COMMENTS CONCERNING POSSIBLE CHANGES TO PENALTY PROVISIONS OF THE INTERNAL REVENUE CODE

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

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

These comments do not discuss the corporate tax shelter provisions of § 6662 of the Code because these provisions and proposed changes to them will be the subject of testimony by the Section of Taxation at a March 10 hearing before the House Ways and Means Committee. However, members of the Civil Penalties Task Force would be pleased to meet with you after this hearing to discuss this testimony and any supplementary thoughts that we may have on this important subject.

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

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

In the case of individual taxpayers, we think the foregoing four factors are more important than penalties and interest in encouraging compliance and deterring noncompliance. However, we also think that penalties and interest are important contributors to a generalized belief in the legitimacy of our tax system and the moral importance of discharging one’s tax obligations, both because they signify society’s disapproval of noncompliance and because taxpayers believe that they and others who fail to discharge their responsibilities will be punished if their noncompliance is detected. The precise terms of penalty and interest provisions are probably not well known among most individual taxpayers, and the deterrent effect of these provisions probably does not turn on such knowledge. Thus, simple, generally applicable provisions probably work best for this set of taxpayers and excessive complexity and fine-tuning of such provisions probably does not ordinarily have a positive compliance effect.
Corporations and others with more complex returns respond to the same concerns and beliefs as individual taxpayers. However, complexity, ambiguity, and constant change in our tax laws; greater use of professional tax advisors; and the larger sums involved all combine to provide substantially more opportunities for aggressive interpretation of the law and to increase the cost-effectiveness of doing so. Since these taxpayers generally examine issues more carefully and their self-interest is more aggressively asserted by more knowledgeable participants, the precise terms of the Code’s penalty and interest provisions are more important to them, as is the existence of a realistic probability of detection.

A third category of taxpayer – both individual and corporate – is the willfully noncompliant. For this class of taxpayer, effective programs for detection and the imposition of civil and perhaps criminal sanctions is important, both to deter such conduct and to assure compliant taxpayers that the noncompliant are getting their just desserts.

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

The § 6662 accuracy-related penalty and the § 6694 return preparer penalty are also poorly coordinated with each other. If a taxpayer, acting on the advice of a return preparer, takes a position that lacks a "reasonable basis," the taxpayer may be subjected to a penalty of 20%, even if the position is disclosed. However, so long as the position is disclosed and not "patently improper," the preparer is not subject to penalty. According to Congress, "reasonable basis" is "a relatively high standard of tax reporting, that is, significantly higher than 'not patently improper.'" H. R. Conf. Rep. No. 103-213, at 669 (1993).

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

Additionally, a taxpayer may take a position on a return without penalty under § 6662 if the position is supported by "substantial authority," while a preparer may advise taking such a position without penalty under § 6694 if the position has a "realistic possibility of being sustained on its merits." These standards differ slightly; and, to complicate the landscape further, each group of practitioners authorized to practice before the IRS – lawyers, accountants, enrolled agents, and actuaries – is subject both to its own professional standards and to those of Treasury Department Circular 230, while commercial tax return preparers are governed only by the penalty provisions of §§ 6694 and 6695. This rather complex situation does not support voluntary compliance as well as a simpler, more uniform landscape would. For example, under the existing provisions, some tax advisers can, without fear of § 6694 penalty, counsel a taxpayer not to disclose an aggressive position, even though such nondisclosure could result in the taxpayer’s being penalized. A simpler approach to these penalties would involve only two standards: one for
undisclosed positions and one for disclosed positions, with the application of such standards to the practitioners appropriately adjusted to reflect the limits of the practitioner’s professional involvement. Ideally, such an adjustment in the statutes would occur only after consultation with practitioner groups, so that it could be coordinated to the maximum extent possible with the various groups’ ethical rules.

Inequitable Results and Undue Hardships for Taxpayers. The failure to deposit penalty is one obviously inequitable situation in the Code. It applies to the failure to timely deposit, in the appropriate way, employment, excise, and certain other taxes, and thus can be imposed on a deposit that is late or that is made in the wrong way (e.g., a check mailed to the IRS, rather than a deposit in a designated depository institution). Clearly, the prompt payment of taxes withheld from wages and other amounts is very important. However, for larger deposits, the potential penalties – 2, 5, or 10% on an amount delinquent for 1, 6, or 16 days, respectively – can be completely out of proportion to the harm to the fisc resulting from modest delay. A 10% penalty for a two-week payment delay is equivalent to an interest rate of approximately 260%; and, unlike interest, the penalty is not deductible. A restructuring of the failure to deposit penalty may be warranted, with consideration given to adjusting the size of the penalty to reflect more closely the processing costs associated with unfavored forms of payment and the time-value costs of delayed payment, while continuing to provide an adequate financial incentive for prompt correction of the delinquency. Congress may wish to consider whether an interest charge would be more appropriate than a penalty, at least in the case of relatively modest delays in payment.

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

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

While little data on which to base recommendations exist, we think that the large number of collection-related penalties indicates a flawed statutory system, since it is likely classifying as noncompliant conduct fairly marginal failures by individual taxpayers. It would seem wiser to provide economic incentives for prompt payment while reserving penalty terminology for the more egregious failures to file or pay. We
think IRS should continue to encourage audit personnel to exercise discretion in the assertion of accuracy-related penalties, but that audit coverage has become so light that, for most classes of taxpayer, being the subject of audit has become akin to being struck by lightning, and that the audited, noncompliant taxpayer may therefore take as a lesson from the experience that he was unlucky rather than unwise. This situation should not endure.

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

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

Disparities With Commercial Borrowing Rates. We cannot comment explicitly on the disparity between interest rates charged and paid by IRS with respect to under and overpayments and those charged and paid by commercial financial institutions because taxpayers have differing levels of creditworthiness and differing abilities to invest funds. We do think that, in general, interest rates charged and paid on over and underpayments should be the same and should be linked to commercial rates, having due regard for the involuntariness of the Federal government’s status as lender or borrower. We further think that serious thought should be given to integrating the time-value charge inherent in the estimated tax and failure to pay penalties with the interest rate charged on underpayments. We would encourage the Joint Committee to consider elimination of the so-called "hot interest" charge imposed on certain large corporate deficiencies and the differential overpayment rate for corporations, since we think the basic interest rates charged are adequate and that particular types of deficiencies should not be singled out for punitive interest charges without regard to the quality of the taxpayer’s position. Finally, as discussed elsewhere, the rate structure of the failure to deposit penalty is excessive and is not related to commercial rates at all and therefore should be adjusted downwards.

As currently structured, "hot interest" in effect functions as a complicated "no-fault" penalty for large corporate taxpayers. If a "no-fault" audit addition is desirable as a policy matter – a question on which we are internally divided – it could be accomplished in a dramatically simpler fashion, by simply adding the audit charge to the deficiency and making it bear interest from the due date of the return.
Result In Inefficient Or Ineffective Tax Administration. We have no further comments on this topic at this time.

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

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

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

Source and Scope of Penalty Waiver Authority . As an administrative agency created by Congress, the only sources of IRS authority to waive penalties are the federal statutes. If a statute does not provide waiver authority to IRS or limits it, presumably such authority does not exist. In general, the tax statutes provide IRS the authority to waive penalties based on a finding of the existence of "reasonable cause" and that the taxpayer acted in "good faith." See, e.g., § 6664. A finding by IRS that reasonable cause does not exist is generally reviewable in federal court either de novo or for the abuse of administrative discretion. In general, this statutory approach works reasonably well, since IRS and the courts can take into account the particular circumstances of each case to determine whether a waiver is warranted. Such flexibility is important, since a penalty statute cannot incorporate all of the mitigating factors that might arise.

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

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

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

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

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

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

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

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

We have no comment at this time on this question.

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

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

This is not to say that different types of taxpayers do not have different types of responsibilities or present different types of challenges to IRS or that IRS should not respond to such challenges in context-specific ways.
Question 7: What specific recommendations can be made on ways to (a) encourage voluntary compliance, (b) deter noncompliance, tax avoidance, and fraud, (c) align the structure of the penalty and interest provisions with the pending reorganization of the Internal Revenue Service, (d) simplify the present-law penalty and interest provisions, (e) make the administration of penalty and interest provisions more efficient and effective, and (f) reduce inequities and burdens of taxpayers who are (or may be) subject to the penalty and interest provisions.

Encourage Voluntary Compliance and Deter Noncompliance. In addition to considering the comments provided above with respect to other penalties, some attention should be given to information return penalties of §§ 6721-24. These penalties, which encourage financial institutions and others to provide Forms 1099 and other similar forms to taxpayers, generally seem to perform their function reasonably well. However, we perceive a few issues that might be addressed. First, IRS in its enforcement programs probably relies excessively on computer generated notices (thus focusing on modest failures in the accuracy of what is reported to them) and perhaps too little on audits and other activities that might identify those who are not trying to comply with the law.

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

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

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

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

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

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

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

Reduce Inequities and Burdens. In the area of federal deposit penalties, one problem that might be addressed is "snowballing." IRS’s computer routines apply federal tax deposits to the earliest deposit due. If a single deposit is omitted, this algorithm causes a deposit penalty to be imposed with respect to every
subsequent deposit until the omitted deposit is paid. We understand that it is now IRS policy to grant relief with respect to the subsequent deposit dates by matching each date with the intended deposit. However, we also understand that it will not be possible to reprogram IRS’s computers to fix the snowball effect systemically until the year 2001. While IRS is working on this issue, it might nevertheless be helpful to provide legislative direction regarding how these systemic problems should be handled in the interim.

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

A third issue with respect to deposit penalties is the complexity of the deposit regime for fuel taxes, some of which must be deposited on a 9-day cycle and some of which must be deposited on a 14-day cycle. Although these taxes are reported on a single excise tax return, deposits attributable to one class of fuel excise tax cannot be applied to the other class of fuel excise tax or to other taxes reported on the same form. This walling off of one class of deposits from another, even though all are reported on the same return, seems arbitrary, particularly when a 10% penalty can result. Deposits of tax under the excise tax payment procedures are far too complex.

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

We have no further comments at this time.