form 1040 Schedule F (profit or loss from farming) total gross receipts

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Returns with Schedules C or F may be categorized as nonbusiness rather than business if the reported primary source of income was wages, investments, and other nonbusiness income.

[b]Income level was not available on certain miscellaneous civil penalties.

Source: GAO compilation of IRS data.

Tables IV.11-IV.14 show information on the number and amount of penalty and interest abatements by tax year of return.

Table IV.11: Number of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Individual Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	3,379	1,805	856	1,074	**7,114**
1980-84	89,553	44,039	26,661	25,959	**186,212**
1985-89	443,094	277,406	202,511	219,915	**1,142,926**
1990	167,701	110,988	84,803	86,073	**449,565**
1991	229,634	152,397	104,899	102,122	**589,052**
1992	218,807	253,154	169,260	134,375	**775,596**
1993	409,116	258,460	194,973	174,236	**1,036,785**
1994	393,350	360,043	188,916	175,891	**1,118,200**
1995	938	439,097	409,480	285,014	**1,134,529**
1996	[b]	1,403	505,005	682,380	**1,188,788**
1997	[b]	[b]	1,613	484,471	**486,084**
1998	[b]	[b]	[b]	1,793	**1,793**
Total penalty abatements	**1,955,572**	**1,898,792**	**1,888,977**	**2,373,303**	**8,116,644**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.12: Amount of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	$9	$6	$5	$3	**$23**
1980-84	151	81	71	40	**343**
1985-89	522	357	259	210	**1,348**
1990	162	131	95	82	**469**
1991	184	153	121	107	**565**
1992	155	188	157	118	**618**
1993	217	161	194	150	**722**
1994	53	165	156	146	**521**
1995	1	86	209	150	**447**
1996	[b]	[c]	84	238	**323**
1997	[b]	[b]	1	208	**209**
1998	[b]	[b]	[b]	[c]	[c]
Total penalty abatements	**$1,454**	**$1,330**	**$1,352**	**$1,452**	**$5,588**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1962.

[b]Does not apply.

[c]Less than $1 million.

Source: GAO compilation of IRS data.

Table IV.13: Number of Interest Abatements by Tax Year and Fiscal Year of Abatement—Individual Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	2,922	1,759	960	670	**6,311**
1980-84	34,093	19,826	14,392	8,877	**77,188**
1985-89	213,403	128,271	94,432	57,102	**493,208**
1990	111,210	65,093	47,409	28,565	**252,277**
1991	214,662	102,249	61,941	37,114	**415,966**
1992	238,902	239,965	134,261	64,442	**677,570**
1993	435,155	295,705	195,749	108,128	**1,034,737**
1994	447,362	380,853	195,589	134,077	**1,157,881**
1995	473	483,121	410,139	265,857	**1,159,590**
1996	[b]	848	947,431	660,200	**1,608,479**
1997	[b]	[b]	886	801,287	**802,173**
1998	[b]	[b]	[b]	752	**752**
Total interest abatements	**1,698,182**	**1,717,690**	**2,103,189**	**2,167,071**	**7,686,132**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.14: Amount of Interest Abatements by Tax Year and Fiscal Year of Abatement—Individual Tax Returns

Dollars in millions	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	$82	$43	$25	$19	**$169**
1980-84	278	168	183	114	**742**
1985-89	355	303	238	180	**1,077**
1990	65	58	59	55	**236**
1991	65	59	52	55	**231**
1992	22	84	80	63	**250**
1993	45	59	90	93	**287**
1994	15	31	33	63	**142**
1995	[b]	15	33	40	**89**
1996	[c]	[b]	21	55	**77**
1997	[c]	[c]	[b]	19	**19**
1998	[c]	[c]	[c]	[b]	[b]
Total interest abatements	**$927**	**$820**	**$816**	**$756**	**$3,319**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1962.

[b]Less than $1 million.

[c]Does not apply.

Source: GAO compilation of IRS data.

Tables IV.15-IV.21 show information on selected return characteristics for penalties and/or interest abatements. Tables IV.19-IV.21 show the characteristics for abatements of three specific types of penalties.

Table IV.15: Distribution of Returns With Penalty and Interest Abatements by Filing Status and Fiscal Year of Abatement—Individual Tax Returns

Fiscal year of penalty and interest abatement	Number of returns	Filing status					
		Single	Married, filing jointly	Married, filing separately	Head of household	Widow(er) with dependent child	Total
1995	[a]	[a]	[a]	[a]	[a]	[a]	[a]
1996	[a]	[a]	[a]	[a]	[a]	[a]	[a]
1997	2,319,461	29.1%	52.5%	4.9%	13.5%	0.1%	100%
1998	2,721,264	31.6	50.9	5.3	12.2	0.1	100

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages may not sum to 100 because of rounding.

[a]IRS was unable to reconstruct the filing status data from its historical files within the time frames of our review.

Source: GAO compilation of IRS data.

Table IV.16: Distribution of Returns With Penalty and Interest Abatements by Selected Characteristic and Fiscal Year of Abatement—Individual Tax Returns

Fiscal year of penalty and interest abatement	Number of returns	Selected characteristic			
		Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	1,918,078	8.5%	12.5%	52.1%	3.9%
1996	1,933,715	9.3	13.8	50.8	4.3
1997	2,319,461	8.5	10.6	48.2	3.8
1998	2,721,264	8.6	7.0	52.8	4.9

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table IV.17: Distribution of Returns With Penalty Abatements by Selected Characteristic and Fiscal Year of Abatement—Individual Tax Returns

		Selected characteristic			
Fiscal year of penalty abatement	Number of returns	Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	1,329,636	8.2%	16.7%	51.7%	2.9%
1996	1,351,348	9.1	18.5	49.7	3.1
1997	1,331,583	10.0	16.4	49.1	3.4
1998	1,761,327	9.1	9.6	55.1	4.9

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table IV.18: Distribution of Returns With Interest Abatements by Selected Characteristic and Fiscal Year of Abatement—Individual Tax Returns

		Selected characteristic			
Fiscal year of interest abatement	Number of returns	Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	1,576,967	8.7%	12.5%	53.0%	2.4%
1996	1,595,320	9.5	13.7	51.7	2.6
1997	1,954,573	8.4	10.1	48.3	2.3
1998	2,000,680	9.0	6.9	51.6	2.4

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table IV.19: Distribution of Returns With Failure to File Penalty Abatements by Selected Characteristic and Fiscal Year of Abatement—Individual Tax Returns

		Selected characteristic			
Fiscal year of failure to file penalty abatement	Number of returns	Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	429,811	3.7%	46.9%	30.0%	1.2%
1996	439,040	4.3	52.6	27.1	1.2
1997	434,432	5.1	45.0	31.0	1.9
1998	433,415	5.7	30.8	39.5	2.3

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table IV.20: Distribution of Returns With Estimated Payment Penalty Abatements by Selected Characteristic and Fiscal Year of Abatement—Individual Tax Returns

		Selected characteristic			
Fiscal year of estimated payment penalty abatement	Number of returns	Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	249,270	8.8%	38.0%	41.5%	0.4%
1996	230,018	9.3	44.2	34.1	0.4
1997	210,414	12.3	39.8	36.9	0.4
1998	205,031	15.3	30.5	42.4	0.3

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table IV.21: Distribution of Returns With Failure to Pay Penalty Abatements by Selected Characteristic and Fiscal Year of Abatement—Individual Tax Returns

		Selected characteristic			
Fiscal year of failure to pay penalty abatement	Number of returns	Primary taxpayer over age 65	Substitute for return prepared	Paid preparer on original return	Earned income credit on original return
1995	914,793	9.5%	4.5%	63.3%	3.1%
1996	933,188	10.9	5.0	61.9	3.5
1997	920,358	11.6	5.6	58.9	3.5
1998	1,355,750	9.6	4.1	61.4	5.1

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Tables IV.22-IV.27 show information on the number or amount of abatements by selected IRS activities for penalties and interest combined, or separately for penalty and interest on individual returns.

Table IV.22: Distribution of Number of Penalty and Interest Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement—Individual Tax Returns

Fiscal year of penalty and interest abatement	Number of abatements	Selected IRS activity[a]						
		Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	3,653,754	10.5%	15.8%	30.1%	2.0%	97.6%	6.7%	0.2%
1996	3,616,482	11.1	17.7	31.1	0.9	97.7	4.0	0.1
1997	3,992,166	10.1	14.2	26.3	0.3	98.0	2.7	0.1
1998	4,540,374	10.7	9.2	22.5	0.2	97.7	3.0	0.1

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could be preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table IV.23: Distribution of Amount of Penalty and Interest Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions

Fiscal year of penalty and interest abatement	Amount of abatements	Selected IRS activity[a]						
		Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	$2,382	34.6%	16.4%	48.1%	9.2%	98.8%	25.2%	4.8%
1996	$2,150	34.8	21.4	49.6	4.7	98.9	19.3	2.7
1997	$2,168	35.8	22.7	50.7	1.9	98.9	15.9	4.1
1998	$2,208	35.5	21.8	44.1	1.3	98.3	12.9	2.3

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could be preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third-party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table IV.24: Distribution of Number of Penalty Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement—Individual Tax Returns

Fiscal year of penalty abatement	Number of abatements	Selected IRS activity[a]						
		Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	1,955,572	11.0%	18.6%	27.6%	2.5%	97.9%	8.5%	0.3%
1996	1,898,792	11.0	21.1	29.2	1.1	98.0	5.3	0.2
1997	1,888,977	10.3	18.4	25.8	0.4	97.3	3.9	0.1
1998	2,373,303	11.4	11.2	20.3	0.3	97.1	4.4	0.1

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could be preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third-party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table IV.25: Distribution of Amount of Penalty Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions

Fiscal year of penalty abatement	Amount of abatements	Selected IRS activity[a]						
		Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	$1,454	20.6%	13.1%	28.7%	9.1%	98.7%	18.9%	2.9%
1996	1,330	21.1	17.0	30.7	4.9	99.0	15.4	1.8
1997	1,352	22.3	17.1	31.1	2.0	98.0	12.5	2.9
1998	1,452	22.2	14.4	26.1	1.2	98.6	10.7	1.4

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could be preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table IV.26: Distribution of Number of Interest Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement—Individual Tax Returns

Fiscal year of interest abatement	Number of abatements	Selected IRS activity[a]						
		Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	1,698,182	10.0%	12.6%	33.0%	1.4%	97.4%	4.7%	0.2%
1996	1,717,690	11.2	13.8	33.2	0.6	97.4	2.7	0.1
1997	2,103,189	9.9	10.3	26.8	0.2	98.6	1.6	0.1
1998	2,167,071	10.1	7.1	24.8	0.1	98.3	1.4	0.1

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could be preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table IV.27: Distribution of Amount of Interest Abatements on Returns Associated With Selected IRS Activity by Fiscal Year of Abatement—Individual Tax Returns

Dollars in Millions

Fiscal year of interest abatement	Amount of abatements	Selected IRS activity[a]						
		Audit indicator[b]	Substitute for return[c]	Additional tax assessments[d]	Offer-in-compromise[e]	Collection[f]	Litigation[g]	Criminal investigation[h]
1995	$927	56.7%	21.4%	78.5%	9.6%	99.1%	35.1%	7.7%
1996	820	57.1	28.6	80.3	4.3	98.8	25.5	4.2
1997	816	58.2	32.1	83.3	1.8	99.0	21.5	6.2
1998	756	61.1	36.0	78.8	1.3	97.7	17.3	4.1

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could be preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]Return prepared by IRS based on third party information of income paid to a nonfiler.

[d]IRS makes additional tax assessments after the original tax assessment because of an IRS enforcement action, such as an audit, or a taxpayer action, such as filing amended returns.

[e]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[f]Return was in collection stream (notices, installment agreements, delinquent accounts). Abatements on full paid returns result in refunds to taxpayers and would not be in collection status.

[g]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[h]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Tables IV.28-IV.55 show information on penalty and interest abatements on business tax returns. Tables on corporate income tax, employment tax, and other business tax returns, generally, are subsets of the tables titled business tax returns.

Table IV.28: Number and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Business Tax Returns

	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Failure to file (6651(a)(1))	388,319	16.0	375,819	15.1	391,828	16.6	375,457	16.1	**382,856**	**15.9**
Estimated tax (6654 and 6655)	26,737	1.1	29,105	1.2	31,992	1.4	36,730	1.6	**31,141**	**1.3**
Failure to make tax deposit (6656)	866,594	35.6	809,347	32.5	773,695	32.7	740,374	31.7	**797,503**	**33.2**
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	39,644	1.6	39,829	1.6	38,905	1.6	58,106	2.5	**44,121**	**1.8**
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	63,818	2.6	62,415	2.5	43,474	1.8	48,027	2.1	**54,434**	**2.3**
Incomplete partnership return (6698)	4,661	0.2	3,321	0.1	3,077	0.1	2,339	0.1	**3,350**	**0.1**
Failure to pay (6651(a) (2)-(3))	1,038,745	42.7	1,169,099	46.9	1,076,456	45.6	1,062,182	45.5	**1,086,621**	**45.2**
Bad check (6657)	2,037	0.1	1,977	0.1	2,879	0.1	8,665	0.4	**3,890**	**0.2**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	226	[e]	259	[e]	217	[e]	88	[e]	**198**	[e]
Negligence (6662(c))[f]	485	[e]	453	[e]	369	[e]	210	[e]	**379**	[e]
Total penalty abatements	**2,431,266**	**100.0**	**2,491,624**	**100.0**	**2,362,892**	**100.0**	**2,332,178**	**100.0**	**2,404,490**	**100.0**
Interest abatements	**1,376,550**	**100.0**	**1,499,031**	**100.0**	**1,403,958**	**100.0**	**1,365,054**	**100.0**	**1,411,148**	**100.0**
Total	**3,807,816**	**100.0**	**3,990,655**	**100.0**	**3,766,850**	**100.0**	**3,697,232**	**100.0**	**3,815,638**	**100.0**

Note: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]From fiscal year 1995 through 1998, abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for an average of 75 percent of other miscellaneous civil penalty abatements. The remaining abatements, averaging 25 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Less than one-tenth of 1 percent.

[f]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.29: Amount and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement–Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Failure to file (6651(a)(1))	$606	17.5	$913	19.5	$977	23.3	$855	25.6	**$838**	**21.4**
Estimated tax (6654 and 6655)	76	2.2	122	2.6	103	2.5	184	5.5	**122**	**3.1**
Failure to make tax deposit (6656)	1,831	52.7	2,493	53.3	2,182	52.1	1,343	40.2	**1,962**	**50.0**
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	55	1.6	58	1.2	55	1.3	110	3.3	**70**	**1.8**
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	566	16.3	553	11.8	545	13.0	540	16.2	**551**	**14.1**
Incomplete partnership return (6698)	125	3.6	67	1.4	22	0.5	7	0.2	**55**	**1.4**
Failure to pay (6651(a) (2)-(3))	205	5.9	467	10.0	286	6.8	264	7.9	**306**	**7.8**
Bad check (6657)	1	[e]	1	[e]	2	[e]	7	0.2	**3**	**0.1**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	5	0.1	4	0.1	3	0.1	1	[e]	**3**	**0.1**
Negligence (6662(c))[f]	2	0.1	3	0.1	13	0.3	29	0.9	**12**	**0.3**
Total penalty abatements	**$3,471**	**100.0**	**$4,680**	**100.0**	**$4,188**	**100.0**	**$3,343**	**100.0**	**$3,920**	**100.0**
Interest abatements	**$1,720**	**100.0**	**$2,375**	**100.0**	**$1,972**	**100.0**	**$1,381**	**100.0**	**$1,862**	**100.0**
Total	**$5,191**	**100.0**	**$7,054**	**100.0**	**$6,160**	**100.0**	**$4,724**	**100.0**	**$5,782**	**100.0**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Note: Amounts may not sum to totals because of rounding.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]From fiscal year 1995 through 1998, abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for an average of 86 percent of abatement amounts for other miscellaneous civil penalty abatements. The remaining abatement amounts, averaging 14 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Less than one-tenth of 1 percent.

[f]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.30: Percent of Penalty and Interest Abatements Computed Manually and by Computer by Fiscal Year of Abatement—Business Tax Returns

	Fiscal year of abatement							
	1995		1996		1997		1998	
Penalty (IRC section)	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**
Failure to file (6651(a)(1))	47.7	52.3	46.6	53.4	51.3	48.7	50.1	49.9
Estimated tax (6654 and 6655)	77.3	22.7	82.7	17.3	82.8	17.2	85.6	14.4
Failure to make tax deposit (6656)	57.7	42.3	55.1	44.9	50.8	49.2	49.4	50.6
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-trust fund (6672)[c]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-other (6721(e) and others)[d]	100.0	0	100.0	0	100.0	0	100.0	0
Incomplete partnership return (6698)	100.0	0	100.0	0	100.0	0	100.0	0
Failure to pay (6651(a) (2)-(3))	11.8	88.2	9.5	90.5	9.9	90.1	11.0	89.0
Bad check (6657)	95.2	4.8	95.2	4.8	95.6	4.4	98.8	1.2
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	100.0	0	100.0	0	100.0	0	100.0	0
Negligence (6662(c))[e]	100.0	0	100.0	0	100.0	0	100.0	0
Percent of total penalty abatements	**38.4**	**61.6**	**34.6**	**65.4**	**34.4**	**65.6**	**35.0**	**65.0**
Percent of interest abatements	**1.8**	**98.2**	**1.4**	**98.6**	**1.3**	**98.7**	**1.2**	**98.8**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

IRS employees manually make decisions on abatements when taxpayers establish that penalty assessments are in error or they had reasonable cause for being delinquent. IRS computers automatically abate all or portions of penalty and interest assessments when IRS reduces associated tax or other penalty assessments or applies timely payments to taxpayers' accounts.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]From fiscal year 1995 through 1998, abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for an average of 75 percent of other miscellaneous civil penalty abatements. The remaining abatements, averaging 25 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.31: Percent of Amount of Penalty and Interest Abatements Computed Manually and by Computer by Fiscal Year of Abatement—Business Tax Returns

	Fiscal year of abatement							
	1995		1996		1997		1998	
Penalty (IRC section)	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**	**Manual**	**Computer**
Failure to file (6651(a)(1))	58.4	41.6	56.2	43.8	69.6	30.4	64.8	35.2
Estimated tax (6654 and 6655)	98.0	2.0	97.7	2.3	97.6	2.4	98.0	2.0
Failure to make tax deposit (6656)	83.7	16.3	84.9	15.1	77.7	22.3	72.0	28.0
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-trust fund (6672)[c]	100.0	0	100.0	0	100.0	0	100.0	0
Miscellaneous civil-other (6721(e) and others)[d]	100.0	0	100.0	0	100.0	0	100.0	0
Incomplete partnership return (6698)	100.0	0	100.0	0	100.0	0	100.0	0
Failure to pay (6651(a) (2)-(3))	31.1	68.9	57.4	42.6	38.7	61.3	36.0	64.0
Bad check (6657)	82.9	17.1	99.1	0.9	99.6	0.4	99.9	0.1
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	100.0	0	100.0	0	100.0	0	100.0	0
Negligence (6662(c))[e]	100.0	0	100.0	0	100.0	0	100.0	0
Percent of total penalty abatements	**76.4**	**23.6**	**77.7**	**22.3**	**76.5**	**23.5**	**74.4**	**25.6**
Percent of interest abatements	**57.3**	**42.7**	**55.7**	**44.3**	**61.1**	**38.9**	**56.9**	**43.1**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

IRS employees manually make decisions on abatements when taxpayers establish that penalty assessments are in error or they had reasonable cause for being delinquent. IRS computers automatically abate all or portions of penalty and interest assessments when IRS reduces associated tax or other penalty assessments or applies timely payments to taxpayers' accounts.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]From fiscal year 1995 through 1998, abatements of penalties for intentional disregard of the information return filing requirements (section 6721(e)) accounted for an average of 86 percent of abatement amounts for other miscellaneous civil penalty abatements. The remaining abatement amounts, averaging 14 percent, were spread over numerous types of other miscellaneous civil penalties.

[e]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.32: Number and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Corporate Income Tax Returns

	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Failure to file (6651(a)(1))	22,428	16.4	23,807	16.9	25,350	18.5	22,599	16.4	**23,546**	**17.0**
Estimated tax (6654 and 6655)	20,316	14.9	21,438	15.2	21,715	15.8	22,684	16.4	**21,538**	**15.6**
Failure to make tax deposit (6656)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	142	0.1	186	0.1	229	0.2	204	0.1	**190**	**0.1**
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	93,552	68.5	95,213	67.6	89,670	65.4	92,345	66.8	**92,695**	**67.1**
Bad check (6657)	105	0.1	101	0.1	142	0.1	286	0.2	**159**	**0.1**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	30	[e]	24	[e]	29	[e]	16	[e]	**25**	[e]
Negligence (6662(c))[f]	70	0.1	41	[e]	48	[e]	26	[e]	**46**	[e]
Total penalty abatements	**136,643**	**100.0**	**140,810**	**100.0**	**137,183**	**100.0**	**138,160**	**100.0**	**138,199**	**100.0**
Interest abatements	**117,415**	**100.0**	**120,185**	**100.0**	**118,260**	**100.0**	**122,757**	**100.0**	**119,654**	**100.0**
Total	**254,058**	**100.0**	**260,995**	**100.0**	**255,443**	**100.0**	**260,917**	**100.0**	**257,853**	**100.0**

Note: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Because miscellaneous civil penalties account for less than 3 percent of all business penalties, we did not develop information on specific penalties below the level of all businesses.

[e]Less than one-tenth of 1 percent.

[f]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.33: Amount and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Failure to file (6651(a)(1))	$202	53.3	$434	49.2	$150	43.9	$190	39.8	**$244**	**47.0**
Estimated tax (6654 and 6655)	71	18.7	113	12.9	95	27.8	171	35.8	**112**	**21.6**
Failure to make tax deposit (6656)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	2	0.5	2	0.2	3	0.8	2	0.5	**2**	**0.4**
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	100	26.5	331	37.5	80	23.5	84	17.6	**149**	**28.7**
Bad check (6657)	[e]	0.1	[e]	[f]	[e]	0.1	1	0.3	[e]	**0.1**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	2	0.6	1	0.1	2	0.5	1	0.1	**1**	**0.3**
Negligence (6662(c))[g]	1	0.3	1	0.1	11	3.4	28	5.9	**10**	**2.0**
Total penalty abatements	**$379**	**100.0**	**$881**	**100.0**	**$342**	**100.0**	**$477**	**100.0**	**$520**	**100.0**
Interest abatements	**$1,243**	**100.0**	**$1,883**	**100.0**	**$1,299**	**100.0**	**$912**	**100.0**	**$1,334**	**100.0**
Total	**$1,622**	**100.0**	**$2,765**	**100.0**	**$1,641**	**100.0**	**$1,389**	**100.0**	**$1,854**	**100.0**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Amounts may not sum to totals because of rounding.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Because miscellaneous civil penalties account for less than 3 percent of all business penalties we did not develop information on specific penalties below the level of all businesses.

[e]Less than $1 million.

[f]Less than one-tenth of 1 percent.

[g]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.34: Number and Percent of Penalty and Interest Abatements by Fiscal Year of Abatements—Employment Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Failure to file (6651(a)(1))	266,206	13.9	241,556	13.3	228,085	13.0	229,001	12.8	**241,212**	**13.3**
Estimated tax (6654 and 6655)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to make tax deposit (6656)	824,772	43.2	779,226	42.8	745,366	42.4	716,595	40.1	**766,490**	**42.1**
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	705	[e]	665	[e]	677	[e]	523	[e]	**643**	[e]
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	816,661	42.8	798,850	43.8	782,587	44.5	833,261	46.6	**807,840**	**44.4**
Bad check (6657)	1,568	0.1	1,469	0.1	2,228	0.1	7,404	0.4	**3,167**	**0.2**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	67	[e]	41	[e]	140	[e]	42	[e]	**73**	[e]
Negligence (6662(c))[f]	273	[e]	253	[e]	255	[e]	130	[e]	**228**	[e]
Total penalty abatements	**1,910,252**	**100.0**	**1,822,060**	**100.0**	**1,759,338**	**100.0**	**1,786,956**	**100.0**	**1,819,652**	**100.0**
Interest abatements	**1,084,668**	**100.0**	**1,060,487**	**100.0**	**1,033,848**	**100.0**	**1,060,169**	**100.0**	**1,059,793**	**100.0**
Total	**2,994,920**	**100.0**	**2,882,547**	**100.0**	**2,793,186**	**100.0**	**2,847,125**	**100.0**	**2,879,445**	**100.0**

Notes: Employment tax returns include Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Because miscellaneous civil penalties account for less than 3 percent of all business penalties, we did not develop information on specific penalties below the level of all businesses.

[e]Less than one-tenth of 1 percent.

[f]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.35: Amount and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Employment Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Failure to file (6651(a)(1))	$134	7.6	$156	6.5	$243	10.7	117	8.3	**$162**	**8.3**
Estimated tax (6654 and 6655)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to make tax deposit (6656)	1,580	89.2	2,148	90.2	1,885	83.2	1,194	84.7	**1,702**	**87.0**
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	1	0.1	5	0.2	2	0.1	2	0.2	**3**	**0.1**
Incomplete partnership return (6698)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Failure to pay (6651(a) (2)-(3))	54	3.1	70	3.0	132	5.8	92	6.5	**87**	**4.5**
Bad check (6657)	[e]	[f]	[e]	[f]	1	[f]	5	0.3	**2**	**0.1**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	[e]	[f]	[e]	[f]	1	[f]	[e]	[f]	[e]	[f]
Negligence (6662(c))[g]	[e]	[f]	1	0.1	1	[f]	[e]	[f]	**1**	[f]
Total penalty abatements	**$1,770**	**100.0**	**$2,381**	**100.0**	**$2,264**	**100.0**	**$1,410**	**100.0**	**$1,956**	**100.0**
Interest abatements	**$219**	**100.0**	**$298**	**100.0**	**$436**	**100.0**	**$239**	**100.0**	**$298**	**100.0**
Total	**$1,989**	**100.0**	**$2,679**	**100.0**	**$2,701**	**100.0**	**$1,649**	**100.0**	**$2,254**	**100.0**

Notes: Employment tax returns include Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

Amounts may not sum to totals because of rounding.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Because miscellaneous civil penalties account for less than 3 percent of all business penalties we did not develop information on specific penalties below the level of all businesses.

[e]Less than $1 million.

[f]Less than one-tenth of 1 percent.

[g]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.36: Number and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement—Other Business Tax Returns

	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Failure to file (6651(a)(1))	99,685	25.9	110,456	20.9	138,393	29.7	123,857	30.4	**118,098**	**26.4**
Estimated tax (6654 and 6655)	6,421	1.7	7,667	1.5	10,277	2.2	14,046	3.5	**9,603**	**2.2**
Failure to make tax deposit (6656)	41,822	10.9	30,121	5.7	28,329	6.1	23,779	5.8	**31,013**	**6.9**
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	39,644	10.3	39,829	7.5	38,905	8.3	58,106	14.3	[a]	**9.9**
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	62,971	16.4	61,564	11.6	42,568	9.1	47,300	11.6	**53,601**	**12.0**
Incomplete partnership return (6698)	4,661	1.2	3,321	0.6	3,077	0.7	2,339	0.6	**3,350**	**0.7**
Failure to pay (6651(a) (2)-(3))	128,532	33.4	275,036	52.0	204,199	43.8	136,576	33.6	**186,086**	**41.7**
Bad check (6657)	364	0.1	407	0.1	509	0.1	975	0.2	**564**	**0.1**
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	129	[e]	194	[e]	48	[e]	30	[e]	**100**	[e]
Negligence (6662(c))[f]	142	[e]	159	[e]	66	[e]	54	[e]	**105**	[e]
Total penalty abatements	**384,371**	**100.0**	**528,754**	**100.0**	**466,371**	**100.0**	**407,062**	**100.0**	**446,640**	**100.0**
Interest abatements	**174,467**	**100.0**	**318,359**	**100.0**	**251,850**	**100.0**	**182,128**	**100.0**	**231,701**	**100.0**
Total	**558,838**	**100.0**	**847,113**	**100.0**	**718,221**	**100.0**	**589,190**	**100.0**	**678,341**	**100.0**

Note: Other business tax returns include numerous types of returns, such as, estate, gift, partnerships, and fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Because miscellaneous civil penalties account for less than 3 percent of all business penalties we did not develop information on specific penalties below the level of all businesses.

[e]Less than one-tenth of 1 percent.

[f]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.37: Amount and Percent of Penalty and Interest Abatements by Fiscal Year of Abatement–Other Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Average	
Penalty (IRC section)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Failure to file (6651(a)(1))	$270	20.4	$324	22.8	$584	36.9	$468	34.0	**$411**	**28.9**
Estimated tax (6654 and 6655)	5	0.4	9	0.6	9	0.5	14	1.0	**9**	**0.6**
Failure to make tax deposit (6656)	251	19.0	345	24.3	297	18.8	149	10.8	**260**	**18.3**
Failure to furnish taxpayer identification number (6723)	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Daily delinquency (6652(c)(2)(A))[b]	55	4.2	58	4.1	55	3.5	110	8.0	**70**	**4.9**
Miscellaneous civil-trust fund (6672)[c]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Miscellaneous civil-other (6721(e) and others)[d]	563	42.6	546	38.5	540	34.1	536	39.0	**546**	**38.4**
Incomplete partnership return (6698)	125	9.5	67	4.7	22	1.4	7	0.5	**55**	**3.9**
Failure to pay (6651(a) (2)-(3))	50	3.8	66	4.7	73	4.6	88	6.4	**70**	**4.9**
Bad check (6657)	[e]	[f]	[e]	[f]	[e]	[f]	1	0.1	**1**	[f]
Tip income (6652(b))	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]	[a]
Fraud (6663)	2	0.2	2	0.2	[e]	[f]	1	[f]	**1**	**0.1**
Negligence (6662(c))[g]	[e]	[f]	1	0.1	1	[f]	1	0.1	**1**	**0.1**
Total penalty abatements	**$1,322**	**100.0**	**$1,417**	**100.0**	**$1,582**	**100.0**	**$1,374**	**100.0**	**$1,424**	**100.0**
Interest abatements	**$258**	**100.0**	**193**	**100.0**	**237**	**100.0**	**230**	**100.0**	**230**	**100.0**
Total	**$1,580**	**100.0**	**$1,610**	**100.0**	**$1,819**	**100.0**	**$1,605**	**100.0**	**$1,653**	**100.0**

Notes: Other business tax returns include numerous types of returns, such as, estate, gift, partnerships, and fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

Amounts may not sum to totals because of rounding.

[a]Does not apply.

[b]Fee accumulated by certain trusts and exempt organizations for failure to file in a timely manner.

[c]Trust fund penalties are assessed against responsible individuals of a business when they fail to pay IRS the taxes they withheld from employees' earnings.

[d]Because miscellaneous civil penalties account for less than 3 percent of all business penalties we did not develop information on specific penalties below the level of all businesses.

[e]Less than $1 million.

[f]Less than one-tenth of 1 percent.

[g]Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code.

Source: GAO compilation of IRS data.

Table IV.38: Number and Amount of Penalty Abatements by Asset Size and Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
Asset size reported on balance sheet	1995		1996		1997		1998		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Small corporation										
No balance sheet[a]	6,263	$49	6,916	$22	7,970	$35	7,793	$133	**28,942**	**$239**
Assets < $250,000	64,215	10	66,090	11	64,842	13	65,472	14	**260,619**	**48**
$250,000 < $1 million	32,973	11	33,266	14	31,566	14	32,021	15	**129,826**	**54**
$1 million < $5 million	17,865	15	19,287	19	17,991	23	17,948	24	**73,091**	**81**
$5 million < $10 million	3,231	8	3,459	10	3,379	14	3,558	13	**13,627**	**45**
Subtotal	**124,547**	**$92**	**129,018**	**$76**	**125,748**	**$99**	**126,792**	**$199**	**506,105**	**$467**
Large corporation										
$10 million < $50 million	3,897	29	4,130	33	4,043	50	3,962	37	**16,032**	**149**
$50 million < $100 million	962	32	1,133	32	1,018	17	975	22	**4,088**	**104**
$100 million < $250 million	927	54	980	67	877	39	868	29	**3,652**	**189**
$250 million or more	1,032	153	1,097	665	1,133	132	1,097	185	**4,359**	**1,134**
Subtotal	**6,818**	**$269**	**7,340**	**$796**	**7,071**	**$238**	**6,902**	**$273**	**28,131**	**1,577**
Asset size not available[b]	5,278	18	4,452	9	4,364	5	4,466	5	**18,560**	**36**
Total penalty abatements	**136,643**	**$379**	**140,810**	**$881**	**137,183**	**$342**	**138,160**	**$477**	**552,796**	**$2,079**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

We could not provide the asset size for businesses on noncorporate returns because the information is only available for corporate income tax returns.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Taxpayer did not provide, or it is missing.

[b]Asset size was not available on returns transferred from IRS' historical files or non-master file and on special types of assessments.

Source: GAO compilation of IRS data.

Table IV.39: Number and Amount of Interest Abatements by Asset Size and Fiscal Year of Abatement–Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
Asset size reported on balance sheet	1995		1996		1997		1998		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Small corporation										
No balance sheet[a]	4,646	$33	4,949	$25	5,469	$52	5,751	$80	**20,815**	**$190**
Assets < $250,000	54,502	5	56,326	5	56,416	12	58,601	7	**225,845**	**30**
$250,000 < $1 million	27,116	6	27,746	12	26,674	8	27,762	7	**109,298**	**32**
$1 million < $5 million	14,892	9	16,061	9	14,836	11	15,523	12	**61,312**	**41**
$5 million < $10 million	2,961	4	2,891	4	2,882	7	3,011	6	**11,745**	**22**
Subtotal	**104,117**	**$56**	**107,973**	**$56**	**106,277**	**$90**	**110,648**	**$113**	**429,015**	**$316**
Large corporation										
$10 million < $50 million	3,473	32	3,538	28	3,477	40	3,521	22	**14,009**	**122**
$50 million < $100 million	938	35	958	24	979	26	890	18	**3,765**	**103**
$100 million < $250 million	1,004	73	991	50	928	43	989	29	**3,912**	**196**
$250 million or more	2,124	981	2,240	1,678	2,179	1,007	2,250	714	**8,793**	**4,380**
Subtotal	**7,539**	**$1,120**	**7,727**	**$1,781**	**7,563**	**$1,116**	**7,650**	**$783**	**30,479**	**$4,800**
Asset size not available[b]	5,759	$67	4,485	$47	4,420	$93	4,459	$16	**19,123**	**$223**
Total interest abatements	**117,415**	**$1,243**	**120,185**	**$1,883**	**118,260**	**$1,299**	**122,757**	**$912**	**478,617**	**$5,338**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

We could not provide the asset size for businesses on noncorporate returns because the information is only available for corporate income tax returns

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Taxpayer did not provide, or it is missing.

[b]Asset size was not available on returns transferred from IRS' historical files or non-master file and on special types of assessments.

Source: GAO compilation of IRS data.

Table IV.40: Number of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Business Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	6,384	7,547	8,774	10,139	**32,844**
1980-84	5,397	3,135	2,039	1,021	**11,592**
1985-89	57,159	35,033	24,780	17,136	**134,108**
1990	34,437	16,959	10,295	6,621	**68,312**
1991	138,603	38,230	19,066	10,607	**206,506**
1992	135,813	117,874	34,265	16,335	**304,287**
1993	317,009	141,823	109,188	32,015	**600,035**
1994	1,482,759	365,451	132,619	82,529	**2,063,358**
1995	253,705	1,485,025	353,335	125,218	**2,217,283**
1996	[b]	280,547	1,394,962	374,352	**2,049,861**
1997	[b]	[b]	273,569	1,319,677	**1,593,246**
1998	[b]	[b]	[b]	336,528	**336,528**
Total penalty abatements	**2,431,266**	**2,491,624**	**2,362,892**	**2,332,178**	**9,617,960**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.41: Amount of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Business Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	$56	$87	$90	$114	**$347**
1980-84	14	10	5	23	**52**
1985-89	80	51	60	30	**221**
1990	96	425	38	12	**571**
1991	597	193	26	16	**832**
1992	227	575	82	24	**908**
1993	519	206	581	95	**1,400**
1994	1,063	594	253	461	**2,371**
1995	820	2,160	1,012	241	**4,232**
1996	[b]	380	1,944	976	**3,300**
1997	[b]	[b]	96	851	**948**
1998	[b]	[b]	[b]	499	**499**
Total penalty abatements	**$3,471**	**$4,680**	**$4,188**	**$3,343**	**$15,682**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.42: Number of Interest Abatements by Tax Year and Fiscal Year of Abatements—Business Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	8,014	8,283	9,000	9,802	**35,099**
1980-84	3,892	2,277	1,587	898	**8,654**
1985-89	35,850	22,590	16,308	11,490	**86,238**
1990	22,991	11,567	7,150	4,988	**46,696**
1991	90,253	23,490	11,398	6,672	**131,813**
1992	84,576	69,478	19,824	9,427	**183,305**
1993	155,212	92,484	65,640	18,685	**332,021**
1994	842,380	189,132	73,258	35,761	**1,140,531**
1995	133,382	917,238	173,148	70,141	**1,293,909**
1996	[b]	162,492	856,939	180,485	**1,199,916**
1997	[b]	[b]	169,706	824,356	**994,062**
1998	[b]	[b]	[b]	192,349	**192,349**
Total interest abatements	**1,376,550**	**1,499,031**	**1,403,958**	**1,365,054**	**5,644,593**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1961.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.43: Amount of Interest Abatements by Tax Year and Fiscal Year of Abatement—Business Tax Returns

Dollars in millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$274	$260	$398	$166	**$1,097**
1980-84	418	321	323	219	**1,282**
1985-89	362	665	449	337	**1,813**
1990	268	297	111	82	**757**
1991	170	297	66	63	**596**
1992	48	264	80	52	**444**
1993	95	55	194	65	**409**
1994	76	111	73	68	**327**
1995	9	97	140	65	**311**
1996	[b]	9	131	145	**284**
1997	[b]	[b]	8	111	**118**
1998	[b]	[b]	[b]	9	**9**
Total interest abatements	**$1,720**	**$2,375**	**$1,972**	**$1,381**	**$7,448**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1961.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.44: Number of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Corporate Income Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	94	43	38	25	**200**
1980-84	336	235	151	78	**800**
1985-89	2,717	1,627	1,005	579	**5,928**
1990	1,904	1,012	614	376	**3,906**
1991	3,600	1,743	917	539	**6,799**
1992	7,520	3,563	1,787	842	**13,712**
1993	33,035	7,823	3,798	1,745	**46,401**
1994	81,106	54,100	10,047	4,172	**149,425**
1995	6,331	64,053	42,465	9,456	**122,305**
1996	[b]	6,611	70,253	44,016	**120,880**
1997	[b]	[b]	6,108	69,458	**75,566**
1998	[b]	[b]	[b]	6,874	**6,874**
Total penalty abatements	**136,643**	**140,810**	**137,183**	**138,160**	**552,796**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1964.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.45: Amount of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$3	$1	[b]	[b]	**$4**
1980-84	9	7	3	22	**41**
1985-89	18	18	29	14	**79**
1990	46	403	25	5	**479**
1991	131	113	5	3	**252**
1992	33	112	8	3	**154**
1993	90	12	7	5	**113**
1994	48	171	21	8	**248**
1995	1	45	160	30	**237**
1996	[c]	1	82	291	**374**
1997	[c]	[c]	1	94	**95**
1998	[c]	[c]	[c]	2	**2**
Total penalty abatements	**$379**	**$881**	**$342**	**$477**	**$2,079**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1964.

[b]Less than $1 million.

[c]Does not apply.

Source: GAO compilation of IRS data.

Table IV.46: Number of Interest Abatements by Tax Year and Fiscal Year of Abatement—Corporate Income Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	308	237	209	59	**813**
1980-84	737	598	397	257	**1,989**
1985-89	3,743	2,425	1,596	1,145	**8,909**
1990	2,914	1,389	869	585	**5,757**
1991	4,782	2,404	1,258	784	**9,228**
1992	7,865	4,751	2,585	1,280	**16,481**
1993	26,365	8,090	5,038	2,548	**42,041**
1994	65,585	43,957	10,443	5,749	**125,734**
1995	5,116	50,952	33,878	9,754	**99,700**
1996	[b]	5,382	56,880	36,464	**98,726**
1997	[b]	[b]	5,107	58,237	**63,344**
1998	[b]	[b]	[b]	5,895	**5,895**
Total interest abatements	**117,415**	**120,185**	**118,260**	**122,757**	**478,617**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1961.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.47: Amount of Interest Abatements by Tax Year and Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$176	$163	$262	$40	**$641**
1980-84	351	312	315	214	**1,191**
1985-89	318	611	415	310	**1,654**
1990	247	283	98	73	**702**
1991	84	268	50	52	**454**
1992	24	158	39	41	**263**
1993	27	11	17	38	**93**
1994	16	65	21	23	**125**
1995	[b]	13	57	25	**95**
1996	[c]	[b]	24	77	**102**
1997	[c]	[c]	[b]	18	**18**
1998	[c]	[c]	[c]	1	**1**
Total interest abatements	**$1,243**	**$1,883**	**$1,299**	**$912**	**$5,338**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1961.

[b]Less than $1 million.

[c]Does not apply.

Source: GAO compilation of IRS data.

Table IV.48: Number of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Employment Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	214	86	193	94	**587**
1980-84	3,899	2,117	1,550	731	**8,297**
1985-89	43,913	26,057	19,346	13,354	**102,670**
1990	25,635	12,453	7,621	5,008	**50,717**
1991	90,141	28,678	14,308	8,123	**141,250**
1992	96,289	72,760	25,060	12,128	**206,237**
1993	191,883	100,003	70,249	22,886	**385,021**
1994	1,215,070	196,633	85,261	40,995	**1,537,959**
1995	243,208	1,116,212	184,975	83,076	**1,627,471**
1996	[b]	267,061	1,092,954	198,627	**1,558,642**
1997	[b]	[b]	257,821	1,081,064	**1,338,885**
1998	[b]	[b]	[b]	320,870	**320,870**
Total penalty abatements	**1,910,252**	**1,822,060**	**1,759,338**	**1,786,956**	**7,278,606**

Notes: Employment tax returns include Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.49: Amount of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Employment Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$2	[b]	[b]	[b]	**$2**
1980-84	2	$2	$1	[b]	**4**
1985-89	34	18	10	$7	**69**
1990	12	8	5	3	**27**
1991	55	21	10	6	**93**
1992	52	75	26	8	**161**
1993	160	63	135	20	**378**
1994	637	195	84	45	**961**
1995	816	1,623	355	89	**2,883**
1996	[c]	376	1,545	270	**2,191**
1997	[c]	[c]	94	547	**641**
1998	[c]	[c]	[c]	496	**496**
Total penalty abatements	**$1,770**	**$2,381**	**$2,264**	**$1,491**	**$7,907**

Notes: Employment tax returns include Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1962.

[b]Less than $1 million.

[c]Does not apply.

Source: GAO compilation of IRS data.

Table IV.50: Number of Interest Abatements by Tax Year and Fiscal Year of Abatement—Employment Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	152	50	85	53	**340**
1980-84	2,316	1,164	930	486	**4,896**
1985-89	26,774	16,295	12,349	8,417	**63,835**
1990	17,219	8,419	5,250	3,780	**34,668**
1991	78,054	17,912	8,391	4,971	**109,328**
1992	68,501	57,361	14,501	6,686	**147,049**
1993	101,704	75,200	53,813	13,370	**244,087**
1994	665,634	109,771	53,040	24,085	**852,530**
1995	124,314	623,729	102,614	50,854	**901,511**
1996	[b]	150,586	627,866	106,504	**884,956**
1997	[b]	[b]	155,009	663,091	**818,100**
1998	[b]	[b]	[b]	177,872	**177,872**
Total interest abatements	**1,084,668**	**1,060,487**	**1,033,848**	**1,060,169**	**4,239,172**

Notes: Employment tax returns include Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.51: Amount of Interest Abatements by Tax Year and Fiscal Year of Abatement—Employment Tax Returns

Dollars in millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	[b]	[b]	[b]	[b]	**$1**
1980-84	$3	$4	$3	$2	**11**
1985-89	31	36	23	16	**106**
1990	17	9	10	5	**42**
1991	81	27	10	8	**126**
1992	19	99	34	9	**162**
1993	24	40	171	20	**255**
1994	34	25	39	38	**136**
1995	8	49	59	29	**146**
1996	[c]	8	80	35	**123**
1997	[c]	[c]	7	69	**76**
1998	[c]	[c]	[c]	8	**8**
Total interest abatements	**$219**	**$298**	**$436**	**$239**	**$1,192**

Notes: Employment tax returns include Form 940, Employer's Annual Federal Unemployment Tax Return; Form 941, Employer's Quarterly Federal Tax Return; Form 942, Employer's Quarterly Federal Return for Household Employees (for tax periods prior to the requirement that these taxes be reported on Schedule H of the employer's Form 1040); and Form 943, Employer's Annual Tax Return for Agriculture Employees.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1962.

[b]Less than $1 million.

[c]Does not apply.

Source: GAO compilation of IRS data.

Table IV.52: Number of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Other Business Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	6,076	7,418	8,543	10,020	**32,057**
1980-84	1,162	783	338	212	**2,495**
1985-89	10,529	7,349	4,429	3,203	**25,510**
1990	6,898	3,494	2,060	1,237	**13,689**
1991	44,862	7,809	3,841	1,945	**58,457**
1992	32,004	41,551	7,418	3,365	**84,338**
1993	92,091	33,997	35,141	7,384	**168,613**
1994	186,583	114,718	37,311	37,362	**375,974**
1995	4,166	304,760	125,895	32,686	**467,507**
1996	[b]	6,875	231,755	131,709	**370,339**
1997	[b]	[b]	9,640	169,155	**178,795**
1998	[b]	[b]	[b]	8,784	**8,784**
Total penalty abatements	**384,371**	**528,754**	**466,371**	**407,062**	**1,786,558**

Notes: Other business tax returns include numerous types of returns, such as, estate, gift, partnerships, and fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1963.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.53: Amount of Penalty Abatements by Tax Year and Fiscal Year of Abatement—Other Business Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	$51	$86	$90	$114	**$341**
1980-84	4	1	1	[b]	**7**
1985-89	28	15	21	9	**73**
1990	38	14	9	4	**64**
1991	410	58	11	7	**487**
1992	142	389	48	13	**592**
1993	270	132	439	69	**909**
1994	377	228	149	408	**1,161**
1995	2	492	497	122	**1,112**
1996	[c]	2	317	416	**735**
1997	[c]	[c]	1	211	**212**
1998	[c]	[c]	[c]	1	**1**
Total penalty abatements	**$1,322**	**$1,417**	**$1,582**	**$1,374**	**$5,695**

Notes: Other business tax returns include numerous types of returns, such as, estate, gift, partnerships, and fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees. Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1963.

[b]Less than $1 million.

[c]Does not apply.

Source: GAO compilation of IRS data.

Table IV.54: Number of Interest Abatements by Tax Year and Fiscal Year of Abatement—Other Business Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	7,554	7,996	8,706	9,690	**33,946**
1980-84	839	515	260	155	**1,769**
1985-89	5,333	3,870	2,363	1,928	**13,494**
1990	2,858	1,759	1,031	623	**6,271**
1991	7,417	3,174	1,749	917	**13,257**
1992	8,210	7,366	2,738	1,461	**19,775**
1993	27,143	9,194	6,789	2,767	**45,893**
1994	111,161	35,404	9,775	5,927	**162,267**
1995	3,952	242,557	36,656	9,533	**292,698**
1996	[b]	6,524	172,193	37,517	**216,234**
1997	[b]	[b]	9,590	103,028	**112,618**
1998	[b]	[b]	[b]	8,582	**8,582**
Total interest abatements	**174,467**	**318,359**	**251,850**	**182,128**	**926,804**

Notes: Other business tax returns include numerous types of returns, such as, estate, gift, partnerships, and fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1963.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table IV.55: Amount of Interest Abatements by Tax Year and Fiscal Year of Abatement—Other Business Tax Returns

Dollars in millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$97	$97	$135	$126	**$455**
1980-84	65	5	6	3	**79**
1985-89	13	18	11	11	**54**
1990	3	4	2	4	**13**
1991	5	2	6	3	**16**
1992	4	6	6	2	**19**
1993	44	4	6	7	**62**
1994	25	21	13	7	**66**
1995	1	35	24	11	**70**
1996	[b]	[c]	27	33	**59**
1997	[b]	[b]	[c]	23	**24**
1998	[b]	[b]	[b]	1	**1**
Total interest abatements	**$258**	**$193**	**$237**	**$230**	**$918**

Notes: Other business tax returns include numerous types of returns, such as, estate, gift, partnerships, and fiduciaries, and returns used by taxpayers to report withholdings from revenues paid to nonemployees.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Earliest tax year was 1963.

[b]Does not apply.

[c]Less than $1 million.

Source: GAO compilation of IRS data.

Abatements of Tax Assessments on Individual and Business Tax Returns

Table V.1: Number and Distribution of Tax Abatements by Fiscal Year of Abatement—Individual and Business Tax Returns

	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Abatement type	**Number**	**Percent**	**Number**	**Percent**	**Number**	**Percent**	**Number**	**Percent**	**Number**	**Percent**
Abatement of prior tax assessment—non-Examination	2,320,900	87.9	2,129,665	87.2	3,132,257	91.3	2,818,688	91.0	**10,401,510**	**89.6**
Abatement of prior tax assessment—Examination	65,928	2.5	73,305	3.0	65,556	1.9	58,847	1.9	**263,636**	**2.3**
Abatements due to net operating loss carryback	254,443	9.6	240,031	9.8	233,545	6.8	221,137	7.1	**949,156**	**8.2**
Total	**2,641,271**	**100.0**	**2,443,001**	**100.0**	**3,431,358**	**100.0**	**3,098,672**	**100.00**	**11,614,302**	**100.0**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Columns may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table V.2: Amount and Distribution of Tax Abatements by Fiscal Year of Abatement—Individual and Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Abatement type	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
Abatement of prior tax assessment—non-Examination	$9,249	44.4	$10,005	44.5	$10,384	46.9	$10,172	45.7	**$39,810**	**45.4**
Abatement of prior tax assessment—Examination	3,176	15.3	3,608	16.0	3,140	14.2	3,317	14.9	**13,241**	**15.1**
Abatements due to net operating loss carryback	8,395	40.3	8,875	39.5	8,595	38.9	8,751	39.4	**34,617**	**39.4**
Total	**$20,820**	**100.0**	**$22,489**	**100.0**	**$22,119**	**100.0**	**$22,240**	**100.0**	**$87,668**	**100.0**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Tables V.3-V.5 show information on the three types of tax abatements for individual returns, business tax returns, and corporate income tax returns.

Table V.3: Number and Amount of Tax Abatements by Fiscal Year of Abatement—Individual Tax Return

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Abatement type	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Abatement of prior tax assessment—non-Examination	1,751,338	$2,987	1,648,301	$3,056	2,710,881	$3,738	2,426,144	$3,938	**8,536,664**	**$13,720**
Abatement of prior tax assessment—Examination	52,146	410	53,936	464	51,624	468	45,915	435	**203,621**	**1,777**
Abatements due net operating loss carryback	102,714	995	91,837	1,178	86,030	1,060	76,500	1,095	**357,081**	**4,327**
Total	**1,906,198**	**$4,392**	**1,794,074**	**$4,699**	**2,848,535**	**$5,266**	**2,548,559**	**$5,468**	**9,097,366**	**$19,824**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table V.4: Number and Amount of Tax Abatements by Fiscal Year of Abatement—Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Abatement type	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Abatement of prior tax assessment—non-Examination	569,562	$6,262	481,364	$6,949	421,376	$6,646	392,544	$6,234	**1,864,846**	**$26,090**
Abatement of prior tax assessment—Examination	13,782	2,766	19,369	3,144	13,932	2,672	12,932	2,881	**60,015**	**11,463**
Abatements due to net operating loss carryback	151,729	7,401	148,194	7,697	147,515	7,535	144,637	7,657	**592,075**	**30,290**
Total	**735,073**	**$16,428**	**648,927**	**$17,790**	**582,823**	**$16,853**	**550,113**	**$16,772**	**2,516,936**	**$67,843**

Notes: Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table V.5: Number and Amount of Tax Abatements by Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Abatement type	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Abatement of prior tax assessment—non-Examination	23,661	$1,554	23,489	$2,175	24,420	$1,742	23,551	$1,098	**95,121**	**$6,568**
Abatement of prior tax assessment—Examination	5,025	2,205	5,661	2,716	5,785	2,252	5,566	2,539	**22,037**	**9,713**
Abatements due to net operating loss carryback	148,183	7,372	145,409	7,670	145,023	7,507	142,127	7,623	**580,742**	**30,172**
Total	**176,869**	**$11,131**	**174,559**	**$12,560**	**175,228**	**$11,501**	**171,244**	**$11,260**	**697,900**	**$46,452**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Tables V.6-V.8 show one of the three types of tax abatements by corporate asset size.

Table V.6: Number and Amount of Non-Examination Tax Abatements by Asset Size and Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Asset size reported on balance sheet	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Small corporation										
No balance sheet[a]	1,151	$153	1,276	$48	1,577	$97	1,448	$204	**5,452**	**$503**
Assets < $250,000	9,851	27	10,205	26	10,574	33	10,277	36	**40,907**	**121**
$250,000 < $1 million	5,029	30	4,782	36	4,967	40	4,855	39	**19,633**	**145**
$1 million < $5 million	3,414	44	3,326	47	3,400	62	3,322	58	**13,462**	**212**
$5 million < $10 million	794	23	759	20	738	24	784	33	**3,075**	**101**
Subtotal	**20,239**	**$277**	**20,348**	**$178**	**21,256**	**$256**	**20,686**	**$370**	**82,529**	**$1,081**
Large corporation										
$10 million < $50 million	1,183	$60	1,193	$80	1,104	$137	1,002	$95	**4,482**	**$372**
$50 million < $100 million	396	98	390	64	393	41	344	97	**1,523**	**299**
$100 million < $250 million	425	180	346	102	366	105	388	105	**1,525**	**493**
$250 million or more	540	816	460	1,729	494	1,152	480	414	**1,974**	**4,110**
Subtotal	**2,544**	**$1,153**	**2,389**	**$1,974**	**2,357**	**$1,436**	**2,214**	**$711**	**9,504**	**$5,274**
Asset size not available[b]	878	$124	752	$22	807	$49	651	$17	**3,088**	**$212**
Total	**23,661**	**$1,554**	**23,489**	**$2,175**	**24,420**	**$1,742**	**23,551**	**$1,098**	**95,121**	**$6,568**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

We could not provide the asset size for businesses on noncorporate returns because the information is only available for corporate income tax returns.

Totals are based on abatements, not returns.

[a]Taxpayer did not provide ,or it was missing.

[b]Asset size was not available on returns transferred from IRS' historical files or non-master file and on special types of assessments.

Source: GAO compilation of IRS data.

Table V.7: Number and Amount of Examination Tax Abatements by Asset Size and Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
Asset size reported on balance sheet	1995		1996		1997		1998		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Small corporation										
No balance sheet[a]	167	$36	171	$67	204	$76	183	$171	**725**	**$350**
Assets < $250,000	417	2	611	4	794	11	581	14	**2,403**	**30**
$250,000 < $1 million	493	5	667	6	874	11	767	8	**2,801**	**30**
$1 million < $5 million	703	12	808	16	992	25	990	22	**3,493**	**75**
$5 million < $10 million	309	9	294	11	354	15	414	15	**1,371**	**50**
Subtotal	**2,089**	**$64**	**2,551**	**$104**	**3,218**	**$138**	**2,935**	**$230**	**10,793**	**$535**
Large corporation										
$10 million < $50 million	750	$95	892	$79	748	$74	739	$67	**3,129**	**$315**
$50 million < $100 million	318	59	279	45	245	51	266	101	**1,108**	**257**
$100 million < $250 million	372	134	423	105	322	120	373	103	**1,490**	**462**
$250 million or more	1,018	1,738	1,122	2,295	1,024	1,804	1,072	2,005	**4,236**	**7,842**
Subtotal	**2,458**	**$2,027**	**2,716**	**$2,524**	**2,339**	**$2,049**	**2,450**	**$2,276**	**9,963**	**$8,876**
Asset size not available[b]	478	$114	394	$88	228	$65	181	$34	**1,281**	**$302**
Total	**5,025**	**$2,205**	**5,661**	**$2,716**	**5,785**	**$2,252**	**5,566**	**$2,539**	**22,037**	**$9,713**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

We could not provide the asset size for businesses on noncorporate returns because the information is only available for corporate income tax returns.

Totals are based on abatements, not returns.

[a]Taxpayer did not provide, or it was missing.

[b]Asset size was not available on returns transferred from IRS' historical files or non-master file and on special types of assessments.

Source: GAO compilation of IRS data.

Table V.8: Number and Amount of Tax Abatements Due to Net Operating Loss Carryback by Asset Size and Fiscal Year of Abatement—Corporate Income Tax Returns

Dollars in Millions	Fiscal year of abatement									
Asset size reported on balance sheet	1995		1996		1997		1998		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Small corporation										
No balance sheet[a]	1,091	$791	1,082	$380	959	$131	1,000	$122	4,132	$1,424
Assets < $250,000	70,049	111	75,912	149	76,850	145	74,324	148	297,135	553
$250,000 < $1 million	35,042	183	38,388	217	38,760	233	38,645	251	150,835	885
$1 million < $5 million	19,993	305	18,157	366	18,420	427	18,506	447	75,076	1,546
$5 million < $10 million	7,256	171	3,723	195	3,126	206	3,111	247	17,216	819
Subtotal	**133,431**	**$1,560**	**137,262**	**$1,308**	**138,115**	**$1,143**	**135,586**	**$1,215**	**544,394**	**$5,227**
Large corporation										
$10 million < $50 million	3,143	$569	3,206	$575	3,333	$594	3,381	$716	13,063	$2,454
$50 million < $100 million	719	309	738	323	687	345	718	373	2,862	1,350
$100 million < $250 million	699	332	736	517	738	663	748	616	2,921	2,128
$250 million or more	1,051	4,283	1,179	4,756	1,082	4,462	1,069	4,646	4,381	18,146
Subtotal	**5,612**	**$5,493**	**5,859**	**$6,171**	**5,840**	**$6,064**	**5,916**	**$6,350**	**23,227**	**$24,078**
Asset size not available[b]	9,140	$319	2,288	$191	1,068	$300	625	$57	13,121	$867
Total	**148,183**	**$7,372**	**145,409**	**$7,670**	**145,023**	**$7,507**	**142,127**	**$7,623**	**580,742**	**$30,172**

Notes: Corporate returns include all Form 1120, Federal Corporate Income Tax returns.

We could not provide the asset size for businesses on noncorporate returns because the information is only available for corporate income tax returns.

Totals are based on abatements, not returns.

[a]Taxpayer did not provide, or it was missing.

[b]Asset size was not available on returns transferred from IRS' historical files or non-master file and on special types of assessments.

Source: GAO compilation of IRS data.

Abatements Associated With Tax, Penalty, and Interest Assessments on Substitute for Returns

The Internal Revenue Service uses third-party information to prepare a substitute for return for nonfilers. IRS prepares the return without knowledge of filing status, exemptions, and other deductions. When the notice of deficiency is received, some taxpayers file a corrected return. IRS will then abate any overassessed portion of tax, penalty, and interest.

In this appendix, we have excluded tables on return characteristics because the data are unreliable, such as filing status and exemptions, or do not apply, such as paid preparer.

Table VI.1: Number and Amount of Abatements Associated With Assessments on Substitute for Returns by Fiscal Year of Abatement–Individual and Business Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	215,315	$756	454,182	$249	255,100	$219	**924,597**	**$1,225**
1996	234,138	878	466,613	274	267,216	256	**967,967**	**1,408**
1997	203,262	910	419,399	319	250,433	288	**873,094**	**1,516**
1998	152,440	869	347,449	283	191,494	306	**691,383**	**1,457**
Total	**805,155**	**$3,412**	**1,687,643**	**$1,125**	**964,243**	**$1,069**	**3,457,041**	**$5,606**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table VI.2: Number and Amount of Abatements Associated With Assessments on Substitute for Returns by Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	179,375	$614	364,291	$191	214,396	$199	**758,062**	**$1,003**
1996	207,410	757	401,402	225	236,961	235	**845,773**	**1,217**
1997	174,187	763	348,275	232	217,238	261	**739,700**	**1,256**
1998	119,660	667	265,036	209	153,931	272	**538,627**	**1,148**
Total	**680,632**	**$2,801**	**1,379,004**	**$856**	**822,526**	**$967**	**2,882,162**	**$4,624**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table VI.3: Number of Abatements Associated With Assessments on Substitute for Returns by Tax Year and Fiscal Year of Abatement–Individual Tax Returns

	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	20	6	5	10	**41**
1980-84	17,355	13,383	10,291	7,563	**48,592**
1985-89	287,750	199,687	148,612	97,983	**734,032**
1990	169,127	116,575	86,082	53,566	**425,350**
1991	226,368	176,137	108,462	65,480	**576,447**
1992	56,805	284,205	217,535	104,086	**662,631**
1993	624	55,500	159,219	138,389	**353,732**
1994	13	265	9,194	53,885	**63,357**
1995	0	15	291	14,041	**14,347**
1996	[b]	0	9	3,620	**3,629**
1997	[b]	[b]	0	4	**4**
1998	[b]	[b]	[b]	0	**0**
Total	**758,062**	**845,773**	**739,700**	**538,627**	**2,882,162**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1978.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table VI.4: Amount of Abatements Associated With Assessments on Substitute for Returns by Tax Year and Fiscal Year of Abatement–Individual Tax Returns

Dollars in Thousands	Fiscal year of abatement				
Tax year of return	**1995**	**1996**	**1997**	**1998**	**Total**
Before 1980[a]	$124	$16	$1	[b]	**$142**
1980-84	26,503	18,153	12,012	$8,693	**65,361**
1985-89	419,778	349,063	294,944	243,017	**1,306,801**
1990	205,038	162,111	142,247	121,652	**631,048**
1991	288,068	229,396	168,765	140,057	**826,286**
1992	63,245	382,587	301,334	189,936	**937,103**
1993	299	75,586	307,724	274,721	**658,330**
1994	15	182	28,664	124,380	**153,240**
1995	0	8	325	33,104	**33,436**
1996	[c]	0	4	12,315	**12,319**
1997	[c]	[c]	0	37	**37**
1998	[c]	[c]	[c]	0	0
Total	**$1,003,069**	**$1,217,101**	**$1,256,020**	**$1,147,912**	**$4,624,103**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1978.

[b]Less than $1,000.

[c]Does not apply.

Source: GAO compilation of IRS data.

Abatements of Tax, Penalty, and Interest Assessments Associated With Tax on Original Return

Original tax assessments are from returns filed by taxpayers. All abatements of tax, penalty, and interest shown in this appendix are associated with the tax assessment on the original return because IRS had not assessed additional taxes before these abatements. We have excluded substitute for return data fields from this set of tables as these types of returns do not show an original tax assessment amount and would not result in an abatement without an intervening tax assessment.

Table VII.1: Number and Amount of Abatements Associated With Tax on Original Return by Fiscal Year of Abatement–Individual and Business Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	2,182,626	$13,353	3,711,340	$4,135	2,327,540	$598	**8,221,506**	**$18,086**
1996	1,955,283	15,049	3,708,611	5,138	2,471,001	1,104	**8,134,895**	**21,291**
1997	2,981,590	14,058	3,655,941	4,835	2,797,727	656	**9,435,258**	**19,549**
1998	2,732,542	16,452	4,149,059	4,276	2,881,971	630	**9,763,572**	**21,357**
Total	**9,852,041**	**$58,912**	**15,224,951**	**$18,383**	**10,478,239**	**$2,988**	**35,555,231**	**$80,284**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table VII.2: Number and Amount of Abatements Associated With Tax on Original Return by Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Abatement type							
	Tax		Penalty		Interest		Total	
Fiscal year of abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	1,568,051	$2,990	1,416,584	$1,036	1,138,472	$199	**4,123,107**	**$4,226**
1996	1,417,480	2,983	1,343,692	921	1,147,064	162	**3,908,236**	**4,066**
1997	2,490,285	3,710	1,402,363	932	1,540,613	136	**5,433,261**	**4,778**
1998	2,247,338	4,014	1,890,811	1,073	1,629,120	160	**5,767,269**	**5,247**
Total	**7,723,154**	**$13,696**	**6,053,450**	**$3,963**	**5,455,269**	**$657**	**19,231,873**	**$18,317**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

Source: GAO compilation of IRS data.

Table VII.3: Number and Amount of Abatements Associated With Tax on Original Return by Income Level and Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Fiscal year of abatement									
Income level reported on	1995		1996		1997		1998		Total	
original return	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Individual nonbusiness										
1040A TPI<$25,000	479,996	$94	497,377	$98	817,873	$227	824,288	$290	2,619,534	$708
Non1040A TPI<$25,000	392,182	143	406,915	71	463,456	99	490,487	105	1,753,040	418
TPI $25,000<$50,000	847,430	335	821,056	311	1,374,619	572	1,394,568	609	4,437,673	1,827
TPI $50,000<$100,000	676,169	522	670,788	427	1,167,764	741	1,156,208	687	3,670,929	2,378
TPI $100,000 or more	580,293	1,498	513,593	1,644	535,692	1,772	613,133	2,057	2,242,711	6,971
Subtotal	**2,976,070**	**$2,592**	**2,909,729**	**$2,551**	**4,359,404**	**$3,411**	**4,478,684**	**$3,747**	**14,723,887**	**$12,301**
Individual business[a]										
C-TGR < $25,000	197,782	$56	181,239	$56	210,037	$32	254,462	$123	843,520	$266
C-TGR $25,000<$100,000	353,048	248	309,568	174	345,651	150	429,640	208	1,437,907	780
C-TGR $100,000 or more	268,134	441	236,314	496	229,983	401	289,371	450	1,023,802	1,789
F-TGR<$100,000	31,527	15	27,318	12	21,041	11	20,375	9	100,261	47
F-TGR $100,000 or more	39,693	69	33,586	80	26,795	68	24,578	59	124,652	276
Subtotal	**890,184**	**$828**	**788,025**	**$818**	**833,507**	**$662**	**1,018,426**	**$849**	**3,530,142**	**$3,157**
Income level not available[b]	256,853	$805	210,482	$697	240,350	$705	270,159	$651	977,844	$2,858
Total	**4,123,107**	**$4,226**	**3,908,236**	**$4,066**	**5,433,261**	**$4,778**	**5,767,269**	**$5,247**	**19,231,873**	**$18,316**

Legend

1040A = Nonbusiness returns filed by individuals
TPI = Total positive income (income reported as a positive on tax return tables)
C-TGR = Form 1040 Schedule C (profit or loss from business) total gross receipts
F-TGR = Form 1040 Schedule F (profit or loss from farming) total gross receipts

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Returns with Schedules C or F may be categorized as nonbusiness rather than business if the reported primary source of income was wages, investments, and other nonbusiness income.

[b]Income level was not always available on certain penalties.

Source: GAO compilation of IRS data.

Table VII.4: Number of Abatements Associated With Tax on Original Return by Tax Year and Fiscal Year of Abatement–Individual Tax Returns

	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	2,601	1,269	709	630	**5,209**
1980-84	69,766	28,878	15,199	12,525	**126,368**
1985-89	356,621	193,456	128,612	137,329	**816,018**
1990	145,812	75,507	52,973	54,676	**328,968**
1991	313,788	111,529	69,530	69,177	**564,024**
1992	584,699	291,201	120,295	93,487	**1,089,682**
1993	1,301,600	649,974	307,825	150,126	**2,409,525**
1994	1,346,786	1,260,282	504,366	301,476	**3,412,910**
1995	1,434	1,293,844	1,314,666	589,266	**3,199,210**
1996	[b]	2,296	2,916,556	1,910,184	**4,829,036**
1997	[b]	[b]	2,530	2,445,813	**2,448,343**
1998	[b]	[b]	[b]	2,580	**2,580**
Total	**4,123,107**	**3,908,236**	**5,433,261**	**5,767,269**	**19,231,873**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table VII.5: Amount of Abatements Associated With Tax on Original Return by Tax Year and Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions	Fiscal year of abatement				
Tax year of return	1995	1996	1997	1998	Total
Before 1980[a]	$11	$5	$3	$4	**$23**
1980-84	140	73	42	40	**295**
1985-89	713	407	229	176	**1,526**
1990	436	214	111	71	**833**
1991	657	380	147	110	**1,294**
1992	637	707	380	148	**1,872**
1993	966	688	757	435	**2,846**
1994	665	938	655	711	**2,968**
1995	1	652	1,040	681	**2,375**
1996	[b]	1	1,414	1,285	**2,699**
1997	[b]	[b]	1	1,584	**1,585**
1998	[b]	[b]	[b]	1	**1**
Total	**$4,226**	**$4,066**	**$4,778**	**$5,247**	**$18,317**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Earliest tax year was 1962.

[b]Does not apply.

Source: GAO compilation of IRS data.

Table VII.6: Distribution of Returns With Abatements Associated With Tax on Original Return by Filing Status and Fiscal Year of Abatement–Individual Tax Returns

		Filing Status					
Fiscal year of abatement	Number of returns	Single	Married, filing jointly	Married, filing separately	Head of household	Widow(er) with dependent child	Total
1995	[a]	[a]	[a]	[a]	[a]	[a]	[a]
1996	[a]	[a]	[a]	[a]	[a]	[a]	[a]
1997	3,545,398	24.1%	56.6%	3.5%	15.7%	0.1%	100%
1998	3,688,582	27.3	54.1	4.0	14.5	0.1	100

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages may not sum to 100 because of rounding.

[a]IRS was unable to reconstruct the filing status data from its historical files within the time frame of our review.

Source: GAO compilation of IRS data.

Table VII.7: Distribution of Returns With Abatements Associated With Tax on Original Return by Selected Characteristic and Fiscal Year of Abatement–IndividualTax Returns

		Selected characteristic		
Fiscal year of abatement	Number of returns	Primary taxpayer over age 65	Paid preparer on original return	Earned income credit on original return
1995	2,600,897	12.3%	63.7%	3.6%
1996	2,479,891	12.5	62.2	3.9
1997	3,545,398	9.3	54.5	3.8
1998	3,688,582	9.5	57.0	4.3

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because abatements could occur on returns with more than one selected characteristic.

Source: GAO compilation of IRS data.

Table VII.8: Distribution of Number of Abatements Associated With Tax on Original Return by Selected IRS Activity and Fiscal Year of Abatement–Individual Tax Returns

		Selected IRS activity[a]			
Fiscal year of abatement	Number of abatements	Audit indicator[b]	Offer-in-compromise[c]	Litigation[d]	Criminal investigation[e]
1995	4,123,107	4.1%	1.6%	4.6%	0.1%
1996	3,908,236	4.4	0.7	2.7	0.1
1997	5,433,261	2.7	0.2	1.3	0.0
1998	5,767,269	2.6	0.1	1.7	0.0

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because the abatement could have been preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[d]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[e]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Table VII.9: Distribution of Amount of Abatements Associated With Tax on Original Return by Selected IRS Activity and Fiscal Year of Abatement–Individual Tax Returns

Dollars in Millions		Selected IRS activity[a]			
Fiscal year of abatement	Amount of abatements	Audit indicator[b]	Offer-in-compromise[c]	Litigation[d]	Criminal investigation[e]
1995	$4,226	15.6%	4.7%	8.7%	0.6%
1996	4,066	19.4	2.4	5.7	0.4
1997	4,778	16.0	0.7	3.1	0.4
1998	5,247	14.8	0.4	3.2	0.2

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Percentages should not be totaled because the abatement could have been preceded by more than one selected IRS activity.

[a]IRS activity that occurred before the abatement.

[b]Includes audits that are still open and audits closed with a change in tax assessments or no change in tax assessments.

[c]IRS and taxpayer had reached an agreement on the portion of unpaid assessments the taxpayer would pay.

[d]Return was in some phase of the litigation process--open or closed. Would include bankruptcy cases, and cases settled or closed before trial.

[e]IRS investigation of criminal wrongdoing associated with the return. Includes cases open and closed, including those without further action by IRS.

Source: GAO compilation of IRS data.

Other Types of Abatements Associated With Unpaid Assessments on Individual and Business Tax Returns

This appendix provides abatement information on the unpaid balance of assessments that cannot be identified separately as tax, penalty, or interest. The information shown in this appendix is not shown or duplicated in any way in appendixes I through VII.

Table VIII.1: Number and Amount of Other Types of Abatements Associated With Unpaid Assessments–Individual and Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Reason for abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Determined currently not collectible	484	$6	451	$11	771	$7	903	$4	**2,609**	**$28**
Bankruptcy or offer-in-compromise[a]	19,547	446	113,752	1,021	174,867	1,673	191,675	1,697	**499,841**	**4,837**
Collection statute expired	243,260	1,848	376,048	2,724	427,843	3,199	745,517	4,833	**1,792,668**	**12,603**
Trust fund recovery credit[b]	140,189	89	160,052	135	227,385	199	308,237	250	**835,863**	**673**
Total	**403,480**	**$2,389**	**650,303**	**$3,891**	**830,866**	**$5,077**	**1,246,332**	**$6,783**	**3,130,981**	**$18,140**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income. Business tax returns include corporate income tax, various employment taxes, and other types of returns on IRS' business master file.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Abatements of unpaid assessments on bankruptcy and offer-in-compromise returns cannot be separated.

[b]The balance due on a business return that results from employers' not paying IRS withholdings from employees' earnings is abated when credit (payment) is recovered through trust fund penalties assessed on the individual accounts of responsible officers.

Source: GAO compilation of IRS data.

Table VIII.2: Number and Amount of Other Types of Abatements Associated With Unpaid Assessments–Individual Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Reason for abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Determined currently not collectible	452	$6	400	$11	729	$6	851	$4	2,432	$27
Bankruptcy or offer-in-compromise[a]	[b]	[b]	87,770[b]	869[b]	146,128	1,397	164,284	1,521	398,182	3,787
Collection statute expired	45,815	684	132,288	1,315	150,630	1,543	340,643	2,251	669,376	5,792
Total	**46,267**	**$690**	**220,458**	**$2,195**	**297,487**	**$2,946**	**505,778**	**$3,775**	**1,069,990**	**$9,606**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

[a]Abatements of unpaid assessments on bankruptcy and offer-in-compromise returns cannot be separated.

[b]During fiscal year 1996 on individual returns, IRS began abating the balance due rather than specific assessments on bankruptcy and offer-in-compromise cases as it had done in prior years. Abatements on these types of cases before this procedural change are included in the appropriate tables in appendixes I through VII.

Source: GAO compilation of IRS data.

Table VIII.3: Number and Amount of Other Types of Abatements Associated With Unpaid Assessments–Business Tax Returns

Dollars in Millions	Fiscal year of abatement									
	1995		1996		1997		1998		Total	
Reason for abatement	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Determined currently not collectible	32	[a]	51	[a]	42	[a]	52	[a]	177[a]	
Bankruptcy or offer-in-compromise[b]	19,547	$446	25,982	$152	28,739	$276	27,391	$176	101,659	$1,050
Collection statute expired	197,445	1,164	243,760	1,408	277,213	1,656	404,874	2,582	1,123,292	6,811
Trust fund recovery credit[c]	140,189	89	160,052	135	227,385	199	308,237	250	835,863	673
Total	**357,213**	**$1,699**	**429,845**	**$1,696**	**533,379**	**$2,131**	**740,554**	**$3,008**	**2,060,991**	**$8,534**

Notes: Individual tax returns are Form 1040, Federal Individual Income Tax Returns, including those with Schedule C, sole proprietor business income and Schedule F, farm income.

Totals are based on abatements, not returns.

Amounts may not sum to totals because of rounding.

[a]Less than $1 million.

[b]Abatements of unpaid assessments on bankruptcy and offer-in-compromise returns cannot be separated.

[c]The balance due on a business return that results from employers' not paying IRS withholdings from employees' earnings is abated when credit (payment) is recovered through trust fund penalties assessed on the individual accounts of responsible officers.

Source: GAO compilation of IRS data.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF OPERATIONS OFFICER

May 21, 1999

Ms. Cornelia M. Ashby
Associate Director, Tax Policy and
Administration Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Ashby:

Thank you for the opportunity to review and comment on your recent draft report entitled "Tax Administration: IRS' Abatement of Assessments in Fiscal Years 1995-98." We are pleased that you sought our comments as the study progressed and especially during its final stages. The result of this communication is a report that provides good information on certain aspects of the IRS' administration of abatements. For example, the report appropriately describes abatement scenarios which are indicative of the wide range of situations where abatements would be warranted. Further, the statistical tables you have included in the appendices are consistent with our abatement data. We are also pleased that additional footnotes will be added to clarify the data presented. We believe this information should be quite helpful to the Joint Committee on Taxation as they conduct the study mandated by the IRS' Restructuring and Reform Act of 1998 on the IRS' administration and implementation of the interest and penalty provisions of the Internal Revenue Code.

We take quite seriously the mandates of the IRS Restructuring and Reform Act of 1998. We will continue to provide whatever support is required to both the General Accounting Office and the Joint Committee as we all work to implement the requirements of the Act. We believe all of our efforts will help build a tax administration worthy of America's taxpayers.

If you have any questions or need additional information, please call me at (202) 622-6860 or a member of your staff may call Tom Wilson, Assistant Commissioner (Examination), at (202) 622-4400.

Sincerely,

John M. Dalrymple

Major Contributors to This Report

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United States General Accounting Office

GAO

Report to the Joint Committee on Taxation

July 1999

TAX ADMINISTRATION

IRS' Abatement Process in Selected Locations

GAO

Accountability * Integrity * Reliability

GAO/GGD-99-98

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-282811

July 2, 1999

The Honorable Bill Archer
Chairman
The Honorable William V. Roth, Jr.
Vice Chairman
Joint Committee on Taxation

For fiscal years 1995 through 1998, the Internal Revenue Service (IRS) annually abated about $30 billion in tax, penalty, and interest assessments in the tax accounts of individual and business taxpayers. Abatements reduce assessments and can occur for a variety of reasons, such as to correct errors made by IRS and taxpayers and to provide relief from penalties when taxpayers have reasonable cause for failing to comply with tax requirements. The process for making abatements is important for ensuring the equitable treatment of taxpayers across IRS' 10 service centers and 33 district offices.

In a letter dated February 2, 1999, you asked us to describe IRS' abatement process in order to help the Committee fulfill a requirement in the IRS Restructuring and Reform Act of 1998 to report on the administration of penalty and interest assessments by July 22, 1999.[1] On the basis of discussions with your office, our objectives were to describe (1) IRS' process for making abatements from initiation through final review in selected IRS locations and (2) IRS' efforts to improve the abatement process. As agreed with your office, the selected locations were the Kansas City Service Center, Fresno Service Center, Kansas City District Office, and Northern California District Office.

Results in Brief

An abatement may be initiated by a taxpayer or by IRS. Once initiated, IRS' abatement process depends on the type, complexity, and source of the assessment being abated. According to IRS officials, these factors determine the IRS work group, such as those that audit tax returns or answer taxpayer inquiries, that makes the abatement decision.[2] The work group, in combination with the type and complexity of the assessment being abated, influence the type and grade level of staff making abatement decisions, the criteria and supervisory review used to guide decisions, and the quality review done after the decisions are made.

[1]As also requested in this letter, we have reported the number and amount of abatements of tax, penalty, and interest assessments for individual and business taxpayers. See Tax Administration: IRS' Abatement of Assessments in Fiscal Years 1995-98 (GAO/GGD-99-77, June 4, 1999).

[2]For this report, "work group" is a generic term for branches and other offices.

IRS does not have quantitative data on details of the abatement process. An abatement is just one type of adjustment that IRS can make to taxpayer accounts. For example, IRS staff also adjust accounts to reflect the dates and amounts of various types of assessments and payments. Although it has data on the number and amount of abatements, IRS cannot extract any quantitative data about the abatement process from data on all types of adjustments. Determining the costs and benefits of collecting data on just the abatement process is beyond the scope of this report.

IRS' recent efforts to improve the abatement process have generally involved task forces that have been studying various IRS concerns, including, for example, the administration of penalties and treatment of taxpayers. Although the studies have not focused on abatements, they have produced some proposals that would affect the abatement process, such as the documentation required to support abatements.

During 1993-94, concerns about the inventory of tax debts prompted IRS to study abatements at its 10 service centers. This study identified 259 problems and referred 158 to various IRS work groups for analysis and implementation of any needed changes. IRS never formally released a final study.

Background

According to IRS records from its master files on individual and business returns, IRS annually abated, on average, about 10 million tax, penalty, and interest assessments, totaling nearly $30 billion, in fiscal years 1995 through 1998. In fiscal year 1998, IRS abated 11.3 million assessments—3.1 million tax, 4.7 million penalty, and 3.5 million interest assessments. These abatements totaled about $22.2 billion in tax, $4.8 billion in penalty, and $2.1 billion in interest assessments.

An assessment is a formal bookkeeping entry that IRS makes to record the amount of tax, penalty, or interest charged to a taxpayer's account. An assessment establishes not only the taxpayer's liability for amounts due and unpaid, but also IRS' right to collect. Taxpayers essentially assess their taxes owed when they file their tax returns.[3] IRS may assess additional taxes owed, as well as penalty and interest amounts, through an enforcement program.[4] Taxpayers also may file an amended return or

[3]IRS records the assessment as the amount of tax reported on these filed returns.

[4]Before assessing a tax deficiency, IRS is required to provide the taxpayer with a notice of the proposed assessment. Upon receiving the notice, the taxpayer has 90 days (150 days if outside the United States) to file a petition with the Tax Court for a redetermination of the deficiency. Upon expiration of the filing period, IRS may assess the proposed deficiency.

otherwise notify IRS of an error, which may lead to additional assessments.

Section 6404 of the Internal Revenue Code (as well as various other sections) authorizes IRS to abate an assessment under certain conditions. For example, IRS abates an erroneous assessment, which can be caused by either IRS or the taxpayer.[5] A taxpayer may make an error on the original tax return, such as not claiming deductions. Or, IRS may assess incorrect tax amounts as a result of errors made when matching income reported by taxpayers with income reported by third parties (such as employers) on payments made to the taxpayers.

IRS abates a tax assessment of the correct amount for various reasons. For example, as a result of an audit, IRS may correctly assess an additional tax amount for one tax year, but a taxpayer can carry back net operating losses incurred in other tax years to reduce the additional tax liability in that prior tax year. Also, IRS abates an unpaid assessment that involved the correct amount of tax owed but that was made after the time period allowed for assessing additional tax liabilities. Further, IRS abates multiple assessments of the correct amount after that amount is paid. In these cases, IRS assesses multiple taxpayers (such as partners or officers in a business) for the amount owed by the business, knowing that the extra assessments are to be abated after full payment is received.

Whenever IRS abates a tax assessment, any related penalty or interest assessments are also abated. Further, IRS abates certain penalties when a taxpayer provides a reasonable cause for failing to meet a responsibility, such as not paying a tax assessment or not filing a return on time. Reasonable causes can include illness or other nonfinancial hardships and reliance on incorrect written advice from IRS on technical issues. IRS also abates certain interest assessments that accrue, for example, because of

- an unreasonable error or delay by IRS in assigning staff to the case, sending notices to taxpayers, transferring a case to another IRS office, or performing other procedural or managerial actions and
- delays in filing income tax returns and paying taxes because of a natural disaster for those living in a presidentially-declared disaster area.

IRS' interactions with taxpayers on abatements and other types of adjustments to taxpayers' accounts usually occur through IRS' 10 service centers or 33 district offices. Major activities at the service centers include

[5]IRS does not track the amounts abated because of IRS errors or taxpayer errors.

processing tax returns and related tax schedules from taxpayers and information returns from third parties that report payments, such as wages and interest. In addition, service centers provide services to taxpayers, such as responding to taxpayer inquiries, as well as perform enforcement functions, such as audits and collection, usually through correspondence or the telephone. District offices also offer services to taxpayers as well as perform enforcement functions. IRS staff at the district offices are more likely to interact with taxpayers through face-to-face meetings because the issues tend to be more complex or otherwise require more explanation.

Scope and Methodology

To describe IRS' process for making abatements from initiation through final review in selected IRS locations, we talked to IRS National Office work groups that could make abatements and the IRS office that administers penalties. We reviewed the Internal Revenue Manual sections and other IRS documents that govern the abatement process. Our visits to two service centers and two district offices, as discussed below, also helped us describe the process.

Specifically, we visited an IRS service center and district office in the Kansas-Missouri area and a service center and district office in California. We chose these four locations in consultation with your office. We were able to do more work in some of the four locations, depending on which ones we visited first, the availability of data, and the responsiveness of IRS staff within the time frame of our review.

Given time constraints, we did not visit more service centers or district offices. As a result, we do not know how similar or different the process was at the other 8 service centers and 31 district offices. Nor did we attempt to determine whether (1) any differences in the abatement process at the two service centers and two district offices produced significant effects, particularly for similarly situated taxpayers; (2) IRS staff followed the process and related criteria in making abatement decisions; (3) the process was appropriate and adequately controlled;[6] or (4) IRS should be collecting more quantitative data on its abatement process.

During each visit, we interviewed officials from IRS work groups that made abatements. We identified these groups from information provided by IRS' National Office and the four locations we visited. To confirm our understanding of the abatement process, we wrote summaries for each

[6]We did not evaluate IRS' controls for the abatement process because of time constraints and because we have another study under way that is addressing IRS' controls, including those for the abatement process.

location and received comments on these summaries from officials at each location as well as IRS' National Office. The summaries incorporating IRS' comments can be found in appendixes I-IV.

To describe IRS' efforts to improve the abatement process, we interviewed officials in IRS' National Office as well as selected staff in field offices who had worked on a task force or study that addressed abatements in some way. We also collected any available studies. As with our work on the abatement process, we asked the responsible IRS officials to comment on our summary of these efforts.

We performed our audit at IRS headquarters offices in Washington, D.C.; the Kansas City Service Center in Kansas City, MO; the Fresno Service Center in Fresno, CA; the Kansas-Missouri District Office in St. Louis, MO; and the Northern California District Office in Oakland, CA. Our work was done between February and June 1999 in accordance with generally accepted government auditing standards.

On June 22, 1999, we met with representatives of the IRS Commissioner from the Customer Service and Examination Divisions as well as the Taxpayer Advocate and Legislative Affairs Offices to obtain their comments on a draft of this report, which are discussed near the end of this letter.

IRS' Abatement Process Varied

At the two service centers and two district offices we visited, IRS' abatement process depended on the type, complexity, and source of the assessment being abated. The process varied in terms of (1) how abatements are initiated, (2) which IRS work groups make abatement decisions, (3) what level of staff makes the decisions, (4) what tools guide the decisions, and (5) how IRS reviews quality. We did not attempt to evaluate whether any variations in the process affected abatement decisions. Nor do we know how similar or different the process is at the other 8 service centers and 31 district offices.

IRS did not have quantitative data on the details of the abatement process, even though IRS' master files have data on the overall number and amount of abatements. An abatement is just one type of adjustment made to taxpayer accounts. IRS staff also adjust accounts to reflect the dates and amounts of various types of assessments, payments, and refunds. IRS cannot extract quantitative data about the abatement process from data on all types of adjustments. For example, IRS did not have data on the number of abatements made by type of IRS group and staff or reviewed by

IRS supervisors. Determining the costs and benefits of collecting such data on the abatement process was beyond the scope of this report.

Taxpayers and IRS Staff May Initiate Abatements

The two service centers and two district offices we visited did not track how the abatements were initiated. IRS officials, however, identified three basic ways of initiating abatements.

First, taxpayers can initiate a request (also known as claim) for an abatement by filing an amended tax return (e.g., Form 1040-X for individuals and Form 1120-X for corporations); by filing an IRS Form 843, Claim for Refund and Request for Abatement; by writing a letter; or by making a phone call. Taxpayers would generally initiate these requests to correct errors on the original return they filed or to seek relief from penalties when they have reasonable cause for failing to comply with tax requirements.

Second, taxpayers can request an abatement of an additional assessment generated by an IRS enforcement program.[7] In these cases, the taxpayer would be responding to a notice about the assessment, such as a collection notice. These taxes might have been assessed because the taxpayer had not responded adequately to notices about the recommended assessment of additional tax amounts. For example, an audit may recommend additional assessments that the taxpayer did not challenge when the audit closed. The taxpayer might later decide to challenge the assessment and ask IRS for an abatement.[8] Similarly, after receiving a notice of additional assessments, taxpayers may claim a reasonable cause for not timely paying the correct tax amount and ask IRS to abate certain types of penalties.

Third, in some cases, IRS staff can initiate the abatement. For example, an IRS auditor might find evidence that a taxpayer overstated the tax liability on the original tax return. This evidence could lead to an abatement, depending on the results from the rest of the audit.

[7]Section 6404 (b) of the Internal Revenue Code states that a taxpayer may not file a request for abatement of income, estate, or gift tax. Rather, a taxpayer should dispute these tax assessments by paying the tax and filing a request for a refund. IRS does, however, reduce some of these tax assessments without payment when the taxpayer requests an abatement of an audit assessment and provides support for the abatement. These requests are known as audit reconsiderations.

[8]Before IRS assesses additional taxes that an auditor recommends, a taxpayer can challenge the recommended assessment in Examination or IRS' Office of Appeals. Also, upon receiving a notice of a proposed assessment, a taxpayer has 90 days (150 days if outside the United States) to file a petition with the Tax Court. Some taxpayers, for whatever reasons, bypass these options, which results in the recommended taxes being assessed, along with related penalty and interest assessments.

Various IRS Work Groups Make Abatement Decisions

Various IRS work groups at the two service centers and two district offices we visited had the authority to abate assessments. According to IRS officials, the type, complexity, and source of the assessment being abated determine which IRS work group makes the abatement decision. Using these factors as well as IRS routing criteria, a work group that initially receives a requested abatement is to determine whether it should make the abatement decision. If the determination is to route the abatement to another work group, the abatement process to be followed is to be guided by the general IRS criteria for the type of abatement being reviewed and the specific review process of that group.

Each work group can abate different types of tax, penalty, and interest issues. Table 1 shows examples of the most common types or sources of abatements made by work groups at the two service centers, as identified by IRS officials.[9]

Table 1: Examples of Abatements Made in the Kansas City and Fresno Service Centers, as of April 1999

	Examples of abatements at two service centers	
Work group	Kansas City	Fresno
Adjustments Branch	Amended returns	Amended returns
Collection Branch	Substitute for return[a]	Substitute for return[a]
Customer Service Branch	Penalties	Penalties
Examination Branch	Category A claims,[b] audit reconsiderations[c]	Audit reconsiderations[c]
Joint Compliance Branch	Does not exist[d]	Category A claims[b]
Underreporter Branch	Does not exist[e]	Apparent overreported income
Automated Collection Branch	Penalties, erroneous substitute for return[f]	Does not exist[g]
Document Perfection Branch	Simple claims on amended returns	Not applicable[h]

[a]Returns filed by IRS on the basis of information returns that reported income paid to a taxpayer who did not file a tax return.

[b]Category A claims involve issues that are complex or sensitive, or prone to noncompliance.

[c]Audit reconsiderations occur when taxpayers ask IRS to reconsider assessments made in prior audits.

[d]In Kansas City, this work is done through the Examination Branch.

[e]Kansas City's underreporter cases are handled at the Austin or Ogden Service Centers.

[f]Erroneous substitute for returns involve those sent to taxpayers who had filed their returns before receiving the SFR filed by IRS.

[g]In Fresno, this work is done as part of the Collection Branch.

[h]Although Fresno has a Document Perfection Branch, it usually handles simple requests on amended returns in its Adjustments Branch.

Source: GAO interviews and documents collected at each service center.

[9]Each service center had other work groups that made abatements, such as groups that deal with criminal investigations, quality assurance, and account services. We do not discuss these groups here because IRS officials told us these groups made few abatements.

As table 1 shows, each service center organized itself somewhat differently. As a result, each service center had branches that the other center did not have. For example, Fresno had a Joint Compliance Branch that did not exist in Kansas City. This branch dealt with, among other things, abatement requests (known as category A claims) that were complex, sensitive, or involved types of taxpayers prone to noncompliance. Kansas City usually handled category A requests in its Examination Branch. Also, Kansas City allowed clerical staff in its Document Perfection Branch to abate simple requests made on amended returns. Fresno usually handled this type of request in its Adjustments Branch.

The two district offices generally relied on three divisions to abate assessments. Table 2 shows examples of the types or sources of abatements made by the divisions, as identified by officials at the district offices.

Table 2: Examples of Abatements Made in the Kansas-Missouri and Northern California District Offices, as of April 1999

	Examples of abatements at two district offices	
Division	Kansas-Missouri	Northern California
Collection	Various uncollectibles, such as bankruptcies; various penalties	Various uncollectibles, such as bankruptcies; various penalties
Customer Service	Federal tax deposit penalty	Various types of penalties
Examination	Audit reconsiderations,[a] claims	Audit reconsiderations,[a] claims

[a]Audit reconsiderations occur when taxpayers ask IRS to reconsider assessments made in prior audits

Source: GAO interviews and documents collected at each district office.

As table 2 shows, each of the three divisions at both districts made similar types of abatements. Although none of the divisions tracked the number of abatements, IRS officials indicated that the Collection and Customer Service Divisions made the most abatement decisions, many of which involved penalties. The officials said that in the Examination Division, the abatements usually involved tax assessments related to a prior audit, which could also involve penalties, or some form of taxpayer claim.

In addition, at the two service centers and two district offices, the Office of the Taxpayer Advocate had authority to make certain types of abatements.[10] However, officials at most locations we visited said that the Advocate's Office usually referred requests for abatements to other work groups (such as the Collection Division) and then tracked actions taken to

[10]The Office of the Taxpayer Advocate is to represent the interests of taxpayers. For abatements, the Advocate would get involved if taxpayers had difficulty solving their tax problems through IRS' regular channels or if they had major hardships in meeting their tax responsibilities.

help ensure the proper and timely resolution of a taxpayer's problem. Because these work groups usually made any related abatements, the Office of the Taxpayer Advocate would make few abatements compared to the other work groups.

Both Lower and Higher Graded Staff Can Make Abatement Decisions

Various types and grades of IRS staff, ranging from clerks to mid-level staff, can make abatement decisions, depending on the type, complexity, and source of the assessment being abated. Along with other duties, these IRS staff handled many types of adjustments to taxpayers' accounts other than abatements. None of the work groups tracked how many of these adjustments involved abatements.

Both service centers had a wide range of graded staff who made abatement decisions. The staff ranged from federal pay grades GS-3 to GS-9 in one service center and GS-4 to GS-12 in the other.[11] According to officials at the two service centers, staff known as customer service representatives and tax examiner assistants made most abatement decisions. In one service center, grades of customer service representatives ranged from GS-5 to GS-8 and tax examiner assistants ranged from GS-4 to GS-8. In the other service center, the grades were GS-6 to GS-9 and GS-6 to GS-7, respectively.

The two district offices also had various staff make abatement decisions in the three divisions. These staff ranged from federal pay grades GS-5 to GS-13.[12] According to officials at the two district offices, staff known as customer service representatives (GS-5 to GS-9) and revenue officers (GS-7 to GS-12) made the majority of the abatements. The two districts we visited did not differ very much in who made abatement decisions.[13]

Various Tools Can Guide Abatement Decisions

According to information provided by officials at both service centers and both district offices, staff making abatement decisions are to be guided by such tools as training, information provided by the taxpayer or IRS' computers, criteria in IRS manuals, and supervisory involvement. Descriptions of these four tools follow.

[11]The GS, or General Schedule, system ranges from GS-1 to GS-15. Excluding locality or other special pay adjustments, the 1999 pay for GS-3 to GS-12 ranges from about $16,000 to about $59,000.

[12]Excluding locality or other special pay adjustments, the 1999 pay for GS-5 to GS-13 ranges from about $21,000 to about $70,000.

[13]Even so, when we asked about staff that made abatements, officials at the Kansas-Missouri District Office were more likely to identify various types of specialists who were to assist such staff.

- IRS is to provide training on the various duties, including abatements, assigned to staff. The training can include such things as basic tax laws, IRS forms, adjustments in general, amended returns, and other generic tax issues. Training also can cover specific types of adjustments, including abatements to be made to taxpayer accounts. The training is to include classroom and on-the-job instruction.
- Staff can use various types of information provided by taxpayers or through IRS computers to help make abatement decisions. For example, taxpayers can provide additional information that they did not provide during an audit when they ask IRS to abate assessments made in that audit. Or, staff can use information in taxpayers' accounts to confirm taxpayer actions, such as the date a return was filed or a payment was made. To the extent that the computerized information is sufficient, IRS staff could use it to verify oral justifications from taxpayers for making the abatement. If the information is not sufficient, IRS may need to request additional support from the taxpayer.
- Criteria for making abatement decisions vary with the type and amount of the abatement and complexity of the issues. For example, the criteria for decisions about whether to abate a tax assessment would depend on the tax laws and regulations governing the specific tax issue (such as a dependency exemption) and the justification provided by the taxpayer in requesting the abatement. Also, for each type of penalty, IRS has various dollar tolerances that dictate the type of justification needed from the taxpayer to grant the abatement and whether that justification needs to be documented by the taxpayer rather than be provided orally. Because IRS labels the criteria and dollar tolerances as "official use only," which means the information is sensitive, we cannot disclose the specific criteria or tolerances.
- Dollar tolerances also can affect whether supervisors are to review proposed decisions by staff to abate assessments.[14] IRS did not have data on how many of the 11.3 million abatements in fiscal year 1998 had been reviewed by supervisors before the decision was finalized. However, supervisors are only required to review a few types of abatement decisions before they are finalized, such as those on certain types of penalty and interest abatements as well as on large-dollar abatements. Also, officials at some of the locations we visited said that few abatement decisions would be reviewed by supervisors before being finalized because of the large number of adjustments, including abatements, to be processed.

[14]According to service center officials, supervisors also reviewed a small percentage of all adjustments after they were made in order to evaluate the performance of the staff. Although these reviews of closed cases did not influence the original abatement decisions, supervisors are required to tell staff to correct any errors that these reviews uncover.

IRS Review Programs Do Not Track the Quality of Abatement Decisions

The two service centers and two district offices each have a separate staff to review the quality of decisions, including those on abatements, after they are made. None of the locations we visited tracked the number of abatement decisions reviewed for quality as either a percentage of all adjustments reviewed or of all abatement decisions made. The officials we interviewed at all locations could not say what percentage of abatements might be subjected to such quality reviews.

IRS had multiple review programs because each work group has a different set of quality standards. Each program is to use the quality standards established for the types of adjustments made in a specific work group. For example, standards for a collection work group would differ from standards for an examination group. As a result, in both service centers, the Service Center Collection Quality System is to be used to review the quality of the work in the Collection Branch. Across the two district offices, IRS also had a review program for each division (such as the Examination Division).

Officials at both service centers and both district offices also told us that these programs usually are to select cases for review on the basis of random sampling, and the results are to be used to identify systemic quality problems in an IRS work group. Due to our time constraints, we did not evaluate these IRS quality review programs.

IRS' Efforts to Improve the Abatement Process

IRS' efforts to improve the abatement process have involved task force studies that IRS initiated in response to specific concerns. For example, since 1997, task forces have studied issues, such as penalty administration and taxpayer treatment, because of concerns about taxpayer burden and equity. Although they did not focus on abatements, the studies have produced some proposals that would affect the abatement process, such as the documentation required to support abatements.

IRS officials said they initiated these task forces because a 1997 report on reinventing service at IRS called for IRS to, among other things, promote fair and consistent treatment of taxpayers in penalty administration. The report also called for IRS to comprehensively review all penalties and report to Congress on its findings as well as needed legislative changes. The report further recommended that the overall process for handling penalties be streamlined. For example, the report mentioned that one way to streamline would be for IRS employees to have expanded authority to abate certain types of penalties on the basis of oral requests from taxpayers. If done, this action could reduce the burden on taxpayers by requiring less documentation or supervisory approval.

In September 1998, IRS released a study by its penalty task force, as recommended in the 1997 report. IRS reported that for fiscal year 1996, 34 million penalties totaling $13.2 billion were assessed, of which 12 percent and 43 percent, respectively, were abated. Several recommendations focused on the need for (1) consistent treatment of taxpayers; (2) viable management of information systems; (3) clearer penalty policy; and (4) improved penalty administration to allow, among other things, IRS telephone assistors to make abatements for larger amounts on the basis of oral testimony from taxpayers. IRS officials said that legislative changes would be necessary to implement some of the recommendations. These officials also said they are considering the first three recommendations and are planning to expand authority for abating certain penalties for reasonable cause on the basis of oral testimony from taxpayers.

Another task force on taxpayer equity has been studying various IRS programs and issues and had finished several reports as of June 1999. These programs and issues, for example, address taxpayers that do not file required tax returns, make estimated tax payments on a quarterly basis, or make required federal tax deposits. Also included are studies of taxpayers that ask IRS to reconsider an assessment made in a previous audit.

At least three of this task force's reports have made proposals that could affect abatements. These proposals involve (1) easing interest abatement criteria through legislative change, (2) encouraging oral agreements on abatements between IRS and taxpayers over the phone to minimize documentation, and (3) clarifying a penalty abatement policy statement.

As for other efforts, an IRS study of an automated program to create substitute returns for apparent nonfilers has suggested several steps to deal with unproductive or erroneous assessments that create additional work later, including abating these assessments. Further, IRS is testing an automated system to help make abatement decisions related to reasonable cause. IRS is also developing ways to help small business taxpayers meet their federal tax deposit requirements, which could reduce the need for abatements that are associated with these deposits. Finally, IRS' Collection Division officials said they had a team working on redesigning the collection process, but the team was not focusing on abatements.

Before initiating these task forces and efforts, IRS undertook a major study during 1993-94 of the causes of abatements. According to the director of the study, IRS used about 150 employees across its 10 service centers. IRS did this study because of concerns about the inventory of tax debts—about 25 percent of IRS' accounts receivable were being abated.

The study identified problems in various IRS processes that resulted in IRS and taxpayer errors that had to be corrected through abatements. Some examples of IRS errors included miscalculated interest, incorrect posting to accounts, and overlooked support for taxpayers' reasonable cause claims. Examples of taxpayer errors included using the wrong form or coupon, omitting or misstating taxpayer identification numbers, and making math mistakes.

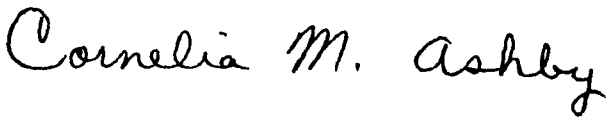
The study identified 259 potential problems, of which 158 were referred to the responsible IRS functions for further analysis and implementation of changes, if necessary, to solve a problem. The study team determined that the other 101 problems did not merit such a referral because analysts at the service centers could address the problem or no further changes were needed. IRS never formally released a final report on the study results.

Agency Comments

On June 22, 1999, we met with representatives of the IRS Commissioner from the Customer Service and Examination Divisions as well as the Taxpayer Advocate and Legislative Affairs Offices. These representatives said that our report provided good information and appropriately described the abatement process at selected organizations in the district offices and service centers.

We are sending copies of this report to Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means, and Senator Daniel P. Moynihan, Ranking Minority Member, Senate Committee on Finance. We are also sending copies to the Honorable Robert E. Rubin, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; the Honorable Jacob Lew, Director, Office of Management and Budget; and other interested parties. We will also send copies to those who request them.

If you or your staff have any questions concerning this report, please contact me or Tom Short on (202) 512-9110, or Royce Baker on (913) 384-3222. Other major contributors are acknowledged in appendix V.



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Abbreviations

EIC	Earned income credit
FSC	Fresno Service Center
GS	General Schedule
IRS	Internal Revenue Service
KCSC	Kansas City Service Center
KMDO	Kansas-Missouri District Office
NCDO	Northern California District Office
PRP	Problem Resolution Program
SFR	Substitute for return

Abatement Processes at the Kansas City Service Center

IRS' Kansas City Service Center (KCSC) processes individual and business tax returns, payments, and taxpayer inquiries from Illinois, Iowa, Minnesota, Missouri, and Wisconsin. The service center also responds to taxpayer inquiries nationwide through toll-free numbers. In addition, KCSC conducts compliance activities, such as doing audits, securing delinquent returns, and collecting unpaid taxes.

Kansas City Groups That Make Abatements

Different IRS work groups make abatements at the Kansas City Service Center.[1] According to KCSC officials, three divisions—Compliance, Customer Service, and Processing—routinely make abatements. Each division has at least one work group that makes abatement decisions. Additionally, the Taxpayer Advocate's Office can make abatements. According to IRS officials, the Quality Assurance Management Support Division has abatement authority, but due to the nature of its workload it rarely makes abatements. As a result, we did not summarize the division's processes.

Each of the work groups is responsible for making abatements of different types. Table I.1 shows these groups as well as examples of the types of abatements made by each.

[1]An abatement occurs when IRS reduces the assessment of tax, penalty, or interest against taxpayers for various reasons (e.g., an incorrect assessment or taxpayer had a reasonable cause for not complying with filing or payment requirements). An abatement may be initiated by a request from a taxpayer, by a taxpayer in response to IRS actions, or solely by IRS. For example, a taxpayer may file an amended return to claim changes to the original return. Factors such as the type, complexity, and source of the abatement determine which IRS group makes the abatement.

Table I.1: Examples of Abatements at the Kansas City Service Center

Division or office	Work group	Type of abatement
Compliance	Collection Branch	Substitute for return (SFR)[a]
	Examination Branch	Claims, including category A claims,[b] SFR, and audit reconsiderations[c]
Customer Service	Automated Collection Systems Branch	Erroneous SFR cases,[d] penalties abated for reasonable cause
	Adjustments/Correspondence Branch	Claims on amended returns, various types of penalties
	Customer Service Branch	Various types of penalties
	Taxpayer Relations Branch	Taxpayer inquiries about assessments
Processing	Document Perfection Branch	Simpler claims made by individuals
Taxpayer Advocate Office	Problem Resolution Program (PRP)	Selected cases that meet PRP criteria (e.g., not resolved elsewhere in IRS)

[a]IRS files a substitute for return when a taxpayer has not filed a tax return but IRS receives third-party information that shows enough income to file a tax return.

[b]Category A claims involve issues that are complex, sensitive, or prone to noncompliance.

[c]Audit reconsiderations occur when taxpayers ask IRS to reconsider assessments made in past audits.

[d]Erroneous SFRs involve those sent to taxpayers who had filed their returns before receiving the SFR filed by IRS.

Source: Information provided by IRS officials.

In the following, we briefly describe the types of abatements made at each of the work groups. We also identify the workload at each work group for all types of adjustments to taxpayers' accounts, including abatements. None of the groups, however, had data on the portion of their workload that involved abatements. We did not independently verify the accuracy of workload data provided by IRS.

Compliance Division

According to IRS officials, the Compliance Division has two branches that routinely make abatements, as summarized below.

Collection Branch

The Collection Branch is responsible for collecting taxes from individuals who have filed but have not paid the total amount due or who have not filed their tax return. For these nonfilers, according to branch officials, a common abatement comes from substitute for return (SFR) cases. Taxpayers receiving an SFR may choose to file a return in order to reduce their tax liability. When the return is filed and accepted by IRS, the branch is to abate the difference between the taxes assessed on the SFR and the taxpayer's return. If the taxpayer's return meets certain criteria, such as a large difference between the taxpayer's and SFR's assessments, classification staff from the Examination Branch are to review the return and determine whether to audit it. For fiscal year 1998, Collection Branch officials reported that the branch closed 1.2 million nonfiler and late payment cases, but it did not track how many of them involved abatements.

Examination Branch

The Classification Section in the Examination Branch is the only section in the branch that routinely makes abatements in the course of its operations, according to Examination officials. The Classification Section is responsible for screening questionable claims, SFR returns, and requests for audit reconsideration.

The Classification Section is to receive category A claims from the Adjustments/Correspondence Branch (also referred to as the Adjustments Branch) for acceptance or selection for audit. Category A claims are more complex, sensitive, or prone to noncompliance than other claims. For calendar year 1998, Classification Section officials reported that the section screened more than 26,000 claims, but it did not track the number that resulted in abatements.

Further, the Classification Section is to review questionable returns filed by taxpayers to replace SFRs and requests for audit reconsiderations. When reviewing SFR cases and audit reconsiderations, Classification is to accept the data provided by the taxpayer in support of an abatement, or select the case for audit.[2] If a case is selected, staff in the Examination Branch or a district office are to decide on any abatements. For calendar year 1998, Classification Section officials reported that the section received nearly 11,000 SFR, audit reconsideration, and other cases. These officials did not track how much of this work resulted in abatements.

Customer Service Division

The Customer Service Division has the following branches that can make abatements.

Automated Collection Systems Branch

The Automated Collection Systems Branch operates an automated call system, which is used to collect taxes from taxpayers that have delinquent accounts and to secure delinquent returns. Abatements can arise when IRS staff talk over the telephone with taxpayers who have had levies placed on their assets because of delinquent taxes or have received a notice that IRS has no record of their return.

In particular, the branch is supposed to make abatements in erroneous SFR cases—cases in which IRS erroneously believes that a taxpayer failed to file a required tax return, but the taxpayer had, in fact, filed. The branch also can abate penalties if the taxpayer has a reasonable cause for not complying originally. For calendar year 1998, IRS officials said that the

[2]In reviewing audit reconsiderations, the staff typically review the adequacy of documentation provided by the taxpayer to counter the additional assessments made after the past audit.

Automated Collection Systems Branch worked more than 119,000 cases, but it did not track how many of them involved abatements.

Adjustments/Correspondence Branch

The Adjustments/Correspondence Branch receives inquiries from taxpayers by phone or correspondence. According to branch officials, most taxpayer contacts are in response to penalty notices. The officials stated that the branch often abates failure-to-file penalties for reasonable cause. The branch is also supposed to process claims that require additional information from the taxpayer or from IRS databases. For fiscal year 1998, the branch reported closing over 989,000 cases, but it did not track how many of them involved abatements.

Customer Service Branch

The Customer Service Branch receives telephone inquiries from taxpayers about their assessments. According to IRS officials, taxpayers usually call to resolve issues on their tax accounts after receiving an IRS notice. These officials stated that late payment and failure-to-file penalties are their most common abatement cases. For fiscal year 1998, the toll-free telephone site answered over 1.2 million telephone calls. Branch officials did not track how many of these calls involved abatements.

Taxpayer Relations Branch

Taxpayer Relations is to help taxpayers resolve a wide variety of problem cases. In addition to the taxpayers, the branch receives referrals from other IRS offices, congressional offices, and the White House. According to IRS officials, typical abatements involve penalties and incorrect tax assessments. For calendar year 1998, IRS officials reported that the branch worked nearly 100,000 cases, but it did not track how many of these cases involved abatements.

Processing Division

Document Perfection Branch

Within the division, only the Document Perfection Branch made abatements. The Document Perfection Branch is to screen amended returns from individual taxpayers and identify those with issues that require additional information from a taxpayer or IRS computer systems. If additional information is not required, Document Perfection is to process the return, along with any resulting abatement. Returns that require information and amended returns from business taxpayers are forwarded to the Adjustments/Correspondence Branch. Document Perfection officials reported that the branch screened about 262,000 amended returns in calendar year 1998. The officials also reported that Document Perfection processed about 95,000 of these cases and routed the rest to other functions for processing. Branch officials did not track how many of these cases resulted in abatements.

Taxpayer Advocate's Office

The Taxpayer Advocate's Office was created to help taxpayers who have been unsuccessful in resolving their problems through normal channels of assistance. The office ultimately reports to the National Taxpayer Advocate. Its involvement with abatements can arise from two taxpayer assistance programs—hardship relief requests and the Problem Resolution Program (PRP), which assists taxpayers in resolving persistent problems.

Taxpayers may submit Form 911 asking for hardship relief under the Application for Taxpayer Assistance Order, according to IRS officials. The Advocate's staff makes a determination on these requests. PRP exists to help taxpayers that have been unsuccessful in resolving their tax problems through regular channels. The Kansas City Taxpayer Advocate has a small staff; thus, for most PRP cases, it relies on staff in the divisions, such as those in Customer Service, to try to resolve the problem. The Taxpayer Advocate monitors the progress of the cases until they are resolved.

Staffing

Staffing for some of the branches varies with the time of year, according to IRS officials. During peak periods (usually during the months when taxpayers are filing returns), staffing levels may temporarily increase, and the staff may sometimes be temporarily assigned to Customer Service to answer taxpayer inquiries about tax law or filing requirements. Table I.2 shows the peak staffing level by the type and grade (GS) level of staff who make abatement decisions for those work groups that make most of the abatements, according to IRS officials.

Most service center staff making abatements were tax examining assistants, customer service representatives, or tax examining clerks, according to IRS officials. Tax examining assistants are responsible for obtaining returns and other taxpayer information necessary to adjust taxpayer accounts and examining selected tax issues on income tax returns. Customer service representatives provide assistance to individuals and businesses through telephone contact. Tax examining clerks have duties that are less complex. They review IRS documents and tax returns, prepare coded entries to amend records, and refer questionable returns and documents for review.

Table I.2: Peak Staffing Levels at Kansas City by Branch and Type and Grade Level of Staff, March 1999

Division	Branch	Tax examining assistant (GS-4 to GS-8)	Tax examining clerk (GS-3 to GS-5)	Correspondence examination technician (GS-5 to GS-7)	Customer service representative (GS-5 to GS-8)	Tax auditor (GS-9)	Total
Compliance	Collection	185	0	0	0	0	**185**
	Examination	49[a]	13[b]	96[c]	0	12	**170**
Customer Service	Automated Collection Systems	174	0	0	0	0	**174**
	Adjustments	0	0	0	264[d]	0	**264**
	Customer Service	0	0	0	108[e]	0	**108**
	Taxpayer Relations	58	0	0	0	0	**58**
Processing	Document Perfection	64[f]	266[g]	0	0	0	**330**
Total[h]		**530**	**279**	**96**	**372**	**12**	**1,289**

Note 1: Staffing levels do not include managerial and support staff.

Note 2: Branches with a consistent level of staffing will not have a nonpeak staffing level.

[a]Nonpeak staff of 45

[b]Nonpeak staff of 11.

[c]Nonpeak staff of 70.

[d]Nonpeak staff of 108.

[e]Nonpeak staff of 99.

[f]Nonpeak staff of 31.

[g]Nonpeak staff of 0.

[h]Does not include 5 staff from the Taxpayer Advocate's Office.

Source: IRS officials.

Abatement Training

In general, training to be given in the work groups that made abatements did not focus on abatements; rather, it focused on the range of duties for the various types of staff. Through our interviews and reviews of documents at KCSC, we learned the following about the training that each work group should provide.

Collection Branch

Before working on a program they have not worked before (such as SFR cases), tax examining assistants are to receive between 3 and 10 days of classroom training on that program. After completing the training, they are to be assigned on-the-job instructors to provide additional guidance on working cases.

Examination Branch

Staff doing abatements are to receive training on the basic types of adjustments associated with the income tax laws. They also are to receive on-the-job instruction as they do audits.

Automated Collection Systems Branch

New customer service representatives are to receive about 3 months of classroom training. The initial training is to address basic skills, such as entering data into IRS' computer system. Afterward, the customer service representatives are to take classes on each of the programs handled in the

branch. After a class on a particular program, the customer service representatives are to work that program for a few weeks to reinforce what they have learned. Then, they are to take a class on another program.

Adjustments/ Correspondence Branch

Training is to cover the abatement of tax and penalties in some form. Customer service representatives responsible for business returns initially are to receive a 5-week training class on the Business Master File and employment tax forms. Later, they are to receive training on IRS forms and notices. Then, they are to receive several weeks of on-the-job training. Customer service representatives responsible for individual tax returns are to receive training on the Individual Master File as well as on amended returns, penalty abatements, and refunds for individuals. The training for abating selected types of interest assessments requires on-the-job coaching for several months.

Customer Service Branch

Before taking phone calls in which the taxpayer is asking for penalty abatements, a new staff member is to receive courses on determining penalty abatements. A staff member working on Business Master File cases is also supposed to attend courses on computing and abating penalties associated with the deposit of federal taxes.

Taxpayer Relations Branch

All staff working abatement cases are to receive training on comprehending computer transcripts, using IRS' computer system, and adjusting accounts on the Individual and Business Master Files, including making abatements. In addition, staff are to receive specific training on programs such as Problem Resolution and Penalty Appeals, which can result in abatements.

Document Perfection Branch

New hires are to receive a 10-day class on the Form 1040. Staff that have prior IRS experience are to receive between 4 and 9 days of training, depending on their duties. A class on editing amended returns is required for staff that review such returns and determine abatements and assessments.

Supervisory and Quality Reviews

Staff making the abatement decision usually adjust the taxpayer's account, according to IRS officials. The exceptions are in the Examination and Document Perfection Branches. Staff in these branches recommend abatements and forward the case to other staff who are responsible for adjusting a taxpayer's account.

IRS officials described two types of supervisory review of the abatement decisions made by staff: one occurring before the decision is made, and

one after. The latter supervisory review of closed decisions is done to evaluate employee performance.

IRS officials also described various types of quality review programs. Reviewers in these programs were to review cases closed in the work group to measure adherence to specific quality standards, which varied with each work group and type of case. According to staff we interviewed, the closed cases for review were to be selected using random sampling.[3]

Neither the supervisory nor quality reviews solely addressed abatements; rather, they covered all types of adjustments, including assessments and abatements. As a result, KCSC officials did not have data on the percentage of abatement decisions that were reviewed.

IRS officials said that other than for a few specific types of cases, the first type of supervisory review, which would occur before the abatement decision, was usually not required. Exceptions were abatements that involved certain types of civil penalties over a specific dollar amount, certain types of Examination assessments, and a selected type of interest assessment. Specific criteria associated with these types of abatements are considered to be sensitive information and may not be disclosed.

The work groups we visited had some data on the review of various types of closed cases by supervisors or quality review staff. Table I.3 shows the number of cases closed and reviewed for quality and the requirements for supervisory review for purposes of evaluating staff performance.

As noted in table I.3, the number of closed cases subjected to supervisory review for performance evaluation purposes differed in each branch. For example, Customer Service required its supervisors to review eight telephone calls and four paper cases per month. According to officials in all the branches, these requirements meant that only a small percentage of all cases would be reviewed. For example, a supervisor would be likely to review about 1 percent of the phone calls that customer service representatives answer in a month. About 10-15 percent of Taxpayer Relations' completed cases would be reviewed, according to branch officials. If supervisors were to find a performance deficiency, they should tell the staff member to correct any errors, and they might choose to review all cases closed by that staff member.

[3]The scope and time frame for our work did not allow us to verify whether these closed cases were selected through random sampling or to analyze the results of the various types of quality reviews.

Table I.3: KCSC Closed Cases, Cases Reviewed for Quality, and Requirements for Supervisory Review in 1998

KCSC branch	Total closed cases	Fiscal or calendar year 1998	Number reviewed for quality	Supervisory review requirements
Collection	1,225,171	Fiscal	8,403	8 per month per employee
Examination	37,168	Calendar	427	Quarterly review of workload of each employee.
Adjustments/Correspondence	989,118	Fiscal	461	5 per week per employee
Customer Service	Calls: 1,211,273 Paper 20,798	Fiscal	Calls: 1,457 Paper: 435	8 calls and 4 paper cases per month per employee
Automated Collection Systems	Calls: 90,597 Paper: 28,456	Calendar	Calls: 579 Paper: 1,681	3-5 calls and 5 paper cases per month per employee
Taxpayer Relations	99,542	Calendar	406	10-15 per employee per week
Document Perfection	Screened: 261,664 Adjusted: 94,525	Calendar	440	30-47 per employee per week

Note: All numbers include both abatement and assessment cases because IRS does not track abatement cases separately.

Source: Developed from interviews with IRS officials.

Separate offices in the service center managed the quality review programs. For example:

- The Quality Assurance Branch was to do quality reviews of cases closed in the Adjustments/Correspondence, Customer Service, Taxpayer Relations, and Document Perfection Branches. This review program is called the Program Analysis System.
- Collection Branch correspondence cases are to be reviewed under the Service Center Collection Quality System.
- The Automated Collection Systems Branch has two review systems. Toll-free calls are to be reviewed under the Quality Management Information System. Correspondence cases are to be reviewed under the Written Products Data Collection Instrument program.
- Examination Branch closed cases are to be reviewed by Quality Measure Support staff.
- Taxpayer Advocate cases are to be reviewed at the Brookhaven Service Center Centralized Quality Location in New York.

Quality review officials told us that they do not correct defective cases. Instead, they are to report any errors they find to the appropriate official in the branch where the case originated. The branch official then is to work with the employee who made the error to correct the mistake.

Abatement Processes at the Fresno Service Center

The Fresno Service Center (FSC) processes various types of tax returns, conducts audits through correspondence, and responds to taxpayer inquiries from Hawaii and parts of California. FSC also responds to taxpayer inquiries nationwide through IRS' toll-free numbers. In addition to auditing, FSC operates compliance programs that use third-party information reporting to identify taxpayers who do not file tax returns or who file returns but understate their tax liability.[1]

Fresno Groups That Make Abatements

Different IRS work groups make abatements at the Fresno Service Center.[2] Three divisions, including Compliance, Customer Service, and Quality Assurance and Management Support, can make abatements. Each division also has at least one branch that makes abatement decisions. Additionally, the Taxpayer Advocate's Office can make abatements.

These work groups are responsible for making different types of abatements. Table II.1 shows the work groups as well as examples of the type of abatements made by each.

[1]In this Information Reporting Program, IRS computers match information reported by third parties, such as banks and employers, to information reported on tax returns. If this match indicates that a taxpayer did not report all income or file a tax return, staff at the service center are to contact the taxpayer to resolve the discrepancy.

[2]An abatement occurs when IRS reduces the assessment of tax, penalty, or interest against taxpayers for various reasons (e.g., an incorrect assessment or taxpayer had a reasonable cause for not complying with filing or payment requirements). An abatement may be initiated by a request from a taxpayer, by a taxpayer in response to IRS actions, or solely by IRS. For example, a taxpayer may file an amended return to claim changes to the original return. Factors such as the type, complexity, and source of the abatement determine which IRS group makes the abatement.

Table II.1: Examples of Abatements at Fresno Service Center

Division or office	Work group	Type of abatement
Compliance	Examination Branch	Audit reconsideration[a] and audits
	Criminal Investigation Branch	Overstated income from false W-2s (Statement of Earnings)
	Joint Compliance Branch	Category A claims[b] and interest claims, substitute for return,[c] offer-in-compromise, audit reconsideration
	Underreporter Branch	Responses to IRS underreporter notices
Customer Service	Customer Service Branch	Taxpayer inquiries about assessments
	Adjustments Branch	Claims on amended returns filed by taxpayers
	Collection Branch	Substitute for return
Quality Assurance and Management Support	Accounting Branch	Credits on masterfile accounts
	Quality and Management Support Branch	Various types of abatements based on reviews of notices sent to taxpayers
Taxpayer Advocate Office	Problem Resolution Program and Taxpayer Advocate	Various types of taxpayer claims that meet set criteria (e.g., problems not satisfactorily handled by other IRS groups)

[a]Audit reconsideration occurs when taxpayers ask IRS to reconsider assessments made in past audits.

[b]Category A claims involve issues that are complex, sensitive, or prone to noncompliance.

[c]IRS files a substitute for return when a taxpayer has not filed a tax return but IRS receives third-party information that shows enough income to file a tax return.

Source: Information provided by IRS officials.

In the following, we briefly describe the types of abatements made at each of the work groups. We also identify the case workload at each group for all types of adjustments, including abatements, to a taxpayer's account. However, none of these groups had data on the portion of the workload that involved abatements.

Compliance Division

The Compliance Division has four branches that can make abatements, as summarized below.

Examination Branch

The Examination Branch is responsible for conducting correspondence audits at the service center. Abatements can occur when taxpayers ask IRS to reconsider (or reaudit) assessments made in past audits. According to IRS officials, in these audits, the taxpayer typically finds documentation that counters the additional assessments. If IRS accepts the taxpayer's documentation, the additional assessments are to be abated.

The Examination Branch may also make various types of abatements in cases referred by the Criminal Investigation Branch or by the National Office. The branch also may abate assessments arising from the computer matching that IRS does to identify math and other errors.

During fiscal year 1998, the branch processed nearly 132,000 cases. Additionally, it processed about 285,000 amended returns (1040X).

Examination officials did not track which cases had abatements; however, branch officials said that the branch abates few assessments.

Criminal Investigation Branch

The Criminal Investigation Branch is responsible for investigating all kinds of criminal activity related to the tax system. A typical abatement case involves a taxpayer filing a false Form W-2, Statement of Earnings, claiming excessive income and withheld tax. In these cases, the taxpayer claims excessive income in order to claim an excessive earned income credit (EIC). The taxpayer claims but never pays the excessive withheld tax in order to get a tax refund. Upon identifying these fraudulent schemes, the branch is to abate the excess tax liability that was claimed (but not paid) and to stop the erroneous refund or collect the overpaid EIC and refund.

Joint Compliance Branch

The Joint Compliance Branch has three sections that process abatement cases.

Classification and Research. This section processes category A claims referred from the Adjustments Branch as well as interest abatement cases. Category A consists of claims and amended returns that are more complex, sensitive, or prone to noncompliance than other claims. Selected category A claims are referred to field offices for further examination and possible abatement decisions. The abatement decisions for nonselected category A claims are made in Joint Compliance. During fiscal year 1998, about 18,300 category A claims were processed, and about 2,000 were sent to field offices. The section also processed about 400 claims for interest abatement.

Automated Substitute for Return. This section processes abatements for the amounts overassessed on a substitute for return (SFR). These abatements are necessary when the taxpayer files a delinquent return that reports a lower tax liability than that assessed on the substitute return prepared by IRS. During fiscal year 1998, the section chief estimated that the branch had made between 500 and 1,000 such abatements at Fresno.

Miscellaneous Balance Due. This section processes offers-in-compromise for wage earners with income under $10,000,[3] and trust fund recovery

[3]By agreeing to an offer-in-compromise with a taxpayer, IRS accepts a lower dollar amount to settle a balance due. FSC is planning a prototype for making offer-in-compromise abatements for wage earners and schedule C and F returns of up to $50,000.

cases.[4] Branch officials did not track how much of the workload involved abatements.

Underreporter Branch

The Underreporter Branch is to process cases involving the amount of income reported on tax returns. These cases are generated in IRS' Martinsburg Computing Center by comparing income amounts reported on information returns and on the tax return. Overall, the typical case involves a taxpayer underreporting income on the tax return. However, in the typical abatement case, the taxpayer overstates some type of income on the tax return, thus overstating the tax liability. To get this overstated tax liability abated, the taxpayer must file an amended return. The Underreporter Branch at FSC processed about 11,400 cases that potentially required abatements. Branch officials, however, did not track how many actual abatements were made.

Customer Service Division

The Customer Service Division has the following branches that can make abatements. None of the branches had information on the number of abatements made.

Customer Service Branch

The Customer Service Branch receives taxpayer inquiries about assessments by phone or correspondence. These inquiries are usually in response to notices or correspondence sent by IRS about various types of possible errors on a tax return. An abatement may occur when a taxpayer requests that IRS abate a failure-to-file penalty due to reasonable cause.

Adjustments Branch

The Adjustments Branch also may process abatements initiated through telephone contacts with taxpayers about their assessments. Further, the branch is responsible for processing claims on amended returns. However, as noted earlier, category A claims are to be referred to the Joint Compliance Branch and some non category A claims may be handled by the Examination Branch.

Collection Branch

The Collection Branch is responsible for call sites at which abatements may arise when taxpayers telephone IRS staff about various types of assessments. Branch officials said the primary source of abatements is the SFR program, in which taxpayers have received a substitute return and IRS has taken action to collect the tax shown on it. If the taxpayer then files a return showing a lower tax that is accepted by IRS, the branch is to abate the difference between the tax amounts assessed on the substitute

[4]Trust fund recovery involves the abatement of trust fund penalties assessed against one or more taxpayers when the balance due to the Social Security Trust Fund is received from one of these taxpayers (usually an officer of the business that owed trust fund taxes).

return and taxpayer's return. During fiscal year 1998, the branch had about 383,000 phone contacts and 2.8 million pieces of correspondence. However, the branch did not track the number of contacts that involved abatements.

Quality Assurance and Management Support Division

The following branches in the Quality Assurance and Management Support Division process abatements.

Accounting Branch

Accounts Services is the only section that makes abatement decisions in the Accounting Branch. Its workload is generated by the Martinsburg Computing Center and consists of tax returns with unsettled credit balances. These credit balances may have resulted from SFRs, audits, math errors, and other transactions. During fiscal year 1998, Accounts Services processed nearly 113,000 adjustment cases, but it did not track how many involved abatements.

Quality and Management Support Branch

The Quality and Management Support Branch is responsible for measuring the quality of actions in other branches by reviewing closed cases. Its Output Review Section is to review notices to be sent to taxpayers and is to make abatements if errors are found. Errors that are found in other quality reviews are to be referred to the initiating branch for correction. During fiscal year 1998, the Output Review Section reviewed about 37,000 individual notices and nearly 24,000 business notices. IRS officials did not have information on how many of these reviews involved abatements.

Taxpayer Advocate's Office

The Taxpayer Advocate's Office reports to the Executive Office of Service Center Operations that, in turn, reports to the National Taxpayer Advocate. The office is responsible for the Problem Resolution Program, which is to help those who meet certain criteria, such as taxpayers that have any contact

- indicating that IRS' systems have not resolved the taxpayer's problems,
- indicating that the taxpayer has not received an IRS response by the date promised, or
- involving the same issue at least 30 days after an initial inquiry or complaint, or 60 days for an original or amended return.

During fiscal year 1998, Fresno's Taxpayer Advocate's Office closed over 20,000 cases, but it did not track how many of them included abatements.

Staffing

Staffing for some work groups varies with the time of year and the function of the group. During peak periods (usually during the months that taxpayers are filing returns), staffing levels may temporarily increase, and the staff may sometimes be used for work other than making adjustments, such as answering taxpayer inquiries about the tax law or filing requirements. Table II.2 shows the peak staffing level by the type and grade (GS) level of staff who make abatement decisions for those work groups that make most of the abatements, according to IRS officials.

Table II.2: Peak Staffing Levels at Fresno by Type of Staff and Grade Level, April 1999

Division or office	Work group	Tax examiner assistant (GS-6 to GS-7)	Revenue agent/ tax auditor (GS-9 to GS-12)	Account technicians (GS-4 to GS-7)	Customer service representative (GS-6 to GS-9)	Total
Compliance	Examination	333[a]	0	0	0	**333**
	Criminal Investigation	56	0	0	0	**56**
	Joint Compliance	124	20	0	0	**144**
	Underreporter	206[b]	0	0	0	**206**
Customer Service	Customer Service	0	0	0	354	**354**
	Adjustments	0	0	0	365	**365**
	Collections	316	0	0	0	**316**
Quality Assurance and Management Support	Accounting	176	0	104[c]	0	**280**
	Quality and Management Support	175[d]	0	0	0	**175**
Taxpayer Advocate's Office	Problem Resolution and Taxpayer Advocate	73	0	0	0	**73**
Total		**1,459**	**20**	**104**	**719**	**2,302**

Note: Branches with a consistent level of staffing will not have a nonpeak staffing level.

[a]Nonpeak staff of 258

[b]Nonpeak staff of 136.

[c]Nonpeak staff of 265.

[d]Nonpeak staff of 135.

Source: IRS officials.

For the most part, those making abatements were tax examiner assistants and customer service representatives. These staff had varying duties, including reviewing notices and interest computations, responding to customer inquiries, processing correspondence, reviewing tax returns to detect fraud, and resolving taxpayer problems.

Abatement Training

In general, training to be given in the work groups that made abatements did not focus on abatements. Rather, the training focused on the range of duties for the various types of staff. Based on our discussions at Fresno, the following briefly describes the training to be provided.

Examination Branch

Tax examiners assistants are to receive 40 hours of initial classroom training, plus 40 hours of on-the-job training; 80 hours of classroom

	training on basic income tax; 80 hours of classroom training, plus 120 hours of on-the-job training on amended returns; 40 hours of classroom training on EIC, plus 40 hours of on-the-job training; and 40 hours of classroom training as a refresher each year.
Criminal Investigation Branch	Newly hired staff are to receive 2 weeks of training followed by 2-4 months of on-the-job training. All staff are to attend a 2-week refresher class each year.
Joint Compliance Branch	Joint Compliance staff are to receive classroom and on-the-job training that covers various topics, such as the guidance and instructions in the Internal Revenue Manual, the processes for making adjustments, and the tax law.
Underreporter Branch	Branch staff are to receive annual training on phases of the underreporter programs being worked for a tax year. This training is to include screening cases, writing responses, reviewing statutes, and learning other core skills. Staff making interest abatements also are to attend bimonthly meetings.
Customer Service, Adjustment, and Collection Branches	These staff are to receive roughly the same training, which is to include 120 hours of classroom training, primarily in refund and EIC issues. After several months of on-the-job training, they are to receive an additional 120 hours of training on more complex issues, such as how to handle balance-due accounts, installment agreements, and return delinquencies.
Accounting Branch	All Accounting Branch training is to be on-the-job training. New staff are to have a coach who assists them through each of the steps involved in adjusting accounts.
Quality and Management Support Branch	Staff in the Output Review Section are to receive 2 weeks of classroom training on the Notice Review Processing System and on-line notice review. They also are to receive 4-6 weeks of on-the-job training.
Taxpayer Advocate's Office	Staff must have 2-3 years of experience dealing with adjustments, customer service, or collection before being selected for the staff. Once selected, staff are to receive classroom training for PRP caseworkers, including PRP quality standards.

Supervisory Review

The branches at the Fresno Service Center had two types of supervisory review of abatement decisions made by staff. One is to occur before the decision is made and one after the decision. Regardless of the type of review, FSC officials did not collect data on the number of reviews done

by supervisors or the percentage of abatement decisions that were reviewed.

According to FSC officials, supervisory review and approval of abatement decisions before they are finalized is required for a few types of abatements. For example, abatement decisions involving comparatively larger dollar amounts or certain types of penalty or interest abatements generally require supervisory review and approval.[5] Also, FSC officials said that supervisors in each branch are to review a random sample of closed cases for each employee each month. These reviews are generally to be conducted to evaluate employee performance. Each branch gave supervisors the discretion to determine the percentage of abatement decisions to review. For example, the supervisors we talked to in at least one branch said they were likely to consider the past experience and performance of the staff member as well as the complexity and size of their caseload.

Quality Review

Fresno Service Center has a quality review program that is designed to ensure that abatement decisions are reviewed for quality by analysts outside the function making the abatement decision. These analysts at the service center are to review a sample of cases closed in each of the branches. The purpose is to measure adherence to specific quality standards.

For example, each branch is subject to quality reviews for a random sample of closed cases by the Program Analysis Section. Also, the Output Review Section in the Quality and Management Support Branch is to review a random sample of notices in each branch monthly. Finally, a random sample of cases closed by the Taxpayer Advocate's Office is to be reviewed at the Brookhaven (NY) Service Center.[6]

[5]We are not disclosing the requirements or criteria for making these abatement decisions because of their sensitivity.

[6]We did not analyze the samples to verify whether they were, in fact, randomly drawn.

Abatement Processes at the Kansas-Missouri District Office

The Kansas-Missouri District Office (KMDO) is located in St. Louis and has satellite offices across its two-state area. The district is responsible for auditing a variety of individual and business tax returns and for responding to taxpayer inquiries. It is also responsible for compliance programs that use third-party information to identify taxpayers who do not file tax returns or who understate their tax liability on filed returns.

Kansas-Missouri Groups That Make Abatements

Different work groups within the district make abatements.[1] Of the five divisions in KMDO, four make abatement decisions, usually through one or more branches. The division not making abatements is Criminal Investigation, whose primary workload involves investigating fraudulent or illegal activities.

Each division or office responsible for making abatements is shown in table III.1, which also lists examples of the type of abatements.

Table III.1: Examples of Abatements at Kansas-Missouri District Office

Division or office	Type of abatement
Collection Division	Discharged bankruptcies, offers-in-compromise,[a] trust fund recovery penalties[b]
Customer Service Division	Federal tax deposits,[c] taxpayer inquiries about assessments
Examination Division	Audit reconsiderations,[d] claims
Office of Taxpayer Advocate	Collection hardships and Problem Resolution Program (PRP)[e]

[a]By agreeing to an offer-in-compromise with a taxpayer, IRS accepts a lower dollar amount to settle a balance due.

[b]IRS makes concurrent assessments against more than one officer or shareholder of a business that has not paid withheld employment taxes. Once the taxes are paid, the other assessments are abated.

[c]IRS is to abate penalties erroneously assessed for failing to properly deposit federal taxes.

[d]Audit reconsiderations occur when taxpayers ask IRS to reconsider assessments made in past audits.

[e]Staff from the divisions resolve many PRP cases.

Source: Information provided by IRS officials.

Several factors affect which group makes the abatement decision, including the following.

- Type of case. Cases can vary by type of taxes (such as gift or excise), type of taxpayers (such as large corporation), and type of transactions (such as bankruptcy).

[1]An abatement occurs when IRS reduces the assessment of tax, penalty, or interest against taxpayers for various reasons (e.g., an incorrect assessment or taxpayer had a reasonable cause for not complying with filing or payment requirements). An abatement may be initiated by a request from a taxpayer, by a taxpayer in response to IRS actions, or solely by IRS. For example, a taxpayer may file an amended return to claim changes to the original return. Factors such as the type, complexity, and source of the abatement determine which IRS group makes the abatement.

- Division function. The normal workload of the work group affects which group makes a specific abatement decision. For example, the Collection Division would make abatements in working cases, such as bankruptcy cases. Customer Service Division abatements could come from responding to taxpayer inquiries, such as those involving federal tax deposits.
- Status of taxpayer account. For example, if a taxpayer is being audited by the district office and files an amended return or claim for refund with the service center, this return or claim is forwarded to the appropriate Examination group conducting the audit.

Summarized below are the responsibilities of each division and office, its workload, and examples of abatements.

Collection Division

The Collection Division is responsible for the collection of taxes from businesses and individuals who have an outstanding balance due or who have not filed required tax returns. In fiscal year 1998, the Collection Division closed about 14,300 cases, but Division officials could not identify how many cases involved abatements because they were not separately tracked.

Abatements in the division involve issues such as offers-in-compromise, trust fund recovery cases, and bankruptcy.[2] According to Collection officials, the most common abatements come from discharged bankruptcies, in which IRS makes abatements at the direction of a court. Offer-in-compromise cases involve an agreement by IRS to accept a taxpayer's offer to settle an outstanding assessment for less than the total due. In trust fund recovery cases, IRS has made assessments against officers or shareholders of a business that has not properly deposited its employment taxes and then is to abate the residual assessments after the tax liability has been paid.

Customer Service Division

The Customer Service Division takes taxpayers' calls and correspondence regarding inquiries about issues such as assessments. Taxpayer correspondence is forwarded to the IRS district office nearest the taxpayer for handling. During February 1998 through January 1999, the division closed nearly 17,000 cases. Customer Service officials said they did not track how many cases involved abatements.

According to division officials, the most common type of abatement results from penalty assessments in failure-to-deposit cases. For IRS to abate this

[2]For these types of cases, IRS abates the aggregated balance due; it does not break out the specific types of tax, penalty, or interest assessments.

penalty, the taxpayer must demonstrate a reasonable cause for not making the required tax deposits by the due date. If IRS agrees that the reason is valid, the penalty is to be abated.

Examination Division

The Examination Division is responsible for auditing individual and business tax returns selected by scoring criteria that identify returns with the greatest potential tax noncompliance. During fiscal year 1998, the Examination Division closed almost 19,000 cases. An Examination official said that the division has not tracked the number of cases that involved abatements, but that the division abates few assessments. This is because audits tend to focus on returns with potentially higher noncompliance, which is more likely to lead to additional taxes being assessed rather than assessed taxes being abated.

According to Examination officials, abatements come largely from claims involving audit reconsiderations that the service center sends to the district for review before being accepted. The Special Programs Section in Examination works the claim and can decide to accept or audit the claim. Audit reconsideration cases result when taxpayers ask IRS to revisit a prior audit that assessed additional taxes. The taxpayer believes that the taxes should not have been assessed. If the taxpayer provides support for that belief and IRS agrees, any excess tax amount is to be abated.

Taxpayer Advocate's Office

The Taxpayer Advocate's Office is to assist taxpayers through the Problem Resolution Program (PRP) and other activities after other IRS contacts have not resolved the taxpayer's concerns or when taxpayers ask for help. During a recent 6-month period, an Advocate official said that the office worked about 230 cases but did not know the number involving abatements because they were not separately tracked.

According to the Advocate official, the office routinely sends cases to a group in the Customer Service Division staffed with employees from other divisions. There, the case is to be worked by a division employee and monitored by the Advocate's Office to see that it is closed properly and timely.

Staffing

District officials said that most abatement decisions are made by authorized staff in the Collection and Customer Service Divisions. Also, a few abatements are made by staff in the Examination Division and Taxpayer Advocate's Office. Table III.2 summarizes the type and number of staff that make abatement decisions in the district, according to IRS officials.

Table III.2: Staffing Levels at Kansas-Missouri by Type of Staff and Grade Level, April 1999

Staff type and grade	Collection	Customer Service[a]	Examination[b]	Taxpayer Advocate	Total
Revenue officer (GS-7 to GS-12)	149[c]	0	0	0	**149**
Tax examiner assistant (GS-5 to GS-9)	17	0	24	0	**41**
Customer/taxpayer service representative (GS-5 to GS-8)	8	480	0	0	**488**
Customer/taxpayer service specialist (GS-6 to GS-11)	1	33	0	0	**34**
Revenue agent (GS-9 to GS-13)	0	0	394	0	**394**
Tax auditor (GS-9)	0	0	42	0	**42**
PRP analyst (GS-9 to GS-12)	0	0	0	9[d]	**9**
Total	**175**	**513**	**460**	**9**	**1,157**

[a]Excludes 8 tax law specialists who advise staff that make abatements.
[b]Excludes 5 lawyers who advise staff that make abatements.
[c]Includes revenue officer aides who do research for revenue officers.
[d]Excludes a taxpayer advocate and 2 management assistants.
Source: IRS officials.

These staff have various duties, as discussed below.

Collection Division

Revenue officers work various types of delinquent accounts and investigations in the office and field. Also, they may work on specific programs, such as trust fund recovery penalties and lien withdrawals. Attorneys and district counsel assist with complex issues, such as bankruptcy. Revenue officer aides assist revenue officers by performing courthouse research and other duties.

Customer Service Division

Customer service representatives provide service to taxpayers who have contacted IRS via correspondence, telephone, or visits. They help prepare returns and answer questions regarding tax law, IRS procedures, and individual accounts.

Examination Division

Revenue agents and tax auditors audit various types of tax returns, such as income tax returns.

Taxpayer Advocate's Office

Staff monitor cases sent to the divisions to ensure that they are resolved promptly and appropriately.

Abatement Training

In general, training to be given in the divisions and offices that made abatements did not focus on abatements; rather, it focused on the range of duties for the various types of staff. The following briefly describes the training to be provided.

Collection Division

Revenue officers are to receive three phases of classroom training and on-the-job training after each phase. Afterward, they are to be assigned a

mentor to provide additional on-the-job training. Revenue officer aides receive no formal classroom training. All their training is on-the-job.

Employees dealing with bankruptcy cases are to receive training on bankruptcy issues, including 1 year of on-the-job training. IRS officials said employees handling the other types of abatements, such as offer-in-compromise and trust fund recovery cases, usually come from other IRS functions at which they have already received training to handle these issues.

Customer Service Division

Customer service representatives are to receive three phases of tax law classroom training and four additional phases of accounts-related classroom training. These courses include installment agreements; credit transfers; refund releases; tax adjustments; and penalty abatements. All classroom training is to be supplemented with on-the-job training.

Examination Division

Staff making abatements in the division are to receive many hours of classroom and on-the-job training, which varies by the type of staff. This training mostly addresses tax law and auditing topics, such as claims and audit reconsiderations. Revenue agents in specialty fields are to receive special training (e.g., a 3-week excise tax course).

Taxpayer Advocate's Office

PRP analysts are to receive some specialized training. However, an Advocate official explained that its office has recruited staff from other IRS divisions that should already have been trained in collection and audit issues that the office addresses.

Supervisory Review

At the district, except for one division, the staff making the abatement decision is usually the same staff that enters information about the decision into the taxpayer accounts on the computer. The exception is the Examination Division, where the staff making the decision do not have access for computer entry.

Two types of supervisory review can affect abatement decisions made by staff. One occurs before the decision is made and one occurs after the decision. Neither of these types of review focus on abatements; rather, they cover all types of adjustments. As a result, KMDO did not have data on the percentage of abatement decisions that were reviewed.

First, supervisors may review proposed decisions to approve them before they are finalized. KMDO did not have similar requirements for these reviews across the divisions. However, Collection officials told us that their supervisors are to review all cases. Examination officials said they

have no requirement except that supervisors are responsible for the quality of the cases closed in their groups.

Second, KMDO officials said that supervisors are supposed to review a random sample of closed cases for each employee each month. These reviews are generally conducted for performance evaluation, and the requirements differ across the divisions. For example, Customer Service officials told us that their supervisors are to review at least 25 percent of the cases closed by each employee.

Quality Review

Each division is subject to reviews by a quality measurement system. Under this system, district office reviewers are to check the quality of work in closed cases against specific quality standards. These standards differ for each division. The closed cases selected for review are to be randomly drawn from all types of cases closed in a division.[3] KMDO did not have data on how many quality reviews addressed abatement decisions because abatement cases were not reviewed separately.

In the Collection Division, for example, a sample of nine closed cases per branch is to be pulled for a nationally centralized review under the Collection Quality Measurement System. Similarly, in the Customer Service Division, Quality Assurance reviewers are required to do a closed case review on paper transactions. The sampling plan for each review period is developed in the National Office. At the time of our work, for example, the Quality Assurance Office was slated to review every 107th closed case. Examination also has closed cases reviewed under a national quality measurement system. The Taxpayer Advocate Office's review only covers those relatively few cases that are not referred to and closed at another division.

[3]Our objectives did not include testing whether IRS used random sampling as described.

Abatement Processes at the Northern California District Office

The Northern California District Office is located in Oakland and is responsible for Northern California from the Oregon border to just south of San Francisco.

Northern California Groups That Make Abatements

The district office has six operating divisions: Collection, Customer Service, Criminal Investigation, Research and Analysis, Examination, and Quality Assurance. Staff in three of the divisions can make abatements through one or more branches.[1] The Taxpayer Advocate's Office can also make abatements, but Advocate officials said their office makes few abatements because most of their cases are referred to the other divisions or the service center for the actual decision.

Table IV.1 shows the divisions or offices that make abatements as well as examples of the type of abatements made by each.

Table IV.1: Examples of Abatements at Northern California District Office

Division or office	Type of abatement
Collection Division	Penalties for reasonable cause for not paying tax debts or filing required tax returns, trust fund recovery penalties,[a] discharged bankruptcies
Customer Service Division	Various penalties for reasonable cause
Examination Division	Audit refunds and audit reconsideration,[b] category A claims and interest claims[c]
Office of Taxpayer Advocate	Issues certain taxpayers have had difficulty getting resolved, penalties for reasonable cause

[a]IRS makes concurrent assessments against more than one officer or shareholder of a business that has not paid withheld employment taxes. Once the taxes are paid, the other assessments are abated.

[b]Audit reconsiderations occur when taxpayers ask IRS to reconsider assessments made through past audits.

[c]Category A claims involve issues that are complex, sensitive, or prone to noncompliance.

Source: Information provided by IRS officials.

In the following, we briefly describe the types of abatements made at each division or office. We also identify the caseload for all types of adjustments, including abatements, to taxpayers' accounts. None of the divisions had data on the portion of the caseload that involved abatements.

Collection Division

The Collection Division is responsible for processing cases involving tax delinquency accounts and tax delinquency investigations. In the former, a tax liability has been assessed but not paid; in the latter, IRS is trying to

[1]An abatement occurs when IRS reduces the assessment of tax, penalty, or interest against taxpayers for various reasons (e.g., an incorrect assessment or taxpayer had a reasonable cause for not complying with filing or payment requirements). An abatement may be initiated by a request from a taxpayer, by a taxpayer in response to IRS actions, or solely by IRS. For example, a taxpayer may file an amended return to claim changes to the original return. Factors such as the type, complexity, and source of the abatement determine which IRS group makes the abatement

obtain an unfiled tax return to determine whether a tax liability exists. The division may abate penalties for these cases. The division receives these cases from the service center and has field branches whose staff can make abatement decisions. During fiscal year 1998, the division processed about 13,600 cases, but it did not track how many of them were abatements.

According to district officials, in a typical Collection Division case, a revenue officer contacts a taxpayer who has not fully paid a tax liability. The taxpayer requests that the failure-to-pay penalty be abated and provides evidence of reasonable cause. The officer is to review the information provided by the taxpayer and make a decision on whether to abate the failure-to-pay penalty. The criteria for Collection abatements are contained in the Internal Revenue Manual, chapter 21.[2] Evidence required to make the abatement includes statements or documents from the taxpayer supporting the reasonable cause claim. Information about the abatement decision is to be maintained in case files at the service center.

Customer Service Division

Abatements in the Customer Service Division result from requests by taxpayers to abate certain types of penalties for reasonable cause. Customer service representatives are to collect evidence from the taxpayer on the reasonable cause and make the abatement decision. Documentation on these decisions is to be maintained in the case file at the service center. Officials from Customer Service could not provide caseload data on these or other types of case decisions for fiscal year 1998.

According to district officials, these penalty abatement cases typically involve penalties for failure to file a required tax return on time or failure to pay assessments on time. The criteria for Customer Service abatements are also contained in the Internal Revenue Manual, chapter 21.

The Customer Service Division refers some abatement cases to other IRS functions for processing. Taxpayer contacts concerning claims or requesting audit reconsideration can be referred to the district's Examination Division or to the service center. Requests for abatement of very large dollar penalties and of assessments to be paid under installment agreements can be referred to the Collection Division for processing.

Examination Division

Abatements in the Examination Division originate as claim referrals from the service centers, reconsideration of assessments from prior audits, requests for interest reduction, and tax reductions identified during audits.

[2]Because these criteria are considered to be sensitive information, we are not disclosing them in any detail throughout this appendix.

Examination staff also are to process abatements referred to them from the district's taxpayer advocate. The Examination Division might refer cases to other divisions or IRS offices either because the taxpayer moved or because the taxpayer has a representative who lives elsewhere. During fiscal year 1998, the division closed about 44,200 cases, but the percentage that involved abatements was not tracked.

According to district officials, a typical Examination abatement case is one in which the taxpayer requests that the findings of a prior audit be reconsidered. Examination staff are to review the issues and make a decision on whether to abate the amount being questioned. Abatements are also considered to be common for category A claims, which are usually referred from the service center and consist of claims and amended returns that are sensitive, prone to noncompliance, or more complex than other claims.

The criteria for Examination abatements are contained in the Internal Revenue Manual, chapter 21. Evidence required for Examination abatements typically includes information from audit files, tax returns, or other documentation provided by the taxpayer that is to be maintained in the case file.

Taxpayer Advocate's Office

The Taxpayer Advocate's Office is responsible for helping taxpayers resolve tax-related problems. The office should receive cases that meet certain criteria, such as repetitive IRS contacts over a short time period or taxpayer problems that have not been resolved through regular channels for a long period of time.

Advocate officials told us that they refer most cases to divisions, service centers, and other districts. For example, cases might be referred to the Examination and Collection Divisions, which have caseworkers to handle these cases. Primarily for geographic reasons, some cases are referred to other districts—that is, to move the case closer to where the taxpayer is located and the actions are being taken.

Generally, the workload does not vary much throughout the year and consists primarily of processing taxpayer requests for reduction or elimination of penalties. This workload totaled about 4,000 cases in fiscal year 1998, but the percentage that involved abatements was not tracked. Advocate officials said their office makes the final decision on a small number of abatements.

According to Advocate officials, a typical case would involve abating a failure-to-file penalty when a taxpayer had reasonable cause for not filing by the required due date. A taxpayer may initiate this action by providing information on why the penalty should be abated (e.g., taxpayer was hospitalized). The criteria for abatements are in the Internal Revenue Manual, chapter 21. Evidence required to make the abatement includes statements from the taxpayer on the reasonable cause claim. This evidence is to be kept in the case file.

Staffing

According to IRS officials, district office staffing does not vary much seasonally because the workload remains fairly constant. Table IV.2 summarizes the type and level of staff that make abatement decisions in the district, according to IRS officials.

Table IV.2: Staffing Levels by Type of Staff and Grade Level, May 1999

Staff type and grade[a]	Collection	Customer Service	Examination	Taxpayer Advocate	Total
Revenue officer (GS-7 to GS-12)	227	0	0	0	**227**
Tax examiner assistant (GS-5 to GS-9)	20	8	0	2	**30**
Customer service representative (G-5 to GS-9)	0	213	0	0	**213**
Revenue agent (GS-9 to GS-13)	0	0	411	0	**411**
Tax auditor (GS-9 to GS-12)	0	0	108	0	**108**
PRP specialist (GS-11)	0	0	0	5	**5**
Total	**247**	**221**	**519**	**7**	**994**

[a]Staff at the highest grade levels usually fill supervisory positions.

Source: IRS officials.

Abatement Training

In general, training to be given in the divisions and offices that made abatements did not focus on abatements. Rather, the training focused on the range of duties for the various types of staff. The following briefly describes the training to be provided.

Collection Division

Training targeted at abatements is limited. According to district officials, the only training directed at abatements was a class on processing Form 3870, Request for Adjustment. Otherwise, the staff making abatement decisions are to receive training in three phases, consisting of over 300 classroom hours. This training is to cover the collection process, including abatements, adjustments, forms, and reasonable cause for abatements. Other training is to be provided on-the-job.

Customer Service Division

Staff making abatements in the division are to receive the basic training module, which includes case processing, telephone routing, customer service core skills, disclosure policies, and telephone training. Other training modules provide more specialized and advanced courses, such as computing and adjusting penalties and determining penalty relief.

Examination Division

Staff making abatements are to receive classroom and on-the-job training. This training mostly addresses the tax law and auditing. None of the training focused on abatements. As of April 1999, the staff had not yet been trained on the new process for audit reconsideration in which the requests for reconsideration are to be submitted directly to the service center and subsequently referred to Examination for action.

Taxpayer Advocate's Office

Staff working the cases are to receive classroom training. Initially, they are to receive 16 hours of PRP caseworker training and on-the-job training for making adjustments on the computer system. The PRP caseworker-training course was being updated, and additional classroom training for PRP specialists and analysts is to be added.

Supervisory Review

Staff that make abatement decisions usually are not the same staff that enter information about decisions into taxpayers' computerized accounts. According to district officials, this improves internal control. Exceptions are the Taxpayer Advocate's Office and Customer Service Division, where the same individual makes the decision and enters the information.

Two types of supervisory review can affect abatement decisions made by staff. One occurs before the decision is made and one occurs after the decision. Regardless of the type of review, district officials did not collect data on either the number of reviews done by supervisors or the percentage of abatement decisions that were reviewed.

First, supervisors may review decisions before they are made for purposes of approval. The requirements for such a review differed according to various division officials. For example, supervisors in the Taxpayer Advocate's Office and Collection Division are to review all requests for abatement and those in Customer Service are to review large-dollar abatements. The other divisions did not require supervisors to review and approve abatement decisions before they became final.

Second, district officials said that supervisors are to review a random sample of closed cases for each employee each month. These reviews are generally conducted for performance evaluation, and the requirements differ across the district. Following is a summary of supervisory review requirements for each division and office.

Collection Division

According to district officials, supervisors' reviews are to be conducted using the Collection Management Information System. Supervisors are to look for appropriate documentation and data. IRS does not maintain data on the number or percent of cases reviewed.

Customer Service Division

District officials said that supervisors are to review five closed cases each month for each employee to evaluate performance for the critical elements in the job description. Supervisors also are to make additional random reviews to ensure quality.

Examination Division

According to district officials, supervisors are to review a sample of closed cases for employee evaluations. The division has no specific criteria for the number of cases to be reviewed. Supervisors may choose to review a higher or lower number of closed cases depending on the auditor's skill level and experience and the supervisor's workload.

Taxpayer Advocate's Office

District officials told us that supervisors are to review all staff decisions. Reviews are to be used for both quality control and staff evaluations.

Quality Review

Reviewers at the district office review closed cases in the divisions to check the quality of the work against specific quality standards. These standards differed for each division, but in general, the standards focused on communication, timeliness, and accuracy.

District officials said that the cases selected for review are to be randomly drawn from all types of cases closed in a division.[3] Because abatement cases are not reviewed separately, district officials did not have data on how many quality reviews addressed abatement decisions.

Specifically, district officials provided the following information about the review of closed cases in each division or office by independent reviewers.

- The Quality Assurance Division reviews a monthly sample of closed cases from the Taxpayer Advocate's Office. According to district officials, Quality Assurance reviews 16 cases plus 100 percent of the cases initiated from IRS' periodic problem solving days.
- The Collection Division reviewed between 5 and 10 percent of the closed cases—about 1,300 reviewed cases in fiscal year 1998—as part of the Collection Quality Measurement System.
- The Customer Service Division's Automated Compliance Section reviewed 439 cases during fiscal year 1998.
- Examination Division cases underwent Quality Assurance review against the Examination Quality Standards. In fiscal year 1998, 506 closed audit cases were reviewed as part of this Examination Quality Measurement System.

[3]Our objectives did not include testing whether IRS used random sampling as described.

GAO Contacts and Staff Acknowledgments

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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF OPERATIONS OFFICER

June 29, 1999

Ms. Cornelia M. Ashby
Associate Director, Tax Policy and
Administration Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Ashby:

Thank you for the opportunity to review and comment on your recent draft report entitled "Tax Administration: IRS' Abatement Process in Selected Locations." We are pleased that you sought our comments as the study progressed. The result of this communication is a report that provides valuable information on the IRS' administration of the abatement process in the Kansas City and Fresno Service Centers and in the Northern California and Kansas-Missouri District Offices. The report accurately describes how district and service center organizations such as Customer Service, Collection, Examination, Adjustments, and the Taxpayer Advocate's Office conduct operations that involve abatements processing.

Historically, the IRS has undertaken a number of efforts to improve the abatement process. For example, as you indicated, the 1994 study identified a significant number of recommendations to improve the abatement process. The IRS adopted those recommendations that could be implemented immediately. As time has passed, many of those recommendations have become dated. But the 1994 study was not a one-time effort. The other studies you cite are ongoing examples of the continuous actions we are undertaking to improve all of our operations -- including those that involve abatements.

We would like to make you aware of some changes that will be occurring in the way abatement cases that are part of the Taxpayer Advocate Program are handled. As your report notes, currently abatement cases are sent to caseworkers in the functions to resolve the taxpayer's inquiry. However, the IRS Restructuring and Reform Act of 1998 required the field Taxpayer Advocates and their employees, including caseworkers, to report directly to the National Taxpayer Advocate. We are restructuring the organization and expect to have the direct reporting of caseworkers completed by October 1, 1999. Once this is accomplished, we anticipate that some of the abatements that had previously been done in the functions will be completed within the Taxpayer Advocate's organization. Others will still be completed by the function that has jurisdiction over the account.

We can assure you and the Joint Committee that we are working to build a better tax administration agency. In partnership with both the General Accounting Office and the Joint Committee we can make the kind of improvements America's taxpayers deserve.

If you have any questions or need additional information, please call me at (202) 622-6860 or a member of your staff may call Tom Wilson, Assistant Commissioner (Examination), at (202) 622-4400.

Sincerely,

John M. Dalrymple

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