My name is Pamela F. Olson. I appear before you today in my capacity as Chair-Elect of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has 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.

The Section of Taxation appreciates the opportunity to appear before the Committee today. We believe the recommendations in the penalty and interest studies by the Joint Committee on Taxation (hereafter "JCT Study") and Department of the Treasury’s Office of Tax Policy (hereafter "Treasury Report") address very important issues. Our testimony today will not include comments on each and every item in the studies. Individual members of the Tax Section would be pleased, however, to provide assistance and comments to members of the House Ways and Means Committee’s Oversight Subcommittee and your Staff on any recommendations you might identify.

As you know, the ABA Tax Section is comprised of approximately 20,000 tax lawyers. As the largest and broadest based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We advise individuals, trusts and estates, small businesses, exempt organizations and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section’s members have served on the staffs of the Congressional tax-writing committees, in the Treasury Department or the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

At the outset, I would like to recognize the time and energy this Subcommittee, the Joint Committee on Taxation, and the Treasury Department’s Office of Tax Policy are devoting and have already devoted to examining the Internal Revenue Code’s penalty and interest provisions. Your thoughtful consideration of this area is important because the law’s approach to penalties and interest affects taxpayers’ views of, and, thus their compliance with, our self-assessment tax system.

We have limited our specific comments today to five areas: (1) accuracy-related penalties, (2) preparer penalties, (3) interest, (4) the failure to file penalty, and (5) late payment penalties. The accuracy-related and preparer penalties are important because they set the standards for what taxpayers and preparers are permitted to report on returns. Interest and the filing and payment
Penalties are important because they are the additions to tax that a taxpayer is most likely to encounter and that most commonly create hardship for less well off individual taxpayers. We will not be addressing any penalties related to tax shelters; they will be discussed in the testimony we anticipate giving in the House Ways and Means Committee hearing tomorrow on corporate tax shelters.

Before we shift to the specific issues we discuss today, I would like to briefly summarize our views on civil penalties and interest. Penalties should be structured to encourage taxpayers to approach their tax obligations carefully and responsibly, but with due regard for the complexity and sometimes uncertain application of our tax laws. If a penalty is too small, or the taxpayer’s duty is expressed in too vague a way, it is unlikely that a penalty will accomplish this goal. On the other hand, if a penalty is too large, or too much is expected of the taxpayer, the penalty may lead to excessive burdens on taxpayers and perceptions that our tax system is unfair. Accordingly, our comments are guided by the views that penalties should be straightforward enough for taxpayers to understand and for the IRS to efficiently administer. Penalties should penalize similarly situated taxpayers similarly and should impose sanctions proportional to a clearly defined transgression. Penalties should reinforce reasonable expectations of taxpayers and should encourage compliance even if untimely.

**Accuracy-Related and Preparer Penalties**

The accuracy-related and preparer penalties set forth the duties of taxpayers and preparers to prepare returns carefully, taking only realistic positions and disclosing those where the tax treatment is unclear or questionable. We think the current structure of these penalties is reasonably sound, but has features that legislation can improve.

**Reporting Standards for Taxpayers and Preparers.** At present, the two penalties are not completely coordinated, since what is expected of preparers is somewhat less than what is expected of taxpayers. Both the JCT Study and the Treasury Report recommend conforming the reporting standards for taxpayers and preparers. However, the JCT Study would set standards for taxpayers and preparers much higher than the standards of current law, while the Treasury Report would set standards at levels nearer those of current law.

**Undisclosed Positions.** At present, Section 6662 penalizes a taxpayer if a position on a return lacks substantial authority and is not disclosed. Section 6694 penalizes a preparer when a position on a return lacks a realistic possibility of being sustained on its merits and is not disclosed. In general, we think that a "substantial authority" standard for undisclosed positions works best for both taxpayers and preparers. The substantial authority standard has now been in the law for 17 years. The regulations defining the standard do an excellent job of guiding both taxpayers and preparers, and a substantial body of case law is developing that gives both taxpayers and preparers useful guidance. Further, the expectation that an undisclosed position should be supported by substantial authority is intuitively reasonable. The objective nature of the standard, which turns on whether adequate legal and factual support for a position exists, avoids messy and difficult inquiries into the taxpayer’s state of mind. Accordingly, we support the Treasury Report’s recommendation that a "substantial authority" standard be retained in Section 6662 for undisclosed return positions and that Section 6694 be amended to establish this standard for preparers as well.

The Joint Committee Staff recommended changing the standard for undisclosed positions from substantial authority to a reasonable belief that the position taken is "more likely than not" correct. We do not believe that this proposal is an improvement on the "substantial authority" standard; it would be less objective, would encourage difficult factual inquiries into the state of
mind of the taxpayer and preparer, could encourage excessive disclosure, and would fail to give adequate weight to the complexity and uncertainty of existing tax law.

**Disclosed Positions**. At present, Section 6662 imposes a penalty on a return position for which adequate disclosure has been made only if, in the case of the taxpayer, the position lacks a reasonable basis. Section 6694 imposes a similar penalty in the case of preparers if the position is frivolous. Historically, this has been the function of the negligence penalty, and the standard for disclosed positions in current law in essence defines a negligence standard.

We believe that the Joint Committee Staff recommendation that the standard for disclosed positions be elevated to "substantial authority" is unwise. We think that it is very important to preserve the essential nature of this expectation of taxpayers and preparers as a negligence standard. The vast majority of taxpayers in this country spend a relatively short period each year preparing and filing their returns. They have a generalized understanding that they must do so carefully and fairly. However, it is doubtful that they ever would spend the time and effort necessary to understand the details of a complex penalty standard. We think it important that the standard for disclosed positions in Section 6662 be viewed as fair and reasonable, and we think that this requires this standard to reflect taxpayers’ general understanding that they must be careful and even-handed in preparing their returns. If the standard were elevated, so that a taxpayer was required to do more than one would expect of a prudent but relatively unsophisticated individual, then we think penalty impositions would likely increase because the expectations of our tax system would exceed the behavior that most taxpayers intuitively think is appropriate. We believe that penalizing taxpayers who have acted in a reasonably careful way would create anger toward our tax system.

Our understanding of the Treasury Report’s proposal for disclosed positions (other than those involving a tax shelter) is that Treasury would retain the essential "negligence" standard of existing law, but conform the definitions in Sections 6662 and 6694 in the language "realistic possibility of success on the merits." We support this proposal. For the last several decades, the overriding debate with respect to the negligence penalty has been to arrive at a definition of negligence conveying the idea that the conduct expected is more than an empty appearance of compliance, but rather reflects the serious effort that a careful and prudent person should make. We think that the language suggested in the Treasury Report for non-tax shelter positions does this. Further, it would conform Section 6694 to existing standards of professional responsibility promulgated by the ABA and the AICPA.

**Reasonable Cause Exception**. Under existing law, the IRS and the courts have the flexibility to waive a Section 6662 penalty to which a taxpayer may become subject. This waiver authority permits IRS and the courts to take into account a person’s education, a personal tragedy, or an isolated failure to identify an issue. We think that this waiver authority is critically important to the smooth functioning of Section 6662. The JCT Study, but not the Treasury Report, recommends repealing the reasonable cause exception for substantial understatement penalties. We oppose repeal of the reasonable cause exception because we think that repeal would result in a penalty that is too rigid and inflexible and would eliminate the discretion of the IRS and courts to waive a penalty even when any reasonable view of the situation would support waiver. Repealing the waiver authority also runs counter to the provisions enacted in the IRS Restructuring and Reform Act that vest IRS with more discretion in administering the interest provisions and collecting late payments.

**Threshold for Imposing the Substantial Understatement Penalty**. At present, the substantial understatement prong of the Section 6662 penalty applies, in the case of corporations, only if the understatement at issue exceeds the greater of $10,000 or 10% of tax liability. The practical
effect of this threshold is that, for very large corporations with very large tax liabilities, the substantial understatement penalty is seldom applicable.

The Treasury Report, but not the JCT Study, suggests changing the definition of a substantial understatement in the case of corporations to the lesser of $10 million or 10% of the tax required to be shown on the return. This proposal would have the practical effect of making the substantial understatement penalty potentially applicable to very large corporations for any issue that exceeds $10 million in amount. We think that this proposal provides a reasonable way to encourage disclosure of significant issues by large corporations, and we support it.

A change in threshold would, we believe, also be warranted for individuals. At present, the threshold (the greater of $5,000 or 10% of tax liability) may encompass many very small cases for which a more general negligence penalty is more appropriate. We suggest that the existing "greater of" format for this threshold works well, but that the dollar threshold should be raised and the percentage threshold dropped, so that the minimum size of an issue subject to disclosure is increased and it is less likely that the overall size of the taxpayer’s liability will prevent the application of the penalty. While we do not feel strongly about any specific numbers, a revised individual threshold along the lines of "the greater of $25,000 or 5% of tax liability" would constitute an improvement over existing law.

**Amount of Penalty.** The percentages at which the Section 6662 penalty is applied are a targeted 20% for the negligence and substantial understatement prongs of the penalty and either 20% or 40% for the valuation penalties, depending on the extent to which the taxpayer’s valuation departs from the correct valuation. These are high rates in comparison to the 5% rate at which the negligence penalty was imposed prior to 1989 and the 10% rate at which the substantial understatement penalty was imposed when it was enacted in 1982. The rates were increased in the mid-80’s with little empirical support. We think that penalty rates that are too high are more difficult to administer consistently and may have the paradoxical result of making the penalty less effective because of a reluctance to impose it. A review of case law indicates that very few 40% penalties have been imposed over the years. We encourage repeal of the 40% rate for gross valuation misstatements.

**Fee-based Preparer Penalties.** Both studies recommend a fee-based measure for preparer penalties. The Joint Committee suggests that, instead of the current flat $250 penalty, first-tier violations incur a penalty of the greater of $250 or 50% of the preparer’s fee, and that the penalty for second-tier violations be the greater of $1,000 or 100% of the preparer’s fee rather than a flat $1,000 penalty. Treasury, without recommending specific thresholds, suggests consideration of a fee-based approach because, it contends, current preparer penalties are low compared with the tax liabilities involved and thus discourage IRS assessment on a cost-benefit basis.

Any concern that the preparer penalties are not an effective deterrent to inappropriate conduct should first focus on the effectiveness of the compliance programs for preparers. A review of decided cases suggests that cases involving preparers very rarely arise. A compliance regime that is not effectively policed is unlikely to be improved by increasing sanctions that are infrequently imposed. Tying preparer penalties to a preparer’s fee creates significant complexity and enforcement issues. Perhaps the issue of greatest concern is that it seems likely to increase the costs of return preparation, as preparers seek to protect themselves from large penalties. This problem is likely particularly to affect small taxpayers.

In situations in which the preparer performs a variety of services for the taxpayer, such a penalty would require an analysis of what portion of the fee relates to actual return preparation, in as much as the fee will vary substantially depending on the nature of the client and the extent of the representation. Because the size of the penalty may be substantial but would not vary based on the size of the position in dispute and is calculated on the preparer’s gross (rather than net) fee, it
seems likely that those subject to the penalty will think it unfair as actually applied. For these and other reasons, we think that a tying of widely applicable preparer penalties to a percentage of the preparer’s fee is unwise. We express no view on whether the $250 and $1,000 amounts of these penalties are adequate to support expectations of preparers. However, we would note that the primary factors encouraging professional conduct from preparers are probably the professional standards of conduct of the preparer’s chosen profession, the professional liability that a preparer may face from a client for a job poorly done, and the possibility of referral to the IRS’s Director of Practice. We are convinced that these factors far more strongly encourage professional and careful conduct and that substantial increases in infrequently asserted penalties are unlikely to elevate conduct substantially.

Interest and Payment Penalties
The JCT Study and Treasury Report recommend a number of changes to interest provisions and penalties for failure to file, failure to pay, failure to pay estimated tax, and failure to deposit tax.

Interest Provisions. The studies suggest various changes for interest, including (1) eliminating the differential between the interest rate the IRS charges on underpayments and the interest rate the IRS pays on overpayments, (2) pegging the interest rate at the applicable federal rate ("AFR") plus five percent, (3) excluding IRS interest from individuals’ income, (4) providing additional interest abatement rules, and (5) instituting "dispute reserve accounts."

Elimination of Rate Differential. The JCT Study proposes eliminating the differential between the interest rates charged on underpayments and paid on overpayments to make the system simpler and fairer. In contrast, the Treasury Report recommends retaining the interest rate differential for the time being in view of the recent enactment of the global interest netting rules and because retaining the differential mirrors the commercial sector model. We support the Joint Committee’s recommendation to eliminate the rate differential because we believe that a uniform interest rate for under- and overpayments will be perceived as evenhanded, simple and fair, while the rate differential of present law creates significant and unnecessary complexity without any significant compliance benefit.

While we accept as a conceptual matter the Treasury Report’s observation that commercial organizations attempt to achieve a profit on their lending and borrowing activities, we think that this observation has little to do with whether a differential in interest rates has a positive effect on tax compliance. Because the relationship between a taxpayer and the IRS is an involuntary one, because it is not always possible for a taxpayer to know whether at the moment the taxpayer is a borrower or lender from the government, and because different taxpayers are able to borrow money from commercial lenders at rates that differ substantially from the underpayment rate, we think it likely that the existing rate differential is viewed as unfair. For taxpayers with complex affairs, the concurrent accrual of the differential rates is a labyrinth of complexity and time is not needed to prove that one can cope with this complexity when a simple solution is available. We strongly encourage the enactment of uniform over- and underpayment interest rates. This will be a significant simplification in the law and is an opportunity to strengthen the image of the tax system as evenhanded and fair.

Interest Rate Increase. Both the Joint Committee and Treasury recommend a higher interest rate: the Joint Committee at the AFR plus 5%, and Treasury at the AFR plus 2-5%. While we have no specific recommendation to make on the most appropriate rate, we note that a significant divergence from market rates, in either direction, may result in taxpayer conduct oriented toward the arbitrage of this differential. Thus, if rates are set too low, taxpayers may be slow to pay their taxes, since the government is a convenient source of cheap borrowings. On the other hand, if rates are set too high, taxpayers may think the tax system unfair or may find an overpayment to
be a relatively attractive investment. Accordingly, we encourage the interest rate to be set, as nearly as possible, at a rate that approximates a market rate. We are also concerned that, at AFR plus 5%, the underpayment rate will increase by two percentage points. This increase will make it more difficult for IRS’s Collection Division to resolve the unpaid liabilities of taxpayers who are in financial difficulty.

**Exclusion of Refund Interest from Income.** The JCT Study recommends excluding IRS interest from individuals’ income so that the effective post-tax interest rates on underpayments and overpayments are equivalent. Treasury does not agree with this suggestion. We have reservations about making refund interest tax free for individuals, particularly if the interest rate exceeds that of tax-exempt investments. We understand the Joint Committee Staff’s view that refund and deficiency interest should receive similar treatment. However, we think this objective would be better served by permitting the deduction of deficiency interest than by excluding refund interest from income. We also note that the present regime, which taxes refund interest but provides no deduction for deficiency interest, is consistent with the law’s general treatment of the interest income and the non-business interest expense of individuals.

**Dispute Reserve Accounts.** The JCT Study proposes the establishment of rules for the creation of dispute reserve accounts, which would be special interest-bearing accounts with the Treasury where taxpayers could deposit amounts in dispute. Under present law, a taxpayer can easily recover a disputed amount paid over to the IRS only if the payment was made in the form of a deposit in the nature of a cash bond, and such deposits are returned without interest. We support the Joint Committee Staff’s recommendation because the government has the use of the deposit until such time as it is returned to the taxpayer, and the establishment of the mechanism of a dispute reserve account will simplify taxpayers’ thinking when faced with a potential controversy.

**Failure to File Penalty.** At present, a failure to file a return results in a penalty of 5% of the unpaid amount each month for the first five months of the delinquency. The Treasury Report recommends imposing a lower penalty over a longer period, but with the same maximum amount. The JCT Study suggests no changes in this area. We support Treasury’s proposal. Once the failure to file penalty has fully accrued, it ceases to encourage the filing of the return; in fact, a taxpayer’s inability to pay the penalty along with any tax due may deter the filing of the return. Further, we think that this penalty, when added to other charges for noncompliance, may exacerbate delinquent taxpayers’ difficulties in returning to a compliant condition. We believe that a penalty that accrues more slowly will help to correct these problems within the current regime.

**Failure to Pay Penalty.** The JCT Study recommends repeal of the failure to pay penalty, replacing it with a five percent annual service charge if the taxpayer does not enter into, and adhere to, an installment agreement by the fourth month after assessment. Treasury, on the other hand, suggests imposing higher penalties, albeit with reductions if the taxpayer makes and follows an IRS payment plan. We think it important that delinquent taxpayers be subject to some significant sanctions for their delinquencies. However, we prefer the Joint Committee’s approach, primarily because, in our view, the totality of interest, failure to file, and failure to pay penalties that currently apply in many delinquency situations often functions as an impediment to full and timely resolution of the delinquency, rather than as an incentive to correction.

**Failure to Pay Estimated Tax.** The Joint Committee recommends converting the failure to pay estimated tax penalty to interest because it is essentially a time-value-of-money computation, and calling it interest rather than a penalty may enhance taxpayers’ view of the tax system’s fairness. Treasury does not support this conversion because it would enable corporations to deduct this charge for the first time. Both studies recommend changes in individuals’ estimated tax thresholds and various simplifications. We support converting the estimated tax penalty to an interest charge and endorse measures to simplify the estimated tax rules. We do note that
frequent changes in the safe harbor threshold in Section 6654(d)(1)(C)(i) make compliance with estimated tax rules more burdensome and cannot be justified on the basis of broad compliance objectives. Accordingly, we strongly encourage both simplification and permanence in the establishment of these thresholds.

**Failure to Deposit Tax.** Both the Treasury and Joint Committee studies note that the Internal Revenue Service Restructuring and Reform Act of 1998 changed rules in this area, so Treasury suggests just two changes, and the Joint Committee recommends no new legislation be enacted in this area. We view Treasury’s penalty-reduction proposals as improvements and encourage Congress to do more to lessen the size of this penalty, which, in our view, is out of proportion to the conduct that it punishes.

**CONCLUSION**

Mr. Chairman, thank you for the opportunity to appear before the Subcommittee today. I will be pleased to respond to any questions.