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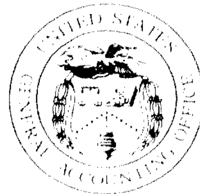
Report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Committee on Finance, U.S. Senate

September 1989

TAX POLICY

Options for Civil Penalty Reform



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The Honorable David H. Pryor
Chairman, Subcommittee on Private
Retirement Plans and Oversight
of the Internal Revenue Service
Committee on Finance
United States Senate

Dear Mr. Chairman:

In response to your June 1989 request, this report provides information on concerns voiced by tax administrators, practitioners, and others about various civil tax penalties. It also contains an analysis of proposals that have been made to respond to those concerns as well as our recommendations for statutory changes to the existing system of penalties.

Proposals analyzed in this report are those contained in the Improved Penalty Administration and Compliance Tax Act of 1989 (H.R. 2528) and in a 1989 Internal Revenue Service (IRS) civil penalty task force report. The data used in preparing this report were drawn from our ongoing and past work examining certain civil tax penalty provisions of the Internal Revenue Code.

Results in Brief

Both the House bill and IRS civil penalty task force report recommend changes to restructure and better rationalize the existing penalty system. Changes are needed to make civil penalties less complex, more equitable, and easier to administer. However, care must be taken to retain the deterrent value obtained from penalties now in the tax system. Civil tax penalties are a major tool in IRS' efforts to promote compliance with the nation's tax laws.

Civil penalty reform should be geared to providing appropriate incentives and sanctions to promote compliance. Significant questions remain about the deterrent value of existing penalties, particularly for the negligence, fraud, and substantial understatement penalties. The House bill and IRS proposal both include a potentially significant new compliance incentive to encourage prompter filing of information returns. However, both proposals could significantly weaken the compliance effort by eliminating the penalty for underreporting taxable income shown on information returns and identified in IRS' computer matching program.

We also recognize that a penalty system must maintain credibility and confidence among the taxpayers. The House bill and IRS proposal make progress here by making penalty provisions more consistent and by better coordinating penalties to avoid overly harsh assessments against taxpayers. However, we believe that further changes are needed to treat similarly situated taxpayers more equitably, including extending the penalty for not filing an income tax return to all late filers, not just those with an outstanding tax liability.

Finally, penalty policy cannot be considered separately from the broader context of the programs the penalties support and their administration. In this regard, the federal tax deposit penalty may not effectively promote compliance because the program regulations are too complex. We believe that the program should be simplified before proceeding with penalty reform in this area. In addition, the design features of other penalties hinder their administration, and we have made recommendations to mitigate these problems.

Background

The success of our tax system depends on voluntary compliance with the nation's tax laws. To encourage compliance and punish noncompliance, Congress has placed a variety of civil penalty provisions in the Code. In 1975 there were 64 civil tax penalties. By 1988 the number had grown to about 150. Much of the growth took place on an ad hoc basis to meet specific compliance problems. As a result, little consideration was given to the effectiveness, fairness, and administrability of the system of penalties that was developing. This trend prompted concerns by tax practitioners that penalties were being assessed inconsistently and were becoming increasingly burdensome to the taxpayer and practitioner. At the same time, IRS became concerned that the growing number of penalties and the lack of coordination among penalties reduced taxpayer confidence and undermined the system of voluntary compliance.

In late 1987 the IRS Commissioner established a task force to examine the value of penalties, identify administrative problems, and recommend statutory and administrative improvements to the system. The task force issued its recommendations to the Commissioner in February 1989. On June 1, 1989, the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, introduced the Improved Penalty Administration and Compliance Tax Act, which was approved as amended on June 20, 1989, by the full Committee.

Objectives, Scope, and Methodology

The objectives of our work were to identify concerns with civil penalty provisions in the Code, analyze changes proposed in the House bill and the IRS task force report, and present our observations on the proposed changes. Our review did not cover the more than 150 civil tax penalties but was limited to the major categories of penalties addressed in the House bill and IRS study.

We based our analysis on penalty data retrieved from IRS individual and business masterfiles for tax years 1984 through 1987 and fiscal years 1985 through 1988. We also drew from our ongoing review of randomly selected penalty assessment and abatement case files.

We reviewed the IRS civil penalty task force study and evaluated its methodology, the bases for the recommendations contained in the report, and the subtask group reports. We interviewed IRS officials at the National Office, service centers, district offices, and the Martinsburg Computer Center. We also reviewed numerous documents, including legislative histories, Joint Committee on Taxation reports, hearing testimony, IRS reports, GAO reports, and positions recently advocated by the tax section of the American Bar Association and the American Institute of Certified Public Accountants.

In evaluating the desirability and design of changes to civil penalties, we considered several key factors. Of paramount importance was the need to ensure that penalties provide adequate incentives to promote voluntary taxpayer and tax practitioner compliance with the tax code. In arriving at our conclusions on the current law as well as the proposals, we focused on whether the economic value of the penalty, its potential coverage, and its assessment criteria could effectively motivate compliance and deter noncompliance.

We also considered whether the penalty treated taxpayers equitably—an important variable in promoting system credibility. This included the appropriateness of the penalty for various groups of taxpayers, such as taxpayers in differing income classes. It also included considering whether the relative severity of the various penalties reflected the relative severity of the offenses.

Finally, as we focus on ways to make civil penalties fairer and more effective, a key factor in determining the success of the changes will be IRS' ability to appropriately and consistently administer the new provisions. IRS has a great challenge to ensure that so many penalties are correctly and consistently administered all across the country. This

challenge is made more difficult by the complexity of the tax code. We have evaluated proposed changes to penalties with this perspective in mind.

We did our review from June 1988 to June 1989 and in accordance with generally accepted government auditing standards.

The following is a summation of the positions taken in the IRS task force study and House bill along with our analyses and recommendations. Appendixes I through VI contain details about current penalty provisions, concerns, and proposed changes for the filing, failure to deposit, and accuracy/conduct penalties.

Filing Penalties

Income Tax Returns

Income tax returns are the basic building blocks of our tax system. The Code requires that tax returns be filed by prescribed dates to accommodate the processing of returns and the payment of taxes. The returns also provide information essential for IRS to track and detect nonfilers and underreporters. The penalty for failing to file a tax return is intended to encourage the timely filing of the return.

The existing failure to file penalty, however, is assessed only against taxpayers who owe taxes, not against delinquent filers who owe no taxes or are due a refund. This is because the penalty is computed as a percentage of the taxpayer's outstanding tax liability. Thus, some taxpayers who file their returns late are penalized while others are not.

Is it fair to penalize delinquent-filing taxpayers who do not owe the government money? This concern must be balanced with IRS' administrative costs for securing delinquent returns, even those for which the taxpayer owes no taxes. Such taxpayers now have a legal duty to file a return, but no corresponding sanction exists for failing to do so. The latest figures indicate that IRS spent nearly $64 million in tax year 1984 to secure delinquent returns, half of which had no balance due.

The IRS task force proposed to extend the failure to file penalty to all delinquent returns; the House bill is silent on this issue. We recommend that a failure to file penalty be established that would penalize all delinquent filers equally. The penalty should increase with the lateness of

the return to encourage prompt filing. (Additional discussion is in app. I.)

Information Returns

Information returns are to be filed with IRS by payors of income to individuals and certain businesses. IRS uses this information to identify taxpayers who either do not file tax returns or do not report all of their income. A penalty can be assessed for each information return that is incorrect, not filed on time, or not filed on magnetic-media as required. The objective of the penalties is to encourage payors to file the information in a usable format in time for it to be used in the computer matching process in which IRS identifies potential underreporters and nonfilers.

Existing information return penalties do not equitably promote payor compliance. Some penalties are "capped" at a maximum dollar amount per payor while others are not. Since the penalty is computed on the number of late or erroneous documents submitted, filers below the capped threshold pay a penalty on all noncompliant returns while filers above the threshold escape penalties on those returns exceeding the threshold. In effect, the caps result in a lower penalty per return for large filers even though the information filed by all filers is equally important.

In addition, the current penalty is not time-sensitive. It penalizes late filers by the same amount regardless of when they submit their returns, so that no incentive is provided for filing late returns that would still be usable in the IRS information matching program. Finally, penalty caps, magnetic-media filing thresholds, and abatement criteria vary across types of information returns. These inconsistencies complicate IRS administration of the penalties.

A revised penalty structure could promote a more effective information returns program and enhance IRS' penalty administration. Consistent with both the House bill and the IRS task force proposal, we recommend that information return penalties be made the same for all types of returns to ease IRS administration and be made time-sensitive to encourage more timely payor submissions.

Caps on the maximum dollar value of the penalty are more controversial. We agree with the IRS task force position and recommend that caps be eliminated to promote equity and maintain a consistent economic deterrent value. This is unlike the House bill, which extends the caps to all types of information returns. The absence of a cap keeps the penalty

proportionate to the number of returns filed and thus promotes equitable treatment of all filers. Under the House bill, the $50-per-return penalty would apply for payors filing less than 5,000 returns, while for very large filers (over 100,000 returns), the average per-return penalty would in effect decline to less than $1. Although less than 1 percent of the form 1099 information return filers fall into the latter category, they file over half of the form 1099s.

Participants in IRS' civil penalty task force focus groups stated that the amount of the penalty is a factor in a business' decision to comply with the information reporting requirements. Capping the penalties could change the balance in favor of noncompliance particularly for large filers whose compliance costs may be in the millions of dollars.

We recognize that IRS has other compliance tools, such as taxpayer technical assistance and education programs; however, these tools work best when supported by an effective penalty structure providing sufficient incentives for payors to learn about their responsibilities. Unlike delinquent taxes, which accumulate interest and carry the possibility of asset seizure as incentives to comply, penalties are IRS' one monetary compliance incentive for payors to submit the required information documents.

While existing law and the House bill provide for an uncapped penalty to be assessed against payors who intentionally disregard the filing requirements, the difficulty in proving intentional disregard reduces the potential effectiveness of this provision. On the basis of information from IRS, it does not appear that IRS has ever assessed this penalty.

Although uncapped penalties may present the specter of overly harsh assessments to large filers, a large penalty for a large filer may not be any more economically severe in relative terms than a smaller penalty for a small filer. If concerns about the economic impact of information return penalties persist, IRS could be given the authority to abate penalties if they cause undue hardship—an option that would be more targeted to the concern and would apply to all payors.

Finally, return due dates and thresholds for filing on magnetic-media should be set administratively by IRS rather than in legislation as proposed in the House bill. This would permit IRS to respond to future changes in technology and program administration without seeking a change to legislation. (Additional discussion of these and related issues is contained in app. II.)

Failure to Deposit Penalty

The federal tax deposit system was designed to ensure a timely flow of tax revenues into the Treasury. Withheld employee income taxes and certain employment taxes make up the bulk of the deposits made annually. In fiscal year 1987, over 75 percent of withheld individual income taxes was remitted through this system. The failure to deposit penalty is assessed if deposits are not properly made or not made on time.

The existing failure to deposit penalty does not vary with the lateness of the deposit and therefore may not provide an incentive for taxpayers to expedite late deposits. However, while we believe this penalty should be time-sensitive, any changes should not complicate the administration of an already complex program.

The large number of failure to deposit penalty assessments reflect broader problems with the deposit program itself rather than the design of the penalty. Since the required deposit-due dates vary with the size of accrued tax liability, many taxpayers must constantly monitor their accrued taxes to determine when their deposits are due. The confusion fostered by this requirement may be partly responsible for almost 30 percent of the depositors receiving at least one penalty in fiscal year 1988 and for the large number of assessments during this period. In fiscal year 1988, 1.6 million depositors received 3.4 million separate assessments.

The House bill suggests a four-tier penalty that would increase with the lateness of the deposit. We are concerned that a four-tier penalty would be administratively burdensome for IRS and confusing to the taxpayer. The IRS task force study advised caution on proceeding with penalty changes until the perceived problems with the federal deposit program itself are studied.

We agree that the underlying programmatic problems should be resolved prior to changing the penalty. However, if Congress believes penalty changes are necessary in the interim, we would advise a simpler time-sensitive penalty than that contained in the House bill. One option would be to assess the 10-percent penalty until 30 days after the due date of the return, at which point the penalty would be increased to 15 percent. According to IRS officials, this would minimize the impact on penalty administration while making the penalty time-sensitive. Concern that the penalty is too harsh could be addressed by making the tiers 5 percent and 10 percent, respectively. (Additional discussion of these and related issues is contained in app. III.)

Accuracy/Conduct Penalties

Taxpayers

The objective of the accuracy/conduct penalties is to encourage the filing of correct returns and to deter the understatement of tax liability. Accuracy penalties fall into two categories: (1) those assessed on subjective criteria involving a determination by IRS of the taxpayer's intent or state of mind (negligence and fraud) and (2) those assessed on objective criteria, such as failure to report income shown on information returns or exceeding an understatement threshold (presumptive negligence and substantial understatement).

Many in the taxpayer community have alleged that the accuracy/conduct penalties are overly harsh. This is partly due to the lack of coordination among the penalties, which permits stacking, or the assessment of more than one accuracy penalty for the same tax understatement. Another commonly mentioned problem is the dissatisfaction with objectively assessed penalties, which penalize taxpayers for understatement of tax while allegedly not fully considering the taxpayer's intent to comply with a complex, and sometimes confusing tax code. The presumption of negligence and the "clear and convincing evidence" abatement standard for penalties on unreported income shown on information returns are also controversial. Other concerns are prompted by the negligence penalty being assessed against the entire tax understatement rather than against just that portion attributed to the negligent behavior.

Both the House bill and IRS proposal represent comprehensive efforts to restructure and rationalize the accuracy/conduct penalties to respond to these concerns. Both proposals share common features that we support. These features include

- better coordinating the accuracy/conduct penalties to eliminate the assessment of more than one penalty for the same tax understatement and
- assessing the negligence penalty against only that portion of the understatement found to be attributable to negligence.

The House bill would also establish reasonable cause as the abatement criterion for all accuracy/conduct penalties to promote uniformity and

ease administration. While we agree with establishing a uniform abatement criterion for the accuracy penalties, we do not support extending the provisions for abatement to fraud.

We have reservations about other aspects of the House bill and IRS task force report proposal, because of their potential impact on IRS programs as well as the economic deterrent value of accuracy/conduct penalties. First, both proposals would repeal the current presumptive negligence penalty, which applies to unreported income disclosed on information returns. This penalty is based on objectively defined negligence criteria in that it is triggered by the unreported income identified by the computer matching program. Unlike regular negligence, it does not require IRS to prove a taxpayer's negligent intent through a time-consuming audit, thereby permitting IRS to assess the penalty on a larger number of noncompliant taxpayers.[1]

Repealing the presumptive negligence penalty would leave the Code without any objectively assessed penalty for underreporting tax liability below the substantial understatement threshold. Only the negligence and fraud penalties would be available. This would weaken the IRS information returns-matching program by eliminating a significant taxpayer incentive to report all income shown on information returns.

The unreported income that is penalized under presumptive negligence is significant. IRS data indicate that the average penalized underreported income exceeds $2,000 per return. Over 60 percent of the penalties are assessed against returns with over $25,000 in total positive income, even though only 35 percent of the returns filed fall into this category. A return showing $50,000 or more in total positive income is 12 times more likely to be assessed this penalty than returns showing $10,000 or less.

Without presumptive negligence or a similar underreporting penalty, taxpayers may have a greater incentive to underreport this income and take their chances that IRS would not detect this. Resource constraints currently prevent IRS from reviewing all of the underreporter cases that are identified in the document matching program. For tax year 1984, IRS was able to review 58 percent of the cases. Even if the unreported income is identified in the matching process, according to IRS officials,

[1]For fiscal year 1988, IRS assessed 833,103 presumptive negligence penalties amounting to over $114 million, and 246,508 regular negligence penalties amounting to over $284 million.

only the tax and accrued interest would be assessed unless IRS audits the taxpayer's return.

In contrast with the House bill and IRS proposal, we recommend retaining a low-rate underreporting penalty in order to continue IRS' ability to penalize this noncompliance on the basis of taxpayers' behavior rather than intent. The penalty could be modified to make the abatement criterion less stringent and consistent with the other accuracy/conduct penalties. Further, the penalty for underreporting income could be set at a lower rate than the more egregious negligence and substantial understatement penalties. These changes will alleviate many of the concerns with this penalty.

In addition, neither proposal considers how recent changes to the broader tax system have eroded the economic value of the accuracy/conduct penalties. Specifically, tax rate reductions in the 1986 Tax Reform Act had the effect of increasing the amount of underreported income required to trigger the substantial understatement penalty for individuals by over 50 percent, far offsetting the increase in the penalty rate from 15 to 25 percent. Both the House bill and IRS proposal would decrease the rate of this penalty from 25 to 20 percent.

Further, in 1988 Congress repealed the interest portion of the fraud and negligence penalties, which also has eroded their value. Although the interest computation date on the penalty was changed concurrently to increase the value of the penalty, this offset was effectively less than 6 percent of the value of the interest repealed. While both the House bill and IRS task force proposal would increase the penalty rate for negligence, the increases may not be adequate to offset these changes. For example, the 20-percent rate proposed by the House bill would have an economic value 23 percent below that of the penalty in 1988.

We recommend that Congress consider alternative ways to restore at least part of the economic value of the accuracy/conduct penalties through such means as increasing the effective rates of the negligence and fraud penalties or reducing the threshold of understated tax liability that would trigger the substantial understatement penalty.

Finally, in setting penalty rates for the accuracy/conduct penalties, Congress should set the rates for each type of misconduct to reflect the relative seriousness of the offense. In this regard, we recommend an alternative structure under which the objectively assessed accuracy

penalties for tax understatement, i.e., underreporting (presumptive negligence) and substantial understatement, would be set at lower rates than the subjectively assessed conduct penalties, i.e., negligence and fraud. This would recognize the more serious intentional nature of the latter offenses. Under such a structure, there could be four progressively higher penalty rates applying to underreporting, substantial understatement, negligence, and fraud, respectively. (Additional discussion of this and other issues related to these penalties is contained in app. IV.)

Return Preparers

A large number of taxpayers depend on return preparers to complete their income tax returns. This occurs for a variety of reasons, including the complexity of the Code and tax forms. In 1976 Congress enacted return preparer penalties in response to reports that a substantial number of preparers were engaging in abusive tax practices.

Our on-going review of IRS administration of the return preparer penalties indicates that the current penalties are too low to effectively deter preparer misconduct or to justify the assessment costs. In addition, the existing penalties create definitional problems, which hamper their consistent administration: for example, the current penalty for intentional disregard overlaps the penalty for willful understatement. This creates problems for IRS examiners in determining which, or whether both, penalties should apply.

We recommend that preparer penalty rates be increased to enhance their economic deterrent value. The House bill would increase the first tier preparer penalty from $100 to $250 and the second tier preparer penalty from $500 to $1,000. The IRS task force did not propose an increase in the rates.

In addition to increasing the rates, the individual preparer penalties need to be more clearly defined. A first-tier penalty for negligence coupled with a second-tier penalty for intentional disregard of rules and willful understatement of tax liability would correct the definitional problem. This is consistent with the IRS task force proposal, except IRS would go one step further and create a third-tier penalty for preparer fraud. We believe a third tier is unnecessary and would complicate IRS administration of the penalties. This is because the difference between willful understatement of tax liability and fraud is not clear.

The House bill would retain two penalties and would clarify the current problem of differentiating intentional disregard from willful understatement, similar to what IRS proposed. However, the bill may create a new problem by introducing a new standard into the Code that would require IRS to penalize preparers who "knowingly" took a position that had no realistic possibility of being sustained on a return. We anticipate that this untested standard could be difficult to administer because of problems proving that the preparer "knowingly" took an unsustainable position. (Additional discussion is provided in app. V.)

Abusive Tax Shelter Promoters

Abusive tax shelters use improper or extreme interpretations of the law or facts to secure for investors substantial tax benefits that are clearly disproportionate to the economic reality of the transaction. To curb their growth, Congress has provided IRS with enforcement tools, including abusive tax shelter promoter penalties.

Even with the promoter penalties, financial incentives remain that could encourage additional abusive tax shelters. Promoters can currently retain as much as 80 percent of the shelter's gross income after paying the penalty. This is because the current law limits the penalty to the greater of $1,000 or 20 percent of gross income.

Our position differs from that taken in the House bill. The House bill recommends changing the penalty to the lesser of $1,000 or 100 percent of shelter gross income. We disagree with making $1,000 the maximum rather than the minimum penalty because its economic deterrent value would be greatly reduced. This change would also discriminate against small shelters with a gross income less than $1,000 while allowing shelters with a gross income exceeding $1,000 to retain some income. We recommend that the penalty be 100 percent of gross income for all shelters. IRS does not take a position on increasing the penalty rate. (These and additional issues are discussed in app. VI.)

Treasury and IRS officials reviewed a draft of this document. They agreed that we accurately reflected their position on the issues raised and provided additional information we considered in preparing the final report. We are providing copies of this report to the Joint Committee on Taxation; the House Committee on Ways and Means, Subcommittee on Oversight; and the IRS Commissioner. As agreed with your Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution until 30 days from the date of this letter. At

that time, copies will be made available to other interested parties upon request.

The major contributors to this report are listed in appendix VII. If you have any questions, please contact me on 272-7904.

Sincerely yours,

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

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Abbreviations

IRS Internal Revenue Service

Income Tax Return Filing Penalty

Current Law

The penalty for failure to file an income tax return is 5 percent of the net tax due, increasing 5 percent per month to a maximum of 25 percent. The penalty applies only when an underpayment of tax occurs. A minimum failure to file penalty is applied for returns with underpayment of tax filed more than 60 days after the due date (considering any extensions granted by IRS). The minimum penalty is the lesser of $100 or 100 percent of any unpaid tax. If both a failure to file and a failure to pay penalty are assessed, the failure to file penalty is reduced by the penalty for failure to pay the amount shown on the return.

Table I.1: Income Tax Return Filing Penalty Assessment/Abatement Statistics, Fiscal Years 1988 and 1987

Dollars in millions

	Assessments		Abatements[a]	
Fiscal year	**Number**	**Amount**	**Number**	**Amount**
1988	4,473,092	$2,558	742,258	$1,423
1987	4,841,972	2,470	778,526	1,451

[a]Some abatements may be for penalties assessed in previous years.

Concerns

The existing penalty does not penalize delinquent filers who owe no taxes or are due refunds. This is because the penalty is calculated as a percentage of the unpaid tax liability.

The minimum failure to file penalty is not time-sensitive. Thus, taxpayers with a $100 tax liability would be subject to the same minimum penalty ($100) whether they filed 60 days late or 2 years late.

The failure to file penalty may be assessed with the accuracy/conduct penalties. For example, a nonfiler whose return is completed by IRS may be assessed not only a late-filing penalty but also the substantial understatement and negligence penalties.

Proposals for Change

H.R. 2528

The House bill eliminates stacking of the accuracy/conduct penalties with the delinquency penalties for nonfilers. It adds a new penalty for fraudulent and intentional failure to file a tax return to replace the conduct penalties that would no longer apply. The penalty would be 15 percent of the outstanding tax liability per month up to 75 percent.

IRS Study

The IRS task force study recommends that a minimum failure to file penalty of $100 be assessed against all late-filed returns, including those for which no taxes are owed or refunds are due.

GAO Analysis

The Failure to File Penalty Is Inequitable.

The failure to file penalty is inequitable because it is assessed against balance due returns only. This is because the penalty is computed on the taxpayer's outstanding tax liability. As a result, it is not assessed against those taxpayers who file late and owe no tax or are due a refund. This creates a situation in which there is a legal duty to file a return without a corresponding sanction for failing to do so. Thus, the failure to file penalty results in differing treatment of taxpayers who commit the same offense.

IRS' latest statistics show that returns with no tax liability or with a refund due accounted for over half of the 2.2 million delinquent returns secured through IRS' program to detect delinquent filers for tax year 1984.

Alleviating this inequity raises a counter issue: should the government penalize taxpayers who file late returns but who are owed refunds or have no tax liability? This concern must be balanced with the statutory requirement to file a return and the administrative costs of securing delinquent returns. This program cost IRS $63.9 million for tax year 1984.

The House bill would not extend the penalty to taxpayers with no tax liability or who are owed a refund. The IRS task force proposes a minimum $100 penalty for these taxpayers.

The Late-Filing Penalty Should Be Time-Sensitive.

If late filing is penalized as a separate offense, the penalty should be time-sensitive. For example, a taxpayer filing 60 days late should be assessed a lesser penalty than a taxpayer filing 2 years late. One option for determining the penalty amount could be to base it on the increasing costs IRS incurs as it makes additional attempts to secure delinquent returns.

Taxpayers Who Intentionally Do Not File a Tax Return Should Be Subject to a Conduct Penalty.

The House bill proposes a new penalty for intentional or fraudulent failure to file. This provision is needed under the House bill because the bill would limit the assessment of the accuracy/conduct penalties to taxpayer-filed returns. Although such conduct warrants a penalty, it may be difficult to administer because by definition it will require that IRS contact delinquent filers to prove their intent and state of mind.

Recommendation

To support the statutory requirement that all taxpayers timely file a tax return, we recommend establishing a time-sensitive failure to file penalty that would be assessed against all delinquent taxpayers regardless of whether or not they had a tax liability, unless the failure is due to reasonable cause. We previously asked Congress to consider such a penalty.[1]

[1] Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them and Collect Their Taxes (GGD-79-69, July 11, 1979).

Information Return Filing Penalties

Current Law

Penalties are assessed against payors who fail to file information returns on time, in the proper machine-readable format, and on magnetic media when the number of returns filed exceeds a set threshold. A $50-per-return penalty can be assessed if any of these conditions are not met. For interest and dividend returns, there are no limits on the amount of the penalty; for all other returns, the cap is generally $100,000 annually. If the failure is due to intentional disregard, an uncapped penalty of at least $100 per return may be assessed.

For interest and dividend returns, the statutory threshold for filing on magnetic media is more than 50 payees. For other returns, IRS has administratively set the threshold at 250 returns. Penalties for not filing on magnetic media are assessed on the total number of returns filed by the payor, not just those exceeding the threshold. For interest and dividend information returns, the abatement criterion is due diligence; for all others, it is generally reasonable cause. In addition, a $50 penalty is generally imposed for each failure to include a correct taxpayer identification number on a return or statement. Payors who fail to provide a statement to the payee are also subject to a penalty of $50 per statement with a $100,000 cap per annum. If an incorrect or incomplete payee statement is provided or an incorrect or incomplete information return is filed, the penalty is $5 per statement or return with a $20,000 cap annually.

Table II.1: Information Return Filing Penalties Assessment/Abatement Statistics, Fiscal Years 1988 and 1987

Dollars in millions

	Assessments		Abatements[a]	
Fiscal year	**Number**	**Amount**	**Number**	**Amount**
1988[b]	45,428	$226	23,733	$136
1987	134,916	118	46,163	90

[a]Some abatements may be for penalties assessed in previous years.

[b]Does not include 21,283 penalties amounting to $870.3 million, which were erroneously assessed and, for the most part, abated before the taxpayer was notified.

Concerns

Interest and dividend returns are treated differently from other types of information returns: the threshold for filing on magnetic media is lower; the abatement criteria is due diligence rather than reasonable cause; and there is no cap on the penalty amount.

These penalties are not time-sensitive, e.g., if returns are filed after the due date but in time for IRS to use the information, the penalty is the same as if the returns were not filed at all.

For failure to file on magnetic media, assessing a penalty against the total number of returns filed rather than the number that exceeds the threshold is perceived to be inequitable and unduly harsh. For example, a payor filing 50 interest and dividend returns on paper receives no penalty while a payor filing 51 returns on paper is penalized $2,550, or $50 for each return filed. This, in effect, creates a minimum penalty of $2,550 for interest and dividend information returns for which the threshold is 50 returns. For other returns for which the threshold is 250, the minimum penalty would be $12,550.

When a taxpayer identification number contained on an information return will not process in the Information Returns Matching Program, IRS is not authorized to tell the payor why because of privacy concerns about releasing taxpayer data. This is thought to impede the payor's ability to correct the information.

Proposals for Change

H.R. 2528

The House bill proposes that information returns be treated uniformly: the Secretary of the Treasury is given authority to set the standard for magnetic media filing, but the regulations cannot require magnetic media filing for less than 250 returns; all penalties would be capped; and reasonable cause would be established as the uniform abatement criteria.

The penalty for failure to file correct information returns would be made time-sensitive. If returns are filed late or corrected within 30 days of the due date, the penalty would be $15 per return with a $75,000 cap. If returns are filed or corrected after the 30 days but on or before August 1, the penalty would be $30 per return with a cap of $150,000. If returns are not filed or corrected by August 1, the penalty would be $50 per return with a cap of $250,000. Special time-sensitive caps of $25,000, $50,000, and $100,000, respectively, would be provided for businesses with average annual gross receipts for the three most recent taxable years of $5 million or less. The caps would be per payor for each calendar year. If the payor's failure to file is due to intentional disregard, a penalty of at least $100 per return would be imposed and penalty caps would not apply.

A de minimis exception would apply to returns timely filed with missing or incorrect information that are corrected on or before August 1. For the greater of 10 or one-half of 1 percent of the number of returns required to be filed, if corrections are made by August 1, the returns would be treated as having been filed with all correct information.

The penalty for not providing correct payee statements to a taxpayer would be increased from $5 per failure ($20,000 cap) to $50 per failure ($100,000 cap).

IRS Study

All information returns would be treated uniformly with reasonable cause as the abatement criterion. Unlike the House bill, the IRS proposal calls for the magnetic media filing threshold to be set administratively and recommends that all caps be eliminated, but recommends a sliding scale in which the per-document penalty is reduced above a certain number of documents.

Like the House bill, the penalty would be time-sensitive but through a two-tier schedule. A $25 penalty per return would apply to late filing as well as to errors that do not prevent the data from being processed to the information returns masterfile. An additional $25 penalty per return would apply for failure to file at all, filing after a date near the end of the processing deadline, or failure to correct a bad magnetic tape that had been returned. Unlike H.R. 2528, the dates for the tiers would be set administratively by IRS.

A penalty for failure to file on magnetic media would be assessed only on documents in excess of the prescribed threshold.

GAO Analysis

Treating All Information Returns Consistently Could Ease Administration.

To simplify administration, all information returns should be treated consistently. However, adequate analysis does not exist to determine, from a compliance policy perspective, whether the differentiation on the basis of type of information return is justified.

All Caps Should Be Eliminated.

Current caps on some types of information return penalties should be eliminated for consistency and equity reasons. Since the penalty is computed on the number of documents submitted, caps penalize filers below the threshold more severely than filers above the threshold. In effect, the cap results in a lower per-return penalty for large filers even though the information from all filers is equally important. Table II.2 illustrates the average per-return penalty for different size catagories of filers under the $250,000 cap proposed in the House bill, assuming that all 1099 returns filed by the payor are penalized.

Table II.2: Effect of Proposed Caps on Information Return Penalty Rates, Tax Year 1987

Number of returns filed by payor	Percent of payors in category	Percent of returns filed in category	Average penalty per return under proposed caps[a]
5,000 or fewer	99.68	13.2	$50.00
5,001-10,000	.13	5.7	35.52
10,001-100,000	.17	27.7	9.14
Over 100,000	.02	53.3	.67

Note: Only 1099 information returns are captured on this table.
[a]Does not reflect proposed caps for small businesses.

This analysis illustrates the equity issue associated with caps, and also the concern that caps may undermine the economic deterrent value of the penalty for large filers.

Participants in IRS civil penalty task force focus groups stated that the amount of the penalty is a factor in a business' decision to comply with the information reporting requirements. According to the study's authors, at $50 per return, businesses generally determine that the cost of complying is less than the penalty because of the large number of returns involved. Capping those penalties could change the balance in

favor of noncompliance particularly for large filers whose average penalty is less that $1 per return.

The economic deterrent value of the information return penalties is also critical because IRS has limited compliance tools in the information return reporting area. We recognize that IRS has other compliance tools, such as taxpayer technical assistance and education programs. However, these tools work best when supported by an effective penalty structure providing sufficient incentives for payors to learn about their responsibilities. Unlike delinquent taxes, which accumulate interest and carry the possibility of asset seizure, information return penalties are IRS' sole monetary "stick" to obtain the required information for the document matching programs, which play a key role in IRS tax administration.

While uncapped amounts on large filers may seem overly harsh, this would keep the penalty proportionate to the number of returns filed. A large penalty for a large filer may not be any more severe than a small penalty for a small filer. If concerns about the economic impact of information returns persist, IRS could be given the authority to abate penalties for undue hardship—an option that would be more targeted and equitable.

While the Code and the House bill provide for an uncapped penalty to be assessed against payors who intentionally disregard the filing requirements, the difficulty in proving intentional disregard reduces the potential effectiveness of this provision. On the basis of information from IRS, it does not appear that IRS has ever assessed this penalty.

According to IRS personnel, special caps provided in the House bill for small businesses may make the penalty more difficult to administer because information on business size cannot be easily matched with information returns filed by each business.

Single Abatement Criterion Could Ease Administration.

A single criterion should be used for abating information return penalties because IRS currently has difficulty administering the due diligence criteria for interest and dividend returns (except for specific mailing requirements to correct tax identification information) and reasonable cause for all other information returns. Currently, it is difficult to differentiate between the two criteria in the IRS manuals.

IRS Should Set Magnetic Media Thresholds Administratively.

IRS should be authorized to administratively set the thresholds for filing on magnetic media to accommodate potential future changes in processing procedures and technology. Setting the minimum threshold statutorily, as is done in the House bill, could impede IRS' future ability to effectively cope with technological advances without new legislation.

Only Returns Exceeding Magnetic Media Threshold Should Be Penalized.

Ideally, only those returns exceeding the threshold for filing on magnetic media should be subjected to a penalty. Penalizing all information returns filed—known as the "cliff effect"— establishes a minimum penalty, which is inequitable because it penalizes payors for returns below the threshold. The revenue implications of this change could be large, however, because penalties would no longer be assessed on returns under the threshold.

Time-Sensitive Penalties Could Encourage Earlier Filing but May Be Difficult to Administer for Incorrect Returns.

Information return penalties should be time-sensitive to encourage filing in time for IRS to use the data in the underreporter program. However, according to an IRS official, time-sensitive penalties may be difficult to administer for corrected returns as contemplated in the House bill. This is because IRS currently cannot identify incorrect returns until the subsequent year when the underreporter program is underway. As a result, it may be impossible for IRS to notify filers that their returns were inaccurate in time to take advantage of the lower penalties in the House bill. For this reason, the House bill would be effective only in those cases in which the inaccuracy is identified by the filer and voluntarily corrected.

Further, if the penalties for late or incorrect returns are made time-sensitive, IRS should set the dates administratively to allow for potential future changes in underreporter program processing time frames.

Increasing Penalty for Corrected Returns May Be Counterproductive.

The House bill would increase the existing penalty for filers who correct inaccurate returns. Currently, the $5 penalty for correcting an inaccurate return is not assessed by IRS because it is not cost effective. In addition, IRS officials told us that it would be counterproductive to penalize filers who voluntarily correct errors in their returns. To avoid this, the penalty should not be assessed against payors who voluntarily correct their returns.

GAO Study of Taxpayer Identification Numbers Not Needed.

The House bill includes a provision that GAO study whether IRS should be permitted to disclose taxpayer information to payors to correct the mismatching of taxpayer identification shown on information returns and to correct such information in IRS records. In September 1988 we issued a report to the Joint Committee on Taxation on how IRS could improve the accuracy of taxpayer identification numbers on information returns.[1] We believe the recommendations in the report, if implemented, would allow IRS to resolve the mismatching issue without disclosing taxpayer information. These recommendations include enforcing the backup withholding provisions of the Code to encourage taxpayers to provide correct information to payors. Thus, we do not believe there is a need for further GAO study.

Recommendations

To simplify administration, we recommend that all types of information returns be treated consistently. Within that context, all caps should be eliminated, there should be a single abatement criterion, magnetic media filing thresholds should be set administratively, and only returns exceeding thresholds should be penalized.

Making information return penalties time-sensitive is a good idea; however, we recommend that IRS administratively set the penalty dates. Further, to promote voluntary correction of returns, penalties should not be assessed against payors who voluntarily correct their returns.

[1] Tax Administration: Accuracy of Taxpayer Identification Numbers on Information Returns Can Be Improved (GAO/GGD-88-110, Sept. 6, 1988).

Failure to Deposit Penalty

Current Law

A penalty of 10 percent of the unpaid tax is assessed against taxpayers who do not deposit employment and other taxes by the prescribed dates.

Table III.1: Failure to Deposit Penalty Assessment/Abatement Statistics, Fiscal Years 1988 and 1987

Dollars in millions

	Assessments		Abatements[a]	
Fiscal year	**Number**	**Amount**	**Number**	**Amount**
1988	3,497,441	$2,689	734,827	$1,247
1987	3,440,854	2,537	527,988	822

[a]Some abatements may be for penalties assessed in previous years.

Concerns

Failure to deposit penalty is not time-sensitive. The failure to deposit penalty is 10 percent of the underpayment regardless of the length of time the payment is unpaid. For example, a taxpayer would be penalized $200 regardless of whether a $2,000 tax deposit was 10 days or 30 days late.

Taxpayers find the requirements difficult to meet. Many taxpayers find it difficult to comply with the complex deposit requirements. Since the required deposit due dates vary with the size of accrued tax liability, taxpayers must closely track their accrued tax liabilities to determine when deposits should be made. For some taxpayers, adherence to deposit rules requires constant monitoring of their accrued tax liability in order to avoid a penalty. Deposits are required on the 15th day after the close of the month whenever accrued liabilities range between $500 and $3,000 a month. If accrued liabilities are more than $3,000, the deposits must be made within 3 banking days of the end of the prescribed eighth-monthly period.

Proposals for Change

H.R. 2528

The House bill proposes a four-tier, time-sensitive penalty. A depositor would be subject to a penalty of 2 percent of the underpayment if taxes are late but deposited within 5 days of the due date; 5 percent if deposited after 5 days but within 15 days; 10 percent if deposited after 15 days; and 15 percent if not deposited before the earlier of 10 days after the date of the first delinquency notice or the day on which notice and demand for immediate payment is given.

IRS Study

The study recommended no changes to the penalty pending completion of an IRS study of the federal tax deposit procedures.

GAO Analysis

A time-sensitive penalty would be fairer to taxpayers. Any changes, however, should not further complicate penalty administration. Our review to date indicates that IRS and taxpayers have significant problems calculating the existing flat rate penalty. For example, IRS' computer is programmed to calculate the penalty on the bases of deposit patterns of the majority of returns processed. When a specific taxpayer's deposit pattern varies from this norm, the computer-generated penalty can be inaccurate. In addition, when the penalty is manually computed, it is prone to math errors because of difficulties in calculating the due dates of the deposits.

The four-tier structure in the House bill could exacerbate existing problems with the calculation of the penalty by requiring IRS to determine how late each deposit was made. In addition, from a taxpayer's standpoint, the four-tier structure would introduce added complexity to an already complex program.

More importantly, the large number of failure to deposit penalty assessments reflect broader problems with the deposit program itself rather than the design of the penalty. Deposit requirements are too variable and should be clarified to enhance taxpayers' ability to comply. Unlike other tax transactions, such as filing tax returns or making estimated tax payments, deposit requirements do not give taxpayers a firm and set time to make deposits when their accrued tax liabilities fluctuate over the quarter.

The confusion fostered by the deposit requirements may be partly responsible for almost 30 percent of the depositors receiving at least one penalty in fiscal year 1988 and for the large number of assessments during this period. In fiscal year 1988, 1.6 million depositors received 3.4 million separate assessments.

Problems with the deposit requirements need to be addressed and changes need to be made. One option to consider would be to tie the deposit requirements to a more predictable factor, such as payroll date or the number of employees at the beginning of the quarter. If firm deposit dates were known at the beginning of the quarter, taxpayers would not have to constantly monitor accrued taxes to comply with the requirements.

In making program changes, consideration should be given to the need for clearer and more explicit IRS instructions on how to meet the requirements and how to complete Form 941—Employer's Quarterly Federal Tax Return.

Conclusions

We believe that improvements in the federal deposit program should be undertaken before proceeding with penalty reform in this area. However, if Congress believes penalty changes are necessary in the interim, we advise a simpler time-sensitive penalty than that contained in the House bill. One option would be to assess the 10-percent penalty until 30 days after the due date of the return, when the penalty would be increased to 15 percent. According to IRS officials, this would minimize the impact on penalty administration while making the penalty time-sensitive. Concern that the penalty is too harsh could be addressed by setting the rates at 5 and 10 percent, respectively.

Taxpayer Accuracy/Conduct Penalties

Current Law

Negligence

IRS can assess a 5-percent penalty on any underpayment of tax if any part of the underpayment required to be shown on a return is due to negligence. On a timely filed return, the penalty is assessed on the total amount of the underpayment if any portion is caused by negligence. On late-filed returns, the penalty is computed on the total corrected tax liability.

The penalty applies to negligence or disregard of rules and regulations, including any failure to make a reasonable attempt to comply with provisions of the Code and any careless, reckless, and intentional disregard of rules and regulations. Negligence includes the failure to exercise the level of care that a reasonable and ordinarily prudent taxpayer would use under the circumstances. The determination of negligence requires a subjective evaluation of taxpayer intent based on all the facts and circumstances surrounding the underpayment.

Presumptive Negligence

A subsection of the negligence penalty, the presumptive negligence penalty can be asserted when taxpayers fail to report income shown on an information return, such as taxable interest or dividend income. Objective assessment criteria are used on the basis of underreported income identified through IRS computer matching of payor information with that reported by taxpayers. If taxpayers fail to report all income, they are presumed to be negligent because they received the income, are required to maintain books and records adequate to ensure that all income is reported on the return, and should have received a payee statement from the payor reflecting such income.

Taxpayers can rebut the presumption of negligence only by showing clear and convincing evidence to prove that they were not negligent. This is a higher standard than the due care standard applied to the regular negligence penalty.

Fraud

IRS can assess a 75-percent penalty on the underpayment of tax if IRS demonstrates that at least some part of the underpayment was due to fraud—the taxpayer knew the tax was being understated and intended to do so. The penalty is applicable to the entire tax understatement unless the taxpayer can show with "clear and convincing evidence" that

other parts of the underpayment were not fraudulent. There are no provisions in the Code for abatement of the fraud penalty.

Substantial Understatement

A 25-percent penalty for substantial understatement of tax liability can be assessed if the corrected tax exceeds the tax shown on the return by the greater of 10 percent of the tax required to be shown on the return or $5,000 for individuals ($10,000 for most corporations). This penalty is assessable if the taxpayer takes a position on the income tax return (1) for which there is no substantial authority and (2) fails to adequately disclose the position on the return. If the understatement involves a tax shelter, the understatement is reduced by amounts for which the taxpayer had both substantial authority and a reasonable belief that the position taken was more likely than not correct.

IRS may waive all or part of the penalty if the taxpayer acted in good faith and had reasonable cause for the understatement. If IRS proposes the penalty, the burden of proof is on the taxpayer to show why the penalty should not be assessed.

Over/Under Valuations

The valuation penalties range from 10 to 30 percent of an underpayment for incorrect property values claimed on a return. The amount claimed must be more than 150 percent of the correct amount and result in at least a $1,000 tax understatement.

Table IV.1: Taxpayer Accuracy/Conduct Penalties Assessment/Abatement Statistics, Fiscal Year 1988

Dollars in millions

	Assessments		Abatements[a]	
	Number	Amount	Number	Amount
Negligence	296,508	$285	35,783	$49
Presumptive negligence	833,103	114	9,534	5
Fraud	11,415	235	1,145[b]	53
Substantial understatement	39,656	119	3,358	8
Over valuation[c]	12,040	18	913	2
Total	**1,192,722**	**$770**	**50,733**	**$117**

[a]Some abatements may be for penalties assessed in previous years.

[b]IRS fraud abatement statistics reflect recomputations of the penalty based on changes to the tax understatement penalized, not on actual abatements. The fraud penalty is not subject to abatement.

[c]Statistics are not available for the under valuation penalties IRS assessed in fiscal year 1988.

Concerns

The presumptive negligence penalty is controversial.

There is an unfounded perception that because the presumptive negligence penalty results from a computer matching program for information returns, the penalty is assessed automatically by the computer without taxpayers being given the opportunity to explain their position. The penalty is also controversial because taxpayers resent the use of the term negligence when the underreporting may be due to oversight rather than intentional disregard. This concern is exacerbated by the fact that the abatement criterion for presumptive negligence is more stringent than for regular negligence. The penalty is also incorrectly assumed to be difficult to administer.

Stacking is thought to lead to overly harsh penalties.

Stacking, i.e., assessing more than one penalty for the same act, is believed to result in penalties that are too severe. For example, substantial understatement can be assessed jointly with the negligence or civil fraud penalties if IRS determines that the taxpayer was negligent or fraudulent and if the understated amount meets the substantial understatement criteria. For taxpayers who refuse to file returns, the negligence and substantial understatement penalties may be assessed in addition to the failure to file and failure to pay penalties. In this example, the penalties could total over 70 percent of the tax deficiency as calculated by IRS under its nonfilers program.

Controversy exists over whether stacking should take place under current statute. Because the law does not specifically preclude stacking, there is concern that various district offices have divergent policies resulting in inconsistent treatment of taxpayers for similar conduct.

Negligence penalty is not targeted.

The negligence penalty being untargeted, i.e., assessed against the entire tax understatement, not just that which is shown to be negligent, may make it disproportionately large when compared with the negligent understatement. For example, even if only 10 percent of the understatement is attributed to negligence, the 5-percent penalty is assessed against the entire understatement.

Abatement criteria are not uniform.

The abatement criteria vary for the accuracy penalties from due care for regular negligence, clear and convincing evidence for presumptive negligence, and good faith and reasonable cause for substantial understatement.

Substantial authority narrowly defined.

The existing IRS definition of substantial authority does not include all guidance that clarifies the tax treatment of an item such as proposed regulations, technical advice memoranda, private letter rulings, general counsel memoranda, and explanations prepared by the Joint Committee on Taxation. Since taxpayers who take positions based on substantial authority are not subject to the substantial understatement penalty, many tax practitioners believe all guidance that clarifies the Code should be included.

Role and desirability of disclosure is controversial.

Disclosure of positions for which the taxpayer does not have substantial authority protects the taxpayer from the substantial understatement penalty. If IRS disallows the disclosed position, the taxpayer pays the additional tax but no penalty. Some parties question whether disclosure should be used by the taxpayer to avoid a negligence penalty. Others assert that IRS uses disclosure statements to target taxpayers for audit.

Proposals for Change

H.R. 2528

The House bill proposes two tiers of accuracy penalties. The first tier includes the existing negligence, substantial understatement, and over/under valuation penalties. The second tier retains the existing 75-percent fraud penalty.

Specifically, the proposal would

- raise the penalty for negligent conduct from 5 to 20 percent but target the penalty to only that portion of the understatement attributable to negligence;

- lower the penalty for substantial understatement of tax liability from 25 to 20 percent;
- repeal the presumptive negligence penalty;
- double the 20-percent first-tier penalty when the understatement is attributed to gross over/under valuation;
- limit the assessment of the accuracy penalties to filed returns and would prohibit the stacking of accuracy/conduct penalties;
- establish reasonable cause and good faith as the waiver criterion for all of the accuracy penalties, including fraud;
- expand the definition of substantial authority, as discussed in the explanation of the proposed legislation, to include such sources as the general explanation of tax legislation prepared by the Joint Committee on Taxation, or "Blue Books," and other interpretative guidance published in the Internal Revenue Bulletin; in addition, IRS is required to publish annually a list of positions for which there is not substantial authority and which affect a significant number of taxpayers; and
- retain the existing disclosure provisions.

IRS Study

IRS recommends a three-tier system. The first tier consists of a 20-percent penalty that would be imposed if the taxpayer failed to exercise reasonable care preparing the return or failed to make a required disclosure. This tier includes the characteristics of the existing substantial understatement penalty and some features of the negligence penalty.

The second tier consists of a 50-percent penalty for willful or intentional failure to file a correct return or for "taking a position that is not litigable." The third tier consists of a 100-percent penalty comparable to the existing fraud penalty. Each tier would be targeted to the portion of the understatement attributed to the noncompliance.

The proposal would repeal the presumptive negligence penalty and incorporate the existing over/under valuation penalties into the three-tier system, with waiver authority granted to IRS.

The definition of substantial authority would be expanded in a manner similar to the explanation accompanying the House bill.

The existing concept of disclosure would be retained. IRS recommends that the role of disclosure in the examination process be studied.

GAO Analysis

Penalties that are not dependent on IRS' establishing taxpayer state of mind are needed for underreporting tax liability.

Both the House bill and IRS propose repeal of the presumptive negligence penalty. If this occurs, the code will contain no objectively assessable penalty for underreporting tax liability below the existing threshold for substantial understatement. Under both the House bill and IRS proposal, a minimum tax understatement of $5,000 for individuals and $10,000 for most corporations is necessary before IRS could assess a penalty on the understatement without proving negligent taxpayer intent. This equals over $15,000 in unreported taxable income for individuals and over $25,000 for most corporations.

The presumptive negligence penalty supports the IRS underreporter program. This program supplements, through computer matching of information returns and income tax returns, traditional IRS audit efforts. For tax year 1983, the most recent year for which data are available, the underreporter program processed 6.3 million cases that yielded approximately $1.4 billion in additional revenues.

Repealing presumptive negligence weakens the IRS information returns-matching program by eliminating a significant taxpayer incentive to report all income shown on information returns. Without presumptive negligence or a similar penalty for unreported income shown on information returns, this underreporting could not be penalized without a time-consuming IRS audit. IRS does not have the audit staff to do this on the scale of the presumptive negligence penalty. In fiscal year 1988, IRS assessed over 833,000 presumptive negligence penalties.

The repeal of this penalty could also jeopardize the integrity of the matching program by improving the taxpayers' chances at winning the "audit lottery." Resource constraints prevent IRS from processing all of the underreporter cases that are identified in the document matching programs. For tax year 1984, IRS was able to process 58 percent of the cases. If an increasing number of taxpayers fail to report income items reported on information returns, the number of mismatches will escalate, and barring the use of additional resources, the ratio of identified cases processed to underreporters will diminish. Taxpayers then will have an increasing chance of the underreported income being undetected. The unreported income that is currently penalized under presumptive negligence is significant. IRS data indicate that the average penalized underreported income exceeds $2,000 per return. Over 60 percent of the penalties are assessed against returns with over $25,000

total positive income, even though only 35 percent of the returns filed fall into this category. A return showing a total positive income of $50,000 or over is 12 times as likely to receive a penalty as one showing $10,000 or less.

It is unclear why the penalty is proposed for repeal. The IRS task force states that the penalty is difficult to administer. However, thus far we have found no indication of this in our review. According to IRS officials responsible for administering the program, the penalty is easy to administer.

Available data also contradict the perception that the penalty is frequently assessed erroneously and subsequently abated. Under the existing process, the returns are screened before the understatement notice is sent to the taxpayer. For tax year 1984, over 64 percent of the discrepancies were resolved without contacting the taxpayer. If IRS cannot resolve the discrepancy, the taxpayer is given an opportunity to provide information identifying the income on the return prior to the penalty being assessed.

For tax year 1984,[1] in those cases in which correspondence regarding the understatement was sent to the taxpayer,

- 28 percent of the time the taxpayers' explanation was adequate and the penalty was not assessed;
- 64 percent of the time the taxpayers agreed with IRS or did not respond to the inquiry and the additional tax and penalty were assessed;
- 8 percent of the cases were transferred out of the underreporter branch to other IRS divisions; and
- fewer than 1 percent went to IRS appeals; fewer than one-half of 1 percent of the presumptive negligence penalties were abated in fiscal year 1987.

On the basis of our discussions with IRS officials, tax practitioners, and others, it appears that by modifying the penalty for unreported income shown on information returns to make the abatement criteria the less stringent reasonable cause, and setting the penalty rate lower than the more egregious negligence and substantial understatement penalties, many of the concerns would be alleviated.

[1] The statistics for tax year 1984 are the latest available and are available in draft form only. However, according to program officials, the final statistics for the underreporter program will not vary significantly from the draft statistics.

Potential stacking of the accuracy penalties should be eliminated.

Both proposals would amend the existing statute to allow only one accuracy/conduct penalty to be assessed on a single understatement. The stacking of the negligence and fraud penalties with the substantial understatement penalty would be eliminated. This would provide for more equitable treatment among taxpayers. Although IRS masterfile data on negligence, substantial understatement, and fraud penalty assessments show only limited indications that stacking is occurring, the potential for inconsistent assessment policies among district offices would be eliminated.

We agree that the statute should be clarified to eliminate stacking. Multiple accuracy penalties should not be assessed for the same infraction. Each penalty should be a sufficient deterrent to noncompliance and should not have to be stacked to achieve its objective.

Although the House bill prohibits stacking for nonfiled returns, it does not preclude stacking the accuracy penalties with the failure to file penalty if the return is filed late. This could prove to be inequitable for voluntary late filers.

Differentiation needed between negligence and understatement.

One of the primary differences in the two proposals is the treatment of negligence. Under the House bill, negligence is penalized equally with substantial understatement. This would put negligent or willful disregard of tax laws on the same footing as taking an aggressive but defensible position without disclosure or substantial authority. IRS deals with the issue with a second-tier penalty for gross negligence that is higher than the substantial understatement penalty.

Economic deterrent value of the penalties needs to be considered.

Recent changes in tax law have decreased the economic deterrent value of the accuracy/conduct penalties. Reduced tax rates from 1986 tax reform increased the amount of underreported income required to trigger the substantial understatement penalty. Prior to the 1986 tax reform, the $5,000 individual threshold for applying the penalty reflected tax liability on $10,000 of understated taxable income (at the top marginal tax rate of 50 percent). At the current rate of 33 percent, the $5,000 threshold reflects an understatement of taxable income over $15,000 for individuals.

In addition, the 1988 repeal of the 50-percent interest add-on for fraud and negligence, including presumptive negligence, reduced the economic deterrent effect of these penalties. Changes made concurrently on the interest computation date for the penalty offset less than 10 percent of this change.

Uniform waiver criteria should ease administration.

The uniform waiver criteria proposed in the House bill for accuracy penalties should make them easier for IRS to administer consistently. Uniform waiver criteria should also be easier for taxpayers to understand. We would not, however, extend the abatement criteria to fraud as proposed in the House bill but would retain the existing fraud provisions intact.

Substantial authority should be statutorily defined.

Both proposals provide for expanding the definition of substantial authority to include private letter rulings, general counsel memoranda, notices, and other such information listed in the Internal Revenue Bulletin and Joint Tax Committee explanations. GAO agrees with statutorily defining substantial authority and broadening its definition to include all the guidance on which taxpayers should be able to rely. More thought may need to be given the specific authorities to be added and their implications.

Under the House bill, IRS would be required to publish an annual list of positions for which there is no substantial authority. According to IRS, this would be administratively impractical to develop and maintain because of the complexity of the tax code and the large number of issues involved.

Controversial use of disclosure is not resolved.

Both proposals retain the disclosure provisions of the existing substantial understatement penalty. We agree with the IRS recommendation that IRS should study the role of disclosure in the examination of returns.

Recommendations

We recommend retaining an underreporting penalty similar to the existing presumptive negligence penalty but that would be subject to abatement for reasonable cause.

We propose an alternative rate structure under which objectively assessed accuracy penalties would be set at lower rates than the subjectively assessed conduct penalties to recognize the more serious nature of the latter offenses. Consideration could be given to four progressively higher penalty rates applying to underreporting, substantial understatement, negligence, and fraud.

With regard to penalty rates, we suggest Congress consider setting higher rates than the House bill or reducing the threshold of understated tax liability that would trigger the substantial understatement penalty to at least partly restore the economic value of the penalties.

To bolster taxpayer confidence in the fairness and equity of these penalties, we recommend the following additional changes:

- eliminating stacking of the accuracy/conduct penalties,
- targeting the application of the negligence penalty,
- establishing reasonable cause as the abatement/waiver criterion, except for fraud, and
- statutorily defining substantial authority.

Return Preparer Accuracy/Conduct Penalties

Current Law

The law includes penalty provisions intended to monitor the conduct of return preparers. Return preparer penalty cases, although handled separately, typically result from district office examinations of taxpayers' returns. IRS district offices assess a $100 penalty per return or claim for refund for an understatement of tax liability due to negligent or intentional disregard of rules or regulations by a return preparer. IRS district offices also assess preparers a $500 penalty per return or claim for refund for a willful understatement of tax liability of another taxpayer. The total amount collected from imposition of both penalties cannot exceed $500.

Table V.1: Return Preparer Accuracy/Conduct Penalties Assessment/Abatement Statistics, Fiscal Years 1988 and 1987

	Assessments		Abatements[a]	
Fiscal year	Number	Amount	Number	Amount
1988	2,179	$3,497,186	206	$147,844
1987[b]	4,076	2,205,987	352	232,330

[a]Some abatements may be for penalties assessed in previous years.

[b]These amounts are adjusted to compensate for erroneous assessments and abatements, miscodings, and fiscal year 1986 assessments transferred to masterfile in fiscal year 1987, which we discovered during our limited review of transcripts and case files for six districts. We also adjusted the numbers to compensate for understatements caused by combining multiple assessments and abatements under one transaction on the masterfile.

Concerns

The preparer penalty value is too low.

The monetary value of the preparer penalties is too low to provide incentive to assess or to effectively deter preparer misconduct. The monetary value is so low in relation to the associated administrative costs that little economic incentive exists to assess these penalties unless they are assessed in multiples against the same preparer; thus the penalties are infrequently assessed.

The current penalty definitions lack differentiation.

The definitions in the existing law make the penalties difficult to administer consistently and may result in inequity to preparers. The current law definitions allow for overlap between the penalty for intentional disregard and the penalty for willful understatement, which requires that IRS subjectively determine which, or whether both, penalties apply. In addition, the definitions in the Code allow IRS to assess either the willful understatement penalty of $500 or the aiding and abetting penalty of $1,000 against return preparers for the same misconduct. Subjective

determinations may result in inconsistent application by IRS and inequity to preparers.

Proposals for Change

H.R. 2528

The House bill keeps the existing two-tier structure of the return preparer penalties, but redefines the two provisions and proposes higher penalty amounts. The House bill increases the first-tier preparer penalty from $100 to $250. The assessment criteria for the penalty is changed to require IRS to prove both that the preparer took a position that had no realistic possibility of being sustained on its merits and that the preparer knew or reasonably should have known of such position on the return. The House bill increases the second-tier penalty from $500 to $1,000 and expands the definition to include both reckless and intentional disregard of the rules or regulations, which is currently contained in the first-tier preparer penalty.

IRS Study

The IRS task force study recommends a three-tier structure for return preparer penalties that would coordinate with the standards set for taxpayer accuracy penalties but does not propose increasing the penalty amounts.

IRS splits the criteria for the existing first-tier penalty into two tiers. The negligence criterion remains part of tier 1 and intentional disregard of rules is combined with willful understatement and a nonlitigable position at tier 2. Tier 2 is similar to the House bill's proposed second-tier penalty. The IRS study also adds a third tier for fraud, creating a new penalty that does not currently exist under this section of the law. The IRS study sets the penalties for the three tiers at $100, $250, and $500, respectively.

GAO Analysis

Preparer penalties need to be increased to improve their economic and deterrent values.

The House bill would increase the monetary value of the preparer penalties. We support this because the monetary value of the preparer penalties is too low in relation to the associated administrative costs. As a

result, these penalties are infrequently assessed. For the preparer penalty case files we have reviewed, the average time examiners spent working these cases was about 8 hours per case. Compared with the $100 or $500 yield from the preparer penalty, an examiner can realize over $3,500, on average, for the same amount of time by pursuing regular taxpayer audits. Because these penalties are infrequently assessed, the deterrent value is questionable.

The deterrent value of preparer penalties is also questionable because required referrals of penalized preparers are not often made to the Director of Practice and the District Director. IRS and practitioners stated that referrals to the Director of Practice motivate compliance by preparers much more than the monetary penalties. We found, however, that required referrals are infrequently made when the penalty is assessed. Our review of preparer penalty cases in one district office showed that only 25 percent, or 16, of the 63 preparers were referred.

Preparer penalties need distinct definitions to provide consistency in administration and equitable treatment among penalized preparers.

Our review indicates that the lack of differentiation between the current preparer penalties can be a reason for inconsistent penalty administration and inequitable treatment of penalized preparers.

In considering how to better differentiate among the preparer penalties, we recommend a two-tier preparer penalty structure, with the first tier consisting of negligence and the second tier containing both intentional disregard and willful understatement. This is similar to the first two tiers in the IRS task force's proposal. By resolving the definitional problems, IRS' administration of the penalties should improve. We do not see any benefit, however, in the IRS proposal to add a third-tier penalty for fraud because it is so closely related to willful understatement in tier 2. We believe the third tier would only further complicate the administration of the preparer penalties.

The proposed first-tier penalty under the House bill could create administration problems for IRS in assessing the penalty. Rather than relying on the traditional concept of negligence, the House bill introduces a new standard that would require IRS to penalize preparers who knowingly took unsustainable positions on a return. We anticipate that this untested standard could be difficult to administer because of problems involved in proving that the preparer "knowingly" took an unsustainable position.

Recommendations

We recommend increasing the monetary value of the return preparer penalties to improve their economic deterrent value. We also recommend a two-tier penalty, with the first tier consisting of negligence and the second tier consisting of willful understatement or intentional disregard.

Promoter Penalties

Current Law

The law includes a penalty intended to deter the promotion and sale of abusive tax shelters. The penalty is the greater of $1,000 or 20 percent of the gross income derived by the promoter from the "activity" promoted if the promoter makes or furnishes a statement concerning the tax benefit that the promoter knows or has reason to know was materially false or fraudulent, or for a grossly overstated value. Promoter is defined as one who organizes, promotes, or sells an entity, plan, or arrangement, and who makes or furnishes a false or fraudulent statement concerning tax benefits, or makes a gross valuation overstatement.

Persons associated with an abusive shelter may be subject to another penalty. IRS district offices assess a penalty on persons who knowingly provide information or advice in connection with a document that helps taxpayers understate their tax liability. The penalty is $1,000 for aiding and abetting an understatement of tax liability for an individual return or claim and $10,000 for a corporate return. This penalty may also apply to return preparers.

Table VI.1: Promoter Penalties Assessment/Abatement Statistics, Fiscal Years 1988 and 1987

	Assessments		Abatements[a]	
Penalty	**Number**	**Amount**	**Number**	**Amount**
Fiscal year 1988				
Abusive tax shelter	289	$35,170,453	93	$5,715,671
Aiding and abetting	220	15,750,700	88	1,104,803
Fiscal year 1987				
Abusive tax shelter	478	36,638,277	74	4,155,408
Aiding and abetting	324	16,470,232	57	792,268

[a]Some abatements may be for penalties assessed in previous years.

Concerns

Financial incentives remain that could encourage further promotions and sales of abusive tax shelters. Promoters can retain as much as 80 percent of the shelter gross income after paying the penalty for promoting an abusive shelter because the current law limits the penalty for promoting abusive tax shelters to the greater of $1,000 or 20 percent of gross income derived from the shelter.

In the provision relating to promoting abusive tax shelters, the term "activity" is not clearly defined. It is not clear whether the penalty is to be applied per sale of each unit of the shelter or for the entire shelter.

Because the "knowingly aiding and abetting" standard of proof is difficult for IRS to administer, the aiding and abetting penalty is infrequently

assessed. Infrequent assessments serve to reduce the penalty's overall effectiveness as a financial disincentive.

Proposals for Change

H.R. 2528

The House bill changes the abusive tax shelter penalty from the greater of $1000 or 20 percent of gross income to the lesser of $1000 or 100 percent of the gross income derived or to be derived by such person from such activity. It also defines "activity" as each organizing of an entity, plan, or arrangement; or participation in a sale.

In addition, the House bill lowers the standard of proof for "knowingly aiding and abetting" by including individuals who have reason to believe they were aiding others to understate their tax liabilities. The bill prohibits multiple penalties once a penalty for knowingly aiding and abetting others to understate their tax liabilities has been assessed.

IRS Study

The IRS task force report recommends that the statute be amended to specify whether the minimum penalty applies to each sale or composite of all sales but does not recommend changing the amount of the penalty until IRS conducts a study on abusive tax shelters. In addition, IRS recommends establishing an explicit statute of limitations for assessing the penalty, and suggests 6 years. Currently, no statute of limitations exists on abusive tax shelter cases. The IRS task force study also lowers the standard of proof required to impose the penalty for aiding and abetting others to understate their tax liabilities. IRS recommends amending the provision to cover those who aid or assist in the use of a document that would result in an understatement. It also recommends prohibiting the assessment of both the abusive tax shelter penalty and the aiding and abetting penalty against the same person for the same misconduct.

In addition, the IRS study provides criteria for waiving the aiding and abetting penalty if the person has either exercised reasonable care to determine there is substantial authority for the position taken or the position is litigable and the person advises disclosure.

GAO Analysis

In July 1988 we issued a report that discusses some of these issues in detail.[1]

A substantial increase in the penalty is needed to effectively deter future sales of abusive shelters.

By making $1,000 the maximum, rather than the minimum, penalty, the House bill would discriminate against shelters whose gross income is less than $1,000 and would still allow a profit for shelters when the gross income per activity exceeds $1,000. For this reason, the penalty should be 100 percent of gross income for all shelters. Increasing the penalty rate to any percent short of 100 would reduce the promoters' gross income but might still allow promoters to continue making a profit, depending on the rate established.

Our 1988 report on abusive tax shelters recommended substantially increasing the value of the penalty to provide greater financial disincentives for promoters of abusive tax shelters. By allowing the promoter to retain 80 percent of the financial proceeds of the sale, current law retains financial incentives, which may encourage continued noncompliance. In nine cases for which gross income data were available, promoters had collectively retained about $54 million of gross income after penalties.

A clearer definition of tax shelter activity could aid IRS in administering these penalties.

Clarification of the term "activity" is needed to help IRS administer the penalty for abusive tax shelters. An IRS tax litigation official stated that IRS has been asserting the penalty based on each unit of a shelter that is sold. However, the Department of Justice informed IRS that it will no longer accept cases for which IRS computed the penalty on a per-unit basis. Justice said it has failed to win the majority of recent cases in which this issue arose because the language in the Code does not sufficiently support the "per-sale" (per-unit) basis.

The House bill clarifies the definition by providing that the penalty will be assessed for each unit of a shelter that is sold.

[1] Tax Administration: IRS Abusive Tax Shelter Efforts Need Improvement (GAO/GGD-88-69, July 25, 1988).

According to an IRS official, the current penalty is asserted on a per-sale basis to remove the economic incentive behind abusive shelters. Applying the penalty to the sale of each unit in the shelter increases the total dollar value of applicable penalties. IRS, in turn, caps the penalty amount when it reaches 100 percent of gross income. If the penalty is increased to 100 percent of gross income, it would no longer be necessary for IRS to use the per-sale definition to capture shelter profits.

Eliminating the per-sale definition would also facilitate penalty administration. Using that definition, IRS must compute the amount of gross income per sale, which can be an administrative burden when a tax shelter case involves thousands of sales.

The "knowingly aiding and abetting" standard of proof needs to be reduced to make it administrable and thus effective.

In our 1988 report, we said that IRS infrequently assesses the penalty because of difficulty in proving that someone "knowingly" aided and abetted in the understatement of another person's tax liability.

Both the House bill and the IRS study support reducing the level of proof required to assert the penalty. The House bill includes not only those who "know" but also those who "have reason to believe" that a document will be used to understate tax liability. We recommended including those who "know or reasonably should have known"—an even lower standard of proof.

Statute of Limitations

The IRS study recommends setting a statute of limitations in the statute for abusive tax shelter cases and recommends a period of 6 years because of the difficulty of prosecuting old cases. Under the current law, there is no statute of limitations and IRS can assert a penalty as far back as the shelter runs. Because of the nature of the noncompliance, we recommend that no limitation be established, such as is the case for fraud and evasion. However, if a statute of limitations is set, it should not be less than 6 years.

Recommendations

In 1988 we recommended that the value of the penalties for promoting abusive tax shelters be substantially increased to provide a greater financial disincentive. Keeping our recommendation in mind, we do not agree with the House bill, which in effect creates a maximum penalty of

only $1,000. Instead, our alternative approach would be to make the penalty simply 100 percent of the gross income from the tax shelter.

Because of the nature of noncompliance associated with tax shelters, we take exception to the IRS study's recommendations that a statute of limitations be imposed. We recommend that no statute of limitations be established, such as in the case of fraud.

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