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GAO

United States General Accounting Office
Washington, DC 20548

General Government
Division

B-196969

JULY 16, 1980

The Honorable Jerome Kurtz
Commissioner of Internal Revenue
Department of the Treasury

AGC 55004

Dear Mr. Kurtz:

Subject: The Internal Revenue Service Can Make
the Estimated Tax Forms and Instructions
Easier to Understand and Use (GGD-80-89)

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By letter dated December 24, 1976, the Joint Committee on Taxation asked us to examine how effectively the Internal Revenue Service (IRS) communicates tax law requirements to taxpayers. This letter, one report in a series in response to the Joint Committee's request, deals with the forms and instructions individual taxpayers use to comply with the estimated tax requirements.

The estimated tax requirements are particularly troublesome to taxpayers. Each year, millions of taxpayers are required to make estimated tax payments because they have income that is not subject to withholding and/or from which not enough tax is withheld. Of these taxpayers, millions are penalized for not making adequate and/or timely payments. The estimated tax penalty is the largest civil penalty in terms of dollars and second largest in terms of numbers that IRS assesses. In fiscal year 1979, approximately 8.5 million taxpayers paid estimated tax, and about 3.5 million of these taxpayers paid related penalties amounting to over \$212 million.

The estimated tax forms and instructions provided by the Service need to be simplified so that taxpayers can more easily understand their estimated tax responsibilities and the consequences of noncompliance. The Service has made some recent improvements that should help, but other improvements are both necessary and possible. In this regard, the Service, in response to the Revenue Act of 1978 and our previous report, 1/

1/"Further Simplification of Income Tax Forms and Instructions Is Needed and Possible," (GGD-78-74, July 5, 1978).



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recently awarded a contract to simplify the tax forms and instructions for individual taxpayers. The Service should assure that the estimated tax forms and instructions are included in the work done under this contract.

We did our work at the IRS national office in Washington, D.C., the Andover, Massachusetts service center, and the Boston district office.

FORMS AND INSTRUCTIONS ARE UNCLEAR
REGARDING WHO MUST FILE AND HOW

About 3.5 million taxpayers incurred penalties in fiscal year 1979 because they either did not have a sufficient amount of tax withheld or had not made any estimated tax payments. Some of these penalties undoubtedly resulted because taxpayers had difficulty in understanding the estimated tax requirements, including who is required to file and how. This information is scattered among various IRS forms and instructions and, when found, is often expressed in a complex, unclear way.

For example, general instructions regarding who is required to make estimated tax payments, how and when the payments should be made, and the consequences of not making the payments are scattered among (1) the instructions for the forms 1040 and 1040A, (2) the Form 1040-ES, "Declaration of Estimated Tax by Individuals," (3) Publication 505, "Withholding and Declaration of Estimated Tax," and (4) Publication 17, "Your Federal Income Tax."

The form 1040 instructions, the primary focal point for most taxpayers, neither adequately explain the estimated tax requirements nor make reference to publication 17 or publication 505, which give fuller explanations. The form 1040 instructions do, however, make reference to the form 1040-ES. IRS improved the situation for tax year 1979 by revising the form 1040-ES to provide a one-sentence definition of the estimated tax and a reference to publication 505. A composite listing of all the various forms and publications that deal with estimated tax, however, would help taxpayers determine whether they are subject to the requirements.

The form 1040 instructions are also often unclear. For example, the paragraph entitled "Should You File A Declaration of Estimated Tax?" states, in part, "If your total estimated tax is \$100 or more, please get form 1040-ES. You may be required to make a declaration of estimated tax." This tells taxpayers they must first determine whether their

estimated tax is \$100 or more, and if so, to then get the form and use it to make a declaration. It does not, however, tell taxpayers that a worksheet to assist them in estimating their tax is an integral part of the form.

As another example, the form 1040 instructions, under the caption "Income Tax Withholding for 1980," state, "If the amount you owe IRS is large, you may have to file a Declaration of Estimated Tax * * *." The term, "large," is meaningless and should be replaced by specific criteria.

The form 1040-ES instructions should also be clarified. For example, a section captioned, "Purpose of Declaration," contains criteria regarding who must file rather than explaining the purpose of a declaration of estimated tax.

Another example is the term "first declaration." This term appears in the form 1040-ES instructions and on three of the four declaration-vouchers, thereby implying that more than one declaration of estimated tax may be required. This is not, however, the case. Only one declaration is required for the tax year.

THE FORM AND INSTRUCTIONS USED TO
ASSESS OR ABATE THE ESTIMATED TAX
PENALTY ARE COMPLEX AND CONFUSING

At the end of the tax year, taxpayers must determine if they have met their tax liability through withholding and/or estimated tax payments. If they have not, they must use Form 2210, "Underpayment of Estimated Tax by Individuals," to calculate the penalty on the amount of the underpayment. In making the calculations, they can consider whether they meet any of the following exceptions:

- Exception 1 applies if the current year's tax payments equal or exceed the tax shown on the previous year's tax return (including self-employment tax but excluding minimum tax). The previous year's return must cover a 12-month period and show a tax liability.
- Exception 2 applies if the current year's withholding and estimated tax payments equal or exceed the tax due on the previous year's income using the current year's rates (including self-employment tax but excluding minimum tax). The taxpayer must use the personal exemptions allowed for the current year but use the other facts and law applicable to the previous year's return.

--Exception 3 applies if the current year's tax payments equal or exceed 80 percent of the tax (excluding minimum tax) on annualized income for periods from January 1 to March 31, May 31, or August 31.

--Exception 4 applies if the current year's tax payments equal or exceed 90 percent of the tax (including self-employment tax but excluding minimum tax) on the actual income from January 1 to March 31, May 31, or August 31.

Once taxpayers have calculated the penalty, they must attach the form 2210 to their form 1040 and remit the amount due. If they fail to do this, IRS will compute the penalty and send them a notice of the amount due. IRS includes with the notice a form 2210 that taxpayers may use to determine if they meet any of the exceptions to the penalty. If the taxpayers find that they can abate all or part of the penalty, they must return the completed form to IRS so that the proper adjustment can be made. Otherwise, the taxpayers must pay the full amount of the penalty as computed by IRS.

Taxpayers apparently find the form 2210 and the instructions for completing it so complex and confusing that they prefer to pay the maximum penalty rather than try to determine if that is the amount they really owe. IRS, in a September 1979 study of civil penalty provisions of the Internal Revenue Code, expressed the opinion that many taxpayers pay the penalty computed by IRS rather than try to determine if they meet one or more of the exceptions. This opinion is shared by taxpayer service personnel at the Boston district office who said that many taxpayers ask if they may pay the penalty rather than prepare the form 2210. The opinion is further supported by available statistics for 1979 which indicate that few taxpayers use the exceptions--less than 5 percent of the 3.6 million taxpayers who were assessed. This lack of use can be attributed in part to the form 2210's confusing design and unclear instructions.

The design of form 2210 precludes taxpayers from completing it in a logical sequence. Part I of the form immediately instructs taxpayers to go to part II to determine if they can meet any of the exceptions to the penalty for all four payment periods. If they cannot, they must go back to the top of the page and complete part I; then to the end of the page to complete part III.

Another problem involves an ambiguous design feature in part II. Specifically, the problem centers around the shaded area entitled "Not Applicable." This design feature was meant to show that Exceptions 3 and 4 cannot be used to avoid a penalty for underpayment of the estimated tax due on January 15.

According to Andover service center personnel, however, taxpayers are construing the "Not Applicable" as pertaining to the penalty rather than to the use of the respective exceptions and, thus, are not calculating an underpayment penalty for this period. Adding the word "Exceptions" to the beginning of the phrase should help eliminate the confusion.

The instructions for completing form 2210 are also confusing some taxpayers. The instructions on the form neither convey fully and clearly the explanation needed to complete the form correctly nor make appropriate reference to publication 505, which gives more information. For example, the instructions on form 2210 state that Exception 1 applies if the current year's tax payments equal or exceed the amount shown on the previous year's return. The instructions also state that the previous year's return must cover a 12-month period and show a tax liability. According to Andover service center personnel, however, some taxpayers who paid tax for the current year but did not file a previous year's return are concluding that their current year's tax exceeds their previous year's tax liability of zero and are erroneously claiming Exception 1 to reduce or abate their respective penalty.

Publication 505 specifically explains that neither Exception 1 nor 2 can be used if the taxpayer did not file a return for the previous year. The instructions on form 2210, however, refer the taxpayer to publication 505 for more information about paying the estimated tax on a current basis; the instructions on the form do not indicate that publication 505 also gives more information about the penalty or the related exceptions.

IRS has recently improved publication 505 by including more detailed information for taxpayer use. The November 1979 version, for example, includes a sample form 2210 which has been filled in to show the calculation of the estimated tax penalty. The publication would be even more useful, however, if it also included a sample showing part II (Exceptions To The Penalty) completed and illustrating how the figures in that part of the form relate to those in parts I and III.

CONCLUSIONS

Millions of taxpayers are penalized each year for not making adequate and/or timely payments of estimated tax. This results, in part, because the related forms and instructions are difficult to use and understand.

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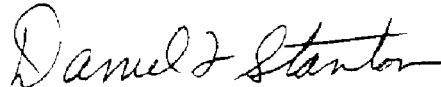
While IRS has made some recent improvements which should alleviate the problem to some degree, taxpayers could more easily understand the forms and instructions if (1) a composite listing of pertinent references were available or if the needed information were not scattered, (2) the instructions better explained the rationale for estimated tax, and, (3) the forms and instructions were written more clearly, included more illustrations, and were better designed.

Given the number of taxpayers being affected, IRS should focus on this problem as quickly as possible. In this regard, a good approach would be to specify these forms and instructions as part of the work to be done under the contract recently awarded to simplify the income tax forms and instructions for individual taxpayers.

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We appreciate the assistance provided us by your staff. We would be pleased to discuss these matters further with you or your staff.

Sincerely yours,



For William J. Anderson
Director